1 T.C. 1057 (1943)

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Advances made by a stockholder to a corporation are treated as loans, not capital contributions, when evidenced by promissory notes, interest payments, and consistent treatment as debt on corporate books, entitling the stockholder to a bad debt deduction when the debt becomes worthless.

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Summary

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Bunker Hill & Sullivan Mining Co. sought to deduct $3,117,023 as a bad debt after advances to Treadwell Yukon Co., Ltd. became worthless. The Tax Court determined that the advances were loans, not capital contributions, based on factors like interest payments and bookkeeping treatment. The court further held that the debt became worthless in 1937 and could be deducted. The court rejected the Commissioner's argument that a corporate reorganization barred the deduction, finding that the creditors' interests weren't proportionate to their pre-transfer interests and that the exchange did not meet the requirements of a tax-free reorganization.

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Facts

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Bunker Hill & Sullivan, along with other companies (the Douglas Island companies), jointly prospected for mining properties, agreeing to share costs with Bunker Hill bearing 50%. They formed Treadwell Yukon Co., Ltd. to manage operations. Bunker Hill and Treadwell Yukon treated Bunker Hill's subsequent cash advances to Treadwell Yukon as loans, with interest paid monthly until 1931. By 1937, Treadwell Yukon was in financial distress. With creditor consent, it transferred all assets to a new corporation in exchange for stock distributed to creditors and stockholders. Bunker Hill received stock valued at less than the outstanding debt and claimed a bad debt deduction for the difference.

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Procedural History

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Bunker Hill claimed a bad debt deduction on its 1937 income tax return. The Commissioner of Internal Revenue disallowed the deduction, leading to a deficiency assessment. Bunker Hill petitioned the Tax Court for review.

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Issue(s)

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Whether advances made by Bunker Hill to Treadwell Yukon were loans or capital contributions.

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Whether the unpaid balance of the advances was properly ascertained to be worthless and charged off in 1937.

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Whether the nonrecognition provisions of Section 112(b)(5) or Section 112(b)(3) of the Revenue Act of 1936 apply to the corporate readjustment, precluding the bad debt deduction.

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Holding

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Yes, the advances were loans because the evidence indicated intent to create a debtor-creditor relationship.

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Yes, the unpaid balance was properly deemed worthless and charged off in 1937 because events in that year demonstrated the uncollectible nature of the debt.

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No, Section 112(b)(5) and Section 112(b)(3) do not apply because the creditors' interests in the new corporation were not substantially proportionate to their

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interests in the old corporation before the transfer; therefore the bad debt deduction is allowed.

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Court’s Reasoning

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The court reasoned that several factors indicated the advances were loans: repayments were made, interest was charged and paid, and the companies’ books treated the advances as loans. The court emphasized that, unlike a capital contribution, the advances were not proportionate to stock ownership. Further, the advances made by outside parties with no equity stake indicated that the parties themselves regarded the transactions as debt.

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Regarding worthlessness, the court noted that despite Treadwell Yukon’s struggles, it continued as a going concern until 1937 and the taxpayer did not treat the debt as worthless on its own books until that year, stating that it had not made

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