

## ***Crook v. Commissioner, 80 T. C. 27 (1983)***

Income from a Subchapter S corporation, when included in a shareholder's gross income as dividends, is treated as investment income for the purpose of calculating the investment interest deduction limitation.

### **Summary**

In *Crook v. Commissioner*, the U. S. Tax Court ruled that income derived by shareholders from three Subchapter S corporations, operating as automobile dealerships, should be treated as dividends and thus as investment income for the purposes of calculating the investment interest deduction under Section 163(d). The court found that the character of the corporations' operating income did not pass through to the shareholders, and thus, it did not impact the investment interest deduction limitation. This decision allowed the shareholders to increase their deduction limit based on the included amounts treated as dividends, highlighting the distinct treatment of Subchapter S corporation income for tax purposes.

### **Facts**

William H. Crook and Eleanor B. Crook were shareholders in three corporations that elected to be treated as Subchapter S corporations. Each corporation operated an automobile dealership and had no investment income or expenses. The Crooks paid substantial investment interest during their taxable years from 1974 to 1977 and were required to include both actual distributions and undistributed taxable income from the corporations in their gross income as dividends. The Commissioner disallowed a portion of their investment interest deductions, arguing that the income from the corporations should not be treated as investment income for the purposes of Section 163(d).

### **Procedural History**

The Crooks filed a petition with