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What is (Not) Income?
Nathal v. Commissioner

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A recent decision of the Court of Appeals for the Second Circuit (affirming the Tax Court)[1] discusses a basic question of Federal corporate income tax law—whether or not contributions by a shareholder to the capital of a corporation constitute "income" to the corporation—in the context of ascertaining a contributing shareholder's basis in loans made by the shareholder to an S corporation. The case also provides a cautionary example of a situation in which steps taken in one tax year, likely motivated by a desire to claim additional income tax deductions, combined with a novel reporting position in a following year intended to protect those deductions from a form of recapture, fostered controversy and litigation, but no ultimate benefit to the taxpayers.

Nathel v. Commissioner

The taxpayers in *Nathel* were two brothers, Ira and Sheldon Nathel. Prior to 2001, the tax year at issue, each brother owned 25% of the stock of each of three S corporations—G&D Farms, Inc. (G&D), Wishnatzki & Nathel, Inc. (W&N), and Wishnatzki & Nathel of California, Inc. (W&N CAL)—that were engaged in food distribution businesses in three states. The other 50% of the stock of each corporation was owned by another individual, Gary Wishnatzki (Gary).

The shareholders made capital contributions to fund the operations of the corporations. In addition, the Nathels made loans to G&D and to W&N CAL on open account; and G&D borrowed approximately $2.5 million in 1999 from two banks through bank loans backed by personal guarantees of the shareholders.

G&D and W&N CAL incurred losses. Under rules set forth in sections 1366 and 1367 of the Internal Revenue Code (IRC), those losses "flowed through" and were allowed to the shareholders, but also correspondingly reduced the shareholders' bases in their stock in G&D and W&N CAL to zero by January 1, 2001. Conversely, a shareholder's share of income, including tax-exempt income, of an S corporation increases the shareholder's basis in the stock of the corporation.

In general, IRC section 1367(d)(1) precludes additional losses from being passed through and allowed to a shareholder once that shareholder's stock basis has been reduced to zero.

However, a shareholder who also makes a loan to the corporation may be allowed additional flow-through losses to the extent of the shareholder's basis in the debt. The shareholder's basis in the debt is reduced, to the extent of such additional flow-through losses, in the same manner as basis adjustments are made for losses that have flowed through with respect to S corporation shares.

If the corporation has flow-through income thereafter, the shareholder's share of the income is first applied to restore the shareholder's basis in the loan, before any income is applied to increase the basis of the shareholder's stock in the S corporation. If, however, the shareholder receives payment of the principal of such debt before its basis has been fully restored, the shareholder may recognize gain equal to the excess of the principal payments over the shareholder's reduced basis in the debt.

The Nathels each made a loan of approximately $650,000 to G&D in December 2000. These loans permitted more than $500,000 of corporate losses to be passed through to each of the Nathels for that year, and the basis of each of the Nathels in his loan to G&D was consequently reduced to approximately $113,000. Those loans were repaid in full in February 2001.

In the spring and summer of 2001, disagreements between the shareholders relating to business plans for the corporations ultimately led to the adoption of a plan to liquidate W&N CAL, to cause Gary to own 100% of G&D, and to cause the Nathels to own 100% of W&N.

In furtherance of this plan, the Nathels and Gary contributed sufficient funds to W&N CAL to permit it to repay outstanding third party loans, and

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then liquidated that corporation. With respect to G&D, each of the Nathels made additional capital contributions of approximately $537,000, the proceeds of which were applied to obtain the release of the Nathels from liability under their guarantees of the bank loans made to G&D and to induce Gary to consent to those releases and to proceed with the ownership restructuring. The stock of the Nathels in G&D and of Gary in W&N was then redeemed for no consideration. These transactions were completed contemporaneously on or about August 30, 2001.

Thus, when the dust settled, shareholder loans had been repaid, Gary was the sole shareholder of G&D and the sole guarantor of its bank debt, and the Nathels owned 100% of the stock of W&N.

