

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NJD:NEW:TL-N-5283/5284-99
REBuchbinder

date: **OCT 08 1999**

to: Chief, Appeals, New Jersey District

from: District Counsel, New Jersey District

subject: Review of Proposed Notices of Deficiency

Taxpayer: [REDACTED]
SSN: [REDACTED]
Year: [REDACTED]
S/L: [REDACTED]¹

Taxpayer: [REDACTED]
TIN: [REDACTED]
Years: [REDACTED]
S/L: [REDACTED]

We have been asked to review your proposed notices of deficiency for the above taxpayers, under constraints of a short statute. We approve the issuance of the proposed notices of deficiency with the suggested revisions shown on pages 6-7.

The sole adjustment at issue on the [REDACTED] notice is distribution from the corporation for the taxable year [REDACTED] and an accuracy-related penalty for substantial understatement. The issues on the corporate notice include interest expense, bad debts related to the distributions, a resulting net operating loss deductions, and IRC section 6662(a) and 6621(c) penalties.

¹ The statute shown is based upon a [REDACTED] received date shown on a transcript. We suggest using no later than [REDACTED] and suggest issuing the notices as soon as possible. [REDACTED]'s original [REDACTED] tax return is not in the file, only a copy with attached extensions until [REDACTED]. With no section 6651(a) penalty asserted, the return was presumably timely filed, and timely based on the timely mailing-timely filing rule. However, under this rule a return is considered filed on the date of mailing (except when before the statutory due date). It is highly unlikely to have been mailed prior to [REDACTED] the [REDACTED] that year. Hence, our suggestion.

General facts:

The taxpayers' protest states that [REDACTED] (" [REDACTED] ") was the sole shareholder and an employee of [REDACTED]. During [REDACTED] amounts were withdrawn from [REDACTED] and recorded on the corporate books as loans. Taxpayers claim these were intended by both parties to be loans at the time withdrawn. Taxpayers claim that repayments were made for several years until [REDACTED] became insolvent in [REDACTED]. Taxpayers insist there was a note but are unable to provide it. They apparently admit there was no security given. They argue that the "loans" became bad debts to [REDACTED] on [REDACTED] and [REDACTED]'s insolvency precludes forgiveness of indebtedness income under IRC §108(a)(1)(B).

As to [REDACTED] the Appeals Case Memorandum ("ACM") describes the interest expense disallowance as a substantiation issue. IRS transcripts show minimal payments by [REDACTED] a cash basis corporation. The NOL deduction adjustment is computational. A bad debt deduction of \$ [REDACTED] was claimed by [REDACTED] on its fiscal [REDACTED] tax return (the "loan" account balance) The ACM concludes that [REDACTED] and [REDACTED] did not have an arm's length debtor-creditor relationship and disallows the bad debt deduction. Also noted is a \$ [REDACTED] increase in the "loan" balance in fiscal year [REDACTED], during which [REDACTED] failed to pay employment taxes of more than \$ [REDACTED]. An accuracy related penalty is based upon lack of substantiation and the absence of substantial authority for the bad debt claimed.

As to [REDACTED], the proposed notice asserts the full \$ [REDACTED] as income to him. Taxpayers allege [REDACTED] was insolvent on [REDACTED] (caused by taxes and loans owed). The ACM notes the additional \$ [REDACTED] in payments between [REDACTED] and [REDACTED], when [REDACTED] already owed [REDACTED] \$ [REDACTED] (as well as additional loans of \$ [REDACTED] after the writeoff). IRS records show [REDACTED] reported income on each of his [REDACTED] [REDACTED] and [REDACTED] tax returns in excess of \$ [REDACTED]. [REDACTED]'s insolvency under IRC section 108(a)(1)(B) on [REDACTED] would exclude forgiveness of indebtedness income to the extent of his insolvency, but it is irrelevant if the funds advanced are dividends.

Documents requested by Appeals for verification of [REDACTED]'s claimed "insolvency" were not provided (financial statements, a residential mortgage application, prior 1040s and 1120s, and information on [REDACTED] a corporation now providing similar services to the same hospital

that [REDACTED] serviced in which [REDACTED] has some interest). No dividends are shown on [REDACTED]'s [REDACTED] and [REDACTED] tax returns and there was no indication of any dividend history.

Legal Discussion

The available evidence (or lack of evidence) supports a finding that the \$ [REDACTED] bad debt deduction by [REDACTED] should be disallowed and that the full amount be treated as a distribution to [REDACTED] on [REDACTED].

