Marshall v. Commissioner, 60 T. C. 242 (1973)

Gross receipts for determining termination of a small business corporation's election under IRC § 1372 do not include loan repayments but do include all interest and rental income as passive investment income.

Summary

In Marshall v. Commissioner, the U. S. Tax Court held that for the purposes of IRC § 1372(e)(5), gross receipts of a small business corporation do not include loan repayments, and interest and rental income are considered passive investment income, even if earned through active business operations. Realty Investment Co. of Roswell, Inc. had elected to be taxed as a small business corporation under Subchapter S. However, in its fiscal year 1968, more than 20% of its gross receipts were from interest, leading to the termination of its election. The court upheld the validity of the regulation excluding loan repayments from gross receipts and clarified that active efforts to generate interest and rental income do not change their classification as passive investment income.

Facts

Realty Investment Co. of Roswell, Inc. (Realty) elected to be taxed as a small business corporation under Subchapter S starting July 1, 1967. In its fiscal year 1968, Realty reported gross receipts of $79,028. 06, including interest from its small loan and real estate departments, rental income, and oil and gas royalties. Realty also received $288,129. 79 as loan repayments during this period. The Internal Revenue Service (IRS) determined that more than 20% of Realty's gross receipts were passive investment income, leading to the termination of its Subchapter S election for 1968 and the disallowance of shareholders' pro rata share of Realty's operating loss for that year.

Procedural History

The IRS issued notices of deficiency to Realty's shareholders, I. J. Marshall, Claribel Marshall, and Flora H. Miller, disallowing their deductions for their share of Realty's operating loss for 1968. The shareholders petitioned the U. S. Tax Court for a redetermination of the deficiencies. The Tax Court upheld the IRS's determination, ruling that Realty's Subchapter S election was terminated due to the passive investment income exceeding 20% of its gross receipts.

Issue(s)

1. Whether repayments of loans should be included in the gross receipts of a corporation for the purpose of determining whether passive investment income exceeds 20% of gross receipts under IRC § 1372(e)(5)?
2. Whether interest income derived from active conduct of a small loan or real estate business is considered passive investment income under IRC § 1372(e)(5)?

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Holding

1. No, because the regulation excluding loan repayments from gross receipts is a valid interpretation of the statute and not plainly inconsistent with it.
2. Yes, because interest and rental income are considered passive investment income under IRC § 1372(e)(5), regardless of the active efforts to generate such income.

Court’s Reasoning

The court upheld the regulation excluding loan repayments from gross receipts as a valid interpretation of IRC § 1372(e)(5), citing its consistency with the statute and the lack of any statutory provision to the contrary. The court rejected the argument that active efforts to generate interest and rental income should exclude such income from being considered passive investment income. It emphasized that the statute defines passive investment income broadly, including all interest and rental income, without considering the efforts to generate it. The court also noted its disagreement with the Fifth Circuit’s decision in House v. Commissioner, which held that interest from active business operations was not passive investment income. Judge Sterrett concurred in the result but suggested that under certain circumstances, interest might not be considered passive income.

Practical Implications

This decision clarifies that for small business corporations electing Subchapter S treatment, loan repayments are not included in gross receipts when calculating the percentage of passive investment income under IRC § 1372(e)(5). However, all interest and rental income, regardless of the active business efforts required to generate it, is considered passive investment income. Legal practitioners advising small business corporations should ensure that passive investment income does not exceed 20% of gross receipts to avoid involuntary termination of Subchapter S status. This ruling also indicates a potential area of future litigation, as suggested by Judge Sterrett’s concurrence, regarding whether certain types of interest income might be treated differently under different circumstances.

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