Osborne v. Commissioner, 49 T. C. 49 (1967)

An election to be treated as a small business corporation under Subchapter S terminates if more than 20% of the corporation's gross receipts are derived from passive income sources.

Summary

In Osborne v. Commissioner, the Tax Court ruled that East Gate Center, Inc. 's Subchapter S election was terminated because its gross receipts from rents exceeded 20% in the taxable years 1960 and 1961. The court rejected the taxpayers' argument that the rent was received due to unavoidable delays in starting their business, emphasizing that the statute did not allow exceptions for such circumstances. This decision underscores the strict application of the 20% passive income rule under Section 1372(e)(5) and its impact on the tax treatment of small business corporations.

Facts

Weldon and Eleanor Osborne owned East Gate Center, Inc. , which they formed to operate a shopping center. Due to delays caused by the State Highway Commission, East Gate could not start its business and instead received rental income from two houses on the property, which exceeded 20% of its gross receipts for the years ended May 31, 1960, and 1961. The Osbornes claimed deductions for their share of East Gate's net operating losses on their personal tax returns, asserting that the Subchapter S election should remain in effect despite the rental income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Osbornes' income tax and disallowed the deductions for East Gate's net operating losses, asserting that the Subchapter S election had terminated. The Osbornes petitioned the Tax Court, which upheld the Commissioner's determination.

Issue(s)

1. Whether East Gate's Subchapter S election was terminated under Section 1372(e)(5) of the Internal Revenue Code due to its receipt of rents exceeding 20% of its gross receipts for the taxable years ended May 31, 1960, and 1961.

Holding

1. Yes, because Section 1372(e)(5) clearly states that the Subchapter S election terminates if more than 20% of the corporation's gross receipts are derived from passive income sources such as rents, and this rule applies regardless of the reasons for receiving such income.

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Court’s Reasoning

The court’s decision hinged on a strict interpretation of Section 1372(e)(5), which did not provide exceptions for corporations delayed in starting their business. The Osbornes argued that Congress intended to deny Subchapter S treatment only to corporations not engaged in active trade or business, but the court found that the statute was clear and unambiguous. The court noted subsequent amendments to the law that allowed exceptions for the first two years of a corporation’s operation, but these amendments were not retroactive to the years in question. The court also cited prior cases like Temple N. Joyce, Max Feingold, Bramlette Building Corp. , and Lansing Broadcasting Co. , which similarly upheld the termination of Subchapter S elections due to excessive passive income. The court concluded that the plain language of the statute must be followed, and East Gate’s election was terminated for the taxable years in question.

Practical Implications

This decision emphasizes the importance of carefully monitoring the sources of a Subchapter S corporation’s income to avoid inadvertent termination of its election. It highlights that the 20% passive income rule under Section 1372(e)(5) is strictly applied without regard to the reasons for receiving such income. Practitioners must advise clients to plan their business operations to ensure compliance with this rule, especially during the startup phase when passive income might temporarily exceed the threshold. Subsequent amendments to the law have provided some relief for new corporations, but this case serves as a reminder of the potential pitfalls for corporations formed before such amendments. The ruling has been cited in later cases to support the strict application of the passive income rule, affecting how similar cases are analyzed and how businesses structure their operations to maintain Subchapter S status.

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