Although there are several supportable approaches, we believe that the primary position should be premised upon holding the taxpayers to their position that these advances were loans, and that the debt was cancelled by [REDACTED] on [REDACTED]. Our analysis indicates that such position results in protection of the most tax. Because there are still facts to be determined, and allegations verified or refuted (primarily concerning the claimed insolvency), we are recommending alternative positions.

The government's position that there was income can be supported based upon : (1) Treating the debt cancellation as a distribution; (2) treating the debt cancellation as COD income under section 61(a)(12)² (to the extent the taxpayer was not insolvent); or (3) treating the alleged loan proceeds as a distribution when paid, instead of a loan. As to (1) and (3), insolvency under section 108(a)(1)(B) does not appear to apply.³ It is relevant for (2).

As to the dividend treatment, the government is not limited to the payments [REDACTED] actually received in [REDACTED]. The primary recommended position is asserting \$ [REDACTED] as a distribution to [REDACTED] by virtue of the cancellation of his indebtedness to [REDACTED] on [REDACTED]. Treas. Reg. 1.301-1(m) states that the cancellation of an indebtedness ("COD") of a shareholder by a corporation shall be treated as a distribution.

The insolvency exception under section 108(a)(1)(B) does not apply if the \$ [REDACTED] is a distribution, and not simply COD

² This anticipates a conceivable argument that there cannot be a dividend where a cancelled debt was worthless because the taxpayer received nothing of value.

³ Subject to the results of the prospective FSA.

income.⁴ There is supporting text in BNA, Tatlock, 540 Tax Mgmt. (BNA) sec. II M. 2.(3), stating that the section 108 exclusions do not apply where the income in question arises out of debt cancellation, but is not characterized as COD income. The examples given, however, are not similar to the instant case.

The treatment of the distribution as a dividend is subject to the provisions of section 316. This limits the dividend to amounts payable out of accumulated or current earnings and profits ("E & P"). Any amounts in excess of the available E & P are considered return of capital to the extent of [REDACTED]'s basis in the stock of [REDACTED] and thereafter capital gains. Adjustments for the tax year [REDACTED] in the [REDACTED] proposed notice result in corrected income of \$ [REDACTED] for the [REDACTED] tax year. The T & E adjustment is \$ [REDACTED]. Tax on the deficiency is \$ [REDACTED] and penalty \$ [REDACTED]. Assuming no other adjustments for E & P, \$ [REDACTED] of the \$ [REDACTED] distribution would be a dividend under section 316(a)(2). The remaining \$ [REDACTED] less the \$ [REDACTED] capital shown on the balance sheet would be capital gain.

Under (3) the no-loan position, only \$ [REDACTED] the amount by which the loans to [REDACTED] increased during [REDACTED] can be argued as a distribution and dividend in [REDACTED]. The available evidence would also support a finding that such distributions representing the [REDACTED] increase in the officer's loan account are dividend income to [REDACTED] in [REDACTED], based upon a determination that [REDACTED] never intended to repay monies advanced by [REDACTED] after [REDACTED] or [REDACTED], prior to his claimed insolvency.

A taxpayer who withdraws funds from his corporation must include this in his gross income unless he can prove that it was not a distribution. Whether such withdrawal from a wholly-owned corporation is a loan or distribution depends on whether, at the time the withdrawal is made, both parties intended the withdrawal to be repaid. See Estate of Chism v. Commissioner, 322 F.2d 956, 960 (9th Cir. 1963). This determination is made based on all the facts and circumstances of the case, with a presumption against the taxpayer. See C.M. Gooch Lumber Sales Co. v. Commissioner, 49 T.C. 649, 656 (1968).

In determining intent, objective factors to be considered include: (1) the extent of the taxpayer's corporate control; (2)

⁴ [REDACTED]'s bad debt write-off would otherwise be considered COD income under section 61(a)(12), subject to section 108(a)(1)(B), and not taxable to the extent taxpayers can establish [REDACTED]'s insolvency in the claimed tax year.

the history of corporate earnings and dividends; (3) the size of the advances; (4) the existence of a limitation on the advances; (5) whether they were collateralized; (6) whether a maturity date was set; (7) how the advances were recorded; (8) steps to enforce repayment; (9) the taxpayer's ability to repay; (10) actual repayments; and (11) the taxpayer's use of the funds. See Alterman Foods, Inc. v. United States, 505 F.2d 873, 877 n. 7 (5th Cir. 1974) (cit. omitted); Busch v. Commissioner, 728 F.2d 945, 948 (7th Cir. 1984).

