Borg v. Commissioner, 50 T. C. 257 (1968)

A shareholder's basis in corporate debt for calculating net operating loss deductions under IRC section 1374(c)(2)(B) is zero if the debt arises from unpaid salary and has not been reported as income, and shareholder guarantees do not count as corporate debt until payment is made by the shareholder.

Summary

In Borg v. Commissioner, the Tax Court addressed the calculation of shareholders' basis in corporate debt for net operating loss deductions under IRC section 1374(c)(2)(B). The case involved Joe E. Borg and Ruth P. Borg, who were shareholders in Borg Compressed Steel Corp. , an electing small business corporation. The court held that the Borgs had zero basis in notes issued by the corporation for unpaid salary, as they were cash basis taxpayers and had not reported the income. Additionally, the court ruled that loans to the corporation endorsed by the Borgs did not constitute corporate debt to them under the same section until they made payments. This decision significantly impacts how shareholders can utilize corporate losses for tax purposes, emphasizing the necessity of recognizing income before establishing a basis in related corporate debt.

Facts

Joe E. Borg and Ruth P. Borg were shareholders in Borg Compressed Steel Corp. , which elected to be treated as a small business corporation under IRC section 1372(a). Borg Steel incurred net operating losses in its fiscal years ending July 31, 1961, and 1962. Joe E. Borg was owed unpaid salary for those years, evidenced by promissory notes from the corporation, which were not reported as income by the Borgs, who used the cash method of accounting. Additionally, Borg Steel obtained loans from a bank, which the Borgs endorsed. The Borgs claimed deductions for their share of the corporation's net operating losses, arguing that the notes for unpaid salary and the endorsed bank loans should be included in their basis calculation under IRC section 1374(c)(2)(B).

Procedural History

The Borgs filed a petition with the United States Tax Court challenging the Commissioner's determination of a deficiency in their 1962 joint Federal income tax. The Tax Court heard the case and issued its opinion on May 7, 1968, addressing the allowable portion of the net operating loss deductions based on the Borgs' basis in their stock and any corporate indebtedness to them.

Issue(s)

1. Whether the Borgs, as cash basis taxpayers, had a basis in the notes issued by Borg Steel for unpaid salary under IRC section 1374(c)(2)(B).

2. Whether loans to Borg Steel endorsed by the Borgs constituted “indebtedness of the corporation to the shareholder” under IRC section 1374(c)(2)(B) before the Borgs made any payments on the loans.

Holding

1. No, because the Borgs, as cash basis taxpayers, had not reported the unpaid salary as income, and thus had a zero basis in the notes issued by Borg Steel for that salary.
2. No, because the loans endorsed by the Borgs were not considered “indebtness of the corporation to the shareholder” under IRC section 1374(c)(2)(B) until the Borgs made payments on the loans.

Court’s Reasoning

The court reasoned that under IRC section 1012, the basis of property is generally its cost, and for cash basis taxpayers like the Borgs, the performance of services without the realization of income does not establish a cost basis in notes for unpaid salary. The court cited precedents such as Detroit Edison Co. v. Commissioner and Byrne v. Commissioner to support this interpretation. The court also noted that allowing a basis in the salary notes would potentially result in double inclusion of income when paid, which was not intended by Congress. Regarding the endorsed bank loans, the court relied on its previous decision in William H. Perry, holding that such loans do not constitute corporate debt to the shareholder until the shareholder makes payments. The court emphasized that under Oklahoma law, the Borgs’ liability as endorsers was contingent upon their making payments, which had not occurred.

Practical Implications

This decision has significant implications for shareholders of small business corporations seeking to deduct corporate net operating losses. It clarifies that cash basis taxpayers cannot establish a basis in corporate debt for unpaid salary without first reporting that income. This ruling impacts how shareholders must account for income and corporate debt to maximize their tax deductions. Additionally, the decision reinforces that shareholder guarantees of corporate debt do not count as basis until the shareholder makes payments, affecting the timing and ability to claim such deductions. Subsequent cases have applied this ruling, and it continues to guide tax planning and compliance for shareholders of electing small business corporations.