The repayment of the Nathels' loans to G&D, at a time when the bases of those loans had been reduced because of losses that flowed through to the shareholders, would normally have caused the Nathels to recognize income to the extent the amount received exceeded their bases in the loans. In calculating their taxes for 2001, however, the Nathels treated the capital contributions they had made to G&D in 2001 as giving rise to a realization of tax-exempt income by G&D, thereby restoring in part their bases in the loans they had made to G&D, but without any actual current tax cost.

Following an audit, the IRS rejected the Nathels' treatment of the capital contributions as tax-exempt income. Rather, the IRS asserted, the capital contributions did not give rise to income of any kind.

However, because the Nathels had made an out-of-pocket expenditure in remitting additional funds to the G&D when they made capital contributions in their capacity as shareholders, the IRS was prepared to permit them to increase their bases in the stock of the corporation. As a result, the IRS determined that each of the Nathels had additional ordinary income by reason of the repayment of their loans by G&D,[2] and a long-term capital loss upon the subsequent redemption of their shares (which could not be used to offset the ordinary income resulting from the repayment of the loans).

Taxpayers' Arguments

The Nathels sought review of the resulting tax deficiencies through petitions to the Tax Court. Before the Tax Court and also on appeal to the Second Circuit Court of Appeals, they argued that the contributions they had made to the capital of G&D constituted tax-exempt income to the corporation that entitled them, under the basis adjustment rules of sections 1366 and 1367, to a basis increase in their loans.

Although there are many cases supporting a broad definition of income for purposes of the IRC, the taxpayers' argument for treating capital contributions as income relied principally on IRC section 118(a), which provides: "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer." The Nathels argued that this meant that, but for section 118(a), such amounts would be income; and, therefore, that section 118(a) caused their contributions to be tax-exempt income.

The Nathels also cited *Gitlitz v. Commissioner*,[3] in which the Supreme Court held that income of an S corporation attributable to a cancellation of its indebtedness that was excludible from gross income under IRC section 108(a) by reason of the corporation's insolvency was tax-exempt income of the corporation and that, accordingly, under section 1366 and related provisions as then in effect,[4] such income increased the S corporation shareholders' bases in their stock. In *Gitlitz* the Commissioner had contended, unsuccessfully, that section 108(a)'s exclusion of cancellation of debt (COD) income from gross income, in language very reminiscent of section 118(a), altered the character of COD income such that it was no longer income at all.

In light of the ruling of the Supreme Court in the taxpayers' favor in *Gitlitz*, the Nathels argued that a receipt of a capital contribution by G&D, similarly excluded from gross income (under section 118 rather than section 108), should be treated in a like manner—that is, as tax-exempt income—for purposes of adjusting their bases in their loans to G&D.

Both the Tax Court and the Court of Appeals rejected this argument. The courts reasoned that, under case law going back at least to 1918 and long antedating the addition of the predecessor of section 118 to the Code, capital contributions by shareholders were not includible in income; the principal purpose of Congress in enacting section 118 in 1954 was to codify a more controversial aspect of prior decisional law that excluded from income certain capital contributions by non-shareholders.

The Court of Appeals decision cited a decision by Judge Learned Hand for the proposition that income was "the increase or increment from the exercise of some economically productive power," as compared to the mere receipt of capital.[5] By contrast, income from the discharge of indebtedness is specifically listed in IRC section 61(a) as an item of income includible in gross income, although section 108 provides that, in a number of special circumstances, taxpayers are not required to include such amounts in gross income.

The Court of Appeals further noted that Treasury Regulation Section 1.118-1 expressly provides that amounts received by a corporation from its shareholders as voluntary pro rata payments "do not constitute income," even though no additional shares of stock are issued in exchange for the payments—implying that such contributions could not be tax-exempt income because they are not income at all.[6]

In addition, the opinion of the Tax Court stressed the well established principle that a capital contribution by a shareholder increases the basis of the shareholder in his stock; the opinion observed that the result desired by the Nathels would undermine this principle by providing a different basis benefit. This is consistent with the apparent purpose of the rule under IRC sections 1366 and 1367 that shareholder basis in shares of stock and (where previously reduced) in shareholder loans to S cor-

porations is increased by tax-exempt income, *i.e.*, to prevent shareholders from being taxed indirectly on tax-exempt income when they dispose of shares of stock of a corporation that had received such income.