The dealings between [REDACTED] and [REDACTED] do not generally support the claim that the advances in [REDACTED] were actually loans. There was a single credit to the shareholder loan account with a corresponding debit to officer's salary of \$ [REDACTED] in [REDACTED]. Other than that, payments were infrequent and minimal. [REDACTED] was the sole shareholder; no dividends were paid in [REDACTED] and [REDACTED], and presumably not prior; advances were substantial, the balance increased significantly during the year prior to the insolvency claim; there was no collateral given, no known limits, and no evidence of any real collection efforts during this period. Finally, the apparent purpose was to pay personal expenses e.g., Alterman Foods, Inc., 505 F.2d at 879 (finding that taxpayer lacked a genuine intention to repay "advances [which] were not intended [by taxpayer] to meet a particular business exigency or emergency...").

One can also infer from [REDACTED]'s [REDACTED] declaration of insolvency that [REDACTED] knew he was in trouble during [REDACTED], yet loaned him an additional \$ [REDACTED]. See Commissioner v. Makransky, 321 F.2d 598, 600-1 (3d Cir. 1963) (finding it material that, inter alia, "all of the parties were aware that [the taxpayer-debtor] was insolvent..."); Despite a prior annual salary of \$ [REDACTED], [REDACTED]'s salary was only \$ [REDACTED] in [REDACTED].

The one large repayment (presumably included by [REDACTED] as salary on his [REDACTED] tax return), along with the interest accruals are a hazard in maintaining a position that no loan was ever intended. Thus, we prefer the "no true loan" argument be made only with respect to the subsequent payments made in [REDACTED], based on their proximity to the date of the claimed insolvency and the absence of collateral under such circumstances.

The taxpayer alternatively suggested to Appeals, that if the transactions are not loans they should be treated as additional compensation to [REDACTED] and deductible to [REDACTED]. Were this the case, the income to [REDACTED] would be reportable as received. The only evidence supporting this is the use of the funds for living expenses and [REDACTED]'s reduced [REDACTED] salary. Neither

██████████, nor ██████████ treated these payments as salary at any time and we consider it simply an argument for use in settlement.

Our recommendations were made after consulting with Attorney Allison Burns in Domestic:Field Service:Corporate in Washington (202-622-8512) regarding the multiple approaches in this matter, including the potential impact of insolvency, if proven. We are awaiting an approval of our request for Non-docketed Significant Advice Review. She has further advised us that the implications of the debtor's alleged insolvency is a subject that needs to be brought in for Field Service Advice. She requests that we submit a request for FSA as soon as possible after the notice is issued.

Revisions to Explanations of Items

██████████ SND - Exhibit 1(a), Item a)

The bad debt deduction of \$ ██████████ shown on your return for the tax year ended ██████████ is not allowable under section 166 of the Internal Revenue Code because cancellation of that debt constitutes a distribution of property made by you to shareholder ██████████ with respect to your stock. Therefore, your taxable income is increased \$ ██████████ for the tax year ended ██████████.

In the alternative, the bad debt deduction of \$ ██████████ is disallowed because it has not been established that the claimed bad debt became worthless during the tax year ended ██████████.

In the second alternative, the payments to shareholder ██████████ ██████████ made during the tax year ██████████ and included as part of the claimed bad debt deduction of \$ ██████████ were dividend distributions to ██████████ in that taxable year and not deductible, because it has not been established that a debtor-creditor relationship existed in ██████████.

██████████ SND - Exhibit 1(a), Item b)

During the taxable year ██████████, ██████████ received taxable dividend distributions of \$ ██████████ from ██████████ ██████████ that were not reported on your tax return. Therefore, your taxable income is increased \$ ██████████. Alternatively, you have capital gain distributions of \$ ██████████.

In the alternative, if the \$ [REDACTED] distributed to you is determined not to be dividend or capital gain income, such distribution is income from cancellation of indebtedness.

In the second alternative, the payments to [REDACTED] during the tax year [REDACTED], and included as part of the \$ [REDACTED] canceled debt owed to [REDACTED] [REDACTED] were dividend distributions to shareholder [REDACTED] in that taxable year, because it has not been established that a debtor-creditor relationship existed between [REDACTED] and [REDACTED] in [REDACTED].

PLEASE NOTE: We are awaiting a reply to our request for Non-docketed Significant Advice Review on this matter from Chief Counsel. They are aware of the short statute. Do not issue the notices until we confirm that we have received the approval on it.

Please contact attorney Richard E. Buchbinder if there are any questions.

A copy of each of the notices should be provided to our office after issuance.

MATTHEW MAGNONE
District Counsel

By: _____
FRANCIS J. STRAPP, JR.
Assistant District Counsel

Attachments: as noted