Perry v. Commissioner, 54 T. C. 1293 (1970)

For corporate indebtedness to increase a shareholder's basis under section 1374(c)(2)(B), there must be an actual economic outlay by the shareholder.

Summary

In Perry v. Commissioner, the Tax Court ruled that a shareholder's exchange of demand notes for a corporation's long-term notes did not constitute "indebtness" under section 1374(c)(2)(B) because it did not involve an actual economic outlay. William Perry, the controlling shareholder of Cardinal Castings, Inc. , attempted to increase his basis in the corporation by issuing demand notes to the company in exchange for its long-term notes. The court held that this transaction, motivated in part by tax considerations, did not make Perry economically poorer and thus could not be used to increase his basis for deducting the corporation's net operating loss.

Facts

William H. Perry owned 99. 97% of Cardinal Castings, Inc. , a small business corporation experiencing financial difficulties. To improve the company's financial statements and increase his basis for tax purposes, Perry exchanged demand notes with Cardinal for the corporation's long-term notes. Specifically, Perry issued a demand note for $7,942. 33 and received a long-term note in the same amount, and later issued another demand note for $13,704. 14 in exchange for another long-term note. These transactions were intended to make Cardinal's balance sheet more attractive and to generate corporate indebtedness sufficient to absorb the corporation's net operating losses.

Procedural History

The Commissioner of Internal Revenue disallowed part of Perry's claimed deduction under section 1374(a), based on the disputed corporate indebtedness. Perry filed a petition with the U. S. Tax Court challenging this disallowance. The Tax Court, after reviewing the case, ruled in favor of the Commissioner, denying the deduction sought by Perry.

Issue(s)

1. Whether the exchange of demand notes by a shareholder for a corporation's long-term notes, without an actual economic outlay, constitutes "indebtness" under section 1374(c)(2)(B) of the Internal Revenue Code.

Holding

1. No, because the exchange did not result in an actual economic outlay by the shareholder, leaving him no poorer in a material sense.

Court's Reasoning

The Tax Court emphasized that for a transaction to create corporate indebtedness under section 1374(c)(2)(B), it must involve an actual economic outlay by the shareholder. The court likened the transactions in question to an "alchemist's brew," suggesting they were merely illusory. The court cited the legislative history of section 1374(c)(2)(B), which intended to limit deductions to the shareholder's actual investment in the corporation. The court also referenced the case of *Shoenberg v. Commissioner*, where a similar attempt to create a deductible loss through a circular transaction was disallowed. The court concluded that the exchange of notes did not make Perry economically poorer and thus could not be considered as creating genuine indebtedness for tax purposes.

Practical Implications

This decision clarifies that shareholders cannot artificially inflate their basis in a corporation for tax purposes through transactions that do not involve an actual economic outlay. It reinforces the principle that tax deductions must be based on real economic losses. Practitioners advising clients on tax strategies involving small business corporations must ensure that any claimed indebtedness is backed by a genuine economic investment. This ruling may affect how shareholders structure their financial dealings with their corporations, particularly in the context of net operating loss deductions. Subsequent cases have applied this principle to similar situations, further solidifying the requirement of actual economic outlay for creating corporate indebtedness.

