Thompson v. Commissioner, 73 T. C. 878 (1980)

Discount income from purchasing tax refund claims is not considered "interest," and shareholder advances to a corporation can be contributions to capital, not deductible as bad debts.

Summary

In Thompson v. Commissioner, the Tax Court addressed whether Westward, Inc. 's income from purchasing tax refund claims at a discount constituted "interest," and whether advances made by shareholder John Thompson to Cable Vision, Inc. were deductible as bad debts. The court held that Westward's income was not "interest" under IRC Sec. 1372(e)(5), allowing it to maintain its subchapter S status. Conversely, Cable Vision's income from renting video cassettes was deemed "rent," terminating its subchapter S election. The court also ruled that Thompson's advances to Cable Vision were contributions to capital, not loans, and thus not deductible as bad debts.

Facts

Westward, Inc. purchased tax refund claims at a 33 1/3% discount from taxpayers, paying them two-thirds of their refund amount. In 1973 and 1974, Westward's gross receipts were solely from this activity. Cable Vision, Inc. was formed to rent recorded video cassettes to cable TV stations. In 1974, it received $3,004. 80 from G. E. Corp. for a one-year license to use its cassettes. John Thompson, a shareholder in both companies, advanced funds to Cable Vision in 1974, which were recorded as loans but treated as capital contributions by the court.

Procedural History

The IRS determined deficiencies in taxes for both Westward and Thompson, asserting that Westward's discount income was "interest" and Cable Vision's rental income was "rent," both leading to the termination of their subchapter S elections. Thompson also claimed a bad debt deduction for advances to Cable Vision, which the IRS denied. The cases were consolidated and heard by the U. S. Tax Court.

Issue(s)

1. Whether the discount income Westward, Inc. derived from purchasing tax refund claims constitutes "interest" under IRC Sec. 1372(e)(5), potentially terminating its subchapter S election.
2. Whether the $3,004. 80 Cable Vision, Inc. received from G. E. Corp. in 1974 constitutes "rent" under IRC Sec. 1372(e)(5), potentially terminating its subchapter S election.
3. Whether the advances John Thompson made to Cable Vision, Inc. in 1974 constituted contributions to capital or loans, and if loans, whether they were deductible as bad debts under IRC Sec. 166.

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Holding

1. No, because the discount income was not received on a valid, enforceable obligation and was not computed based on the passage of time, it was not “interest. “
2. Yes, because the payment was for the use of cassettes for one year, it constituted “rent” under IRC Sec. 1372(e)(5).
3. No, because the advances were contributions to capital rather than loans, they were not deductible as bad debts.

Court’s Reasoning

The court applied the common definition of “interest” as payment for the use of borrowed money, requiring an enforceable obligation and computation based on time. Westward’s discount income lacked these elements, as taxpayers were not indebted to Westward. Cable Vision’s payment from G. E. was clearly for the use of property, fitting the definition of “rent. ” The court considered factors like the relationship between parties, capitalization, and whether the advances were at risk of the business to determine that Thompson’s advances were contributions to capital. The court also noted the lack of credible evidence supporting the loan characterization and the absence of interest payments or security.

Practical Implications

This case clarifies that income from purchasing tax refund claims at a discount is not “interest” for tax purposes, affecting how similar businesses should classify their income. It also reinforces that payments for the use of property are “rent,” impacting subchapter S corporations’ passive income calculations. For shareholders, the ruling emphasizes the importance of clearly documenting advances as loans to avoid them being treated as non-deductible capital contributions. This decision guides legal practice in distinguishing between debt and equity, and has implications for businesses relying on shareholder funding.

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