Llewellyn v. Commissioner, 70 T. C. 370 (1978)

Interest expense cannot be netted against interest income to determine gross receipts from interest for purposes of the passive investment income exception under Section 1372(e)(5)(B) of the Internal Revenue Code.

Summary

In Llewellyn v. Commissioner, the Tax Court ruled that interest expense cannot be offset against interest income when calculating gross receipts for the purpose of the passive investment income rule under Section 1372(e)(5)(B) of the IRC. The case involved shareholders of Lake Havasu Resorts, Inc. , which had elected Subchapter S status. The corporation's interest income exceeded the $3,000 threshold for passive investment income, leading to the termination of its Subchapter S election. The court's decision hinged on the clear statutory language defining gross receipts as total amounts received or accrued without deductions, thereby disallowing the netting of expenses against income.

Facts

Morgan and Mattie Llewellyn, along with other petitioners, owned shares in Lake Havasu Resorts, Inc. , which had elected Subchapter S status in 1969. The corporation entered into a lease agreement requiring a significant deposit, which generated interest income and expense. For fiscal year ending April 30, 1971, Havasu reported $4,206. 69 in interest income, which constituted 100% of its gross receipts. The IRS disallowed the petitioners' deductions for their share of Havasu's losses, claiming Havasu's Subchapter S status terminated because its passive investment income exceeded the $3,000 exception.

Procedural History

The Commissioner filed a motion for summary judgment in the U. S. Tax Court, arguing that Havasu's Subchapter S election terminated due to exceeding the passive investment income threshold. The Tax Court granted the Commissioner's motion, ruling that interest expense could not be netted against interest income for the purpose of calculating gross receipts under Section 1372(e)(5)(B).

Issue(s)

1. Whether interest expense may be netted against interest income to determine gross receipts from interest within the meaning of Section 1372(e)(5)(B) of the Internal Revenue Code.

Holding

1. No, because the statute clearly defines gross receipts as the total amount received or accrued without deductions, and thus interest expense cannot be netted

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against interest income for the purpose of the passive investment income rule.

Court’s Reasoning

The court’s decision was based on the interpretation of Section 1372(e)(5)(B) and the definition of “gross receipts” as stated in the statute and regulations. The court emphasized that gross receipts are not reduced by returns, allowances, costs, or deductions, as per Section 1. 1372-4(b)(5)(iv)(a) of the Income Tax Regulations. The court cited B. Bittker & J. Eustice’s treatise on federal income taxation to support its interpretation. The court found that Havasu’s interest income of $4,206. 69 was 100% of its gross receipts for 1971, and thus exceeded the $3,000 exception, leading to the termination of its Subchapter S election. The court rejected the petitioners’ argument to net interest expense against interest income, as it would contravene the statutory definition of gross receipts.

Practical Implications

This decision has significant implications for Subchapter S corporations and their shareholders. It clarifies that for the purpose of the passive investment income rule, gross receipts must be calculated without netting expenses against income. This ruling affects how Subchapter S corporations manage their finances to avoid termination of their election. Tax practitioners must advise clients to carefully monitor and report gross receipts without offsetting expenses, especially interest income. The decision has been applied in subsequent cases to uphold the strict interpretation of the passive investment income rule, impacting tax planning strategies for Subchapter S corporations.

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