No such protection from indirect taxation is needed with respect to an increase in value resulting from shareholder contributions that are already reflected in stock basis under traditional tax principles.

The Nathels also argued, in the alternative, that their payments to G&D were made to obtain releases from the personal liability of the Nathels as guarantors of bank loans made to G&D, and that a shareholder payment to a corporation or a third party to obtain a release from liability with respect to corporate debt is deductible as an ordinary loss under IRC Section 165(c).

Following a brief discussion of the case law, the Tax Court concluded that such a loss deduction would have been available to the Nathels only if the sole purpose of the contributions had been to obtain the releases from the guarantees. However, it had been stipulated that the contributions were made not only to obtain releases from the guarantees, but also to obtain Gary's consent to proceed with the restructuring. The stipulation to multiple purposes for the contributions was found to preclude an ordinary loss deduction.

The Court of Appeals did not agree with the Tax Court that the taxpayers had to show that the sole purpose of the payments was to obtain a release in order to prevail on this issue. Rather, the taxpayers needed to establish only that the primary purpose for the payments to G&D was to obtain the releases. The Court of Appeals further concluded, however, that the Nathels did not have sufficient evidence as to the reasons for the payments to meet even this "principal purpose" standard, and therefore affirmed the holding of the Tax Court on this issue as well.

Observations

It was at one time a common tax planning technique to make shareholder loans on open account to S corporations in one year, with repayment in the following year, as a means for causing corporate losses to flow through in circumstances where a lack of shareholder basis would otherwise cause the losses to be suspended.[7]

It was recognized, though, that repayment of the loans, the basis of which would be reduced by the flow-through of losses, would give rise to income; in effect, the technique was aimed at achieving a simple, one-year deferral of income. If that was in fact the purpose of the loans made by the Nathels to G&D in December 2000, it seems apparent their efforts to avoid the effective recapture of losses in the following year, when the loans were repaid, by means of a creative and novel argument regarding the treatment of capital contributions as "tax-exempt income," were ultimately unsuccessful.

With the benefit of 20/20 hindsight, it is also possible to speculate that, if the restructuring of the ownership of the corporations in 2001 had been done in a way that made more clear the amounts being paid by the Nathels specifically for the releases, as distinguished from consideration being paid by the Nathels on the one hand and by Gary on the other for any value in the equity interests in the underlying businesses of the two corporations that survived the restructuring, the Nathels would have been in a better position to claim the amount paid for the termination of the guarantees as a loss, thereby offsetting at least in part the income resulting from repayment of the G&D loans.

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[1] *Nathel v. Commissioner*, Docket no. 09-1955-ag (2d Cir. 2010), *aff'g* 131 T.C. No. 17 (2008).

[2] It is a longstanding IRS position that, in the case of shareholder open-account loans to an S corporation, not evidenced by a note, income resulting from the repayment of the loans after their basis has been reduced is ordinary income (see Rev. Rul. 68-537, 1968-2 C.B. 372). The Nathels disputed the notion that they had income of any kind by reason of the loan repayments, but did not challenge the IRS view that any income that they did recognize was ordinary.

[3] 531 U.S. 206 (2001).

[4] The interpretation of the basis adjustment rules adopted by the Supreme Court in *Gitlitz* was subsequently overturned by legislative action. *See* IRC §108(d)(7).

[5] *United States v. Oregon-Washington R. & Nav. Co.*, 251 F. 211, 213 (2d Cir. 1918).

[6] At least with respect to G&D, the Nathels' payments to the corporation in 2001 do not appear to have been matched by equal payments from Gary, the other 50% shareholder. It might, perhaps, be argued that this circumstance suggests that the payments were something other than shareholder capital contributions of the sort dealt with by section 118 and the regulations thereunder, but the decisions in *Nathel* do not appear to have focused on this distinction and the taxpayers do not appear to have advanced it as a reason for a decision in their favor.

[7] Relatively recent changes to the Treasury Regulations concerning shareholder loans to S corporations make the use of shareholder loans to avoid the stock basis limitation more difficult. See generally T.D. 9428 (Oct. 20, 2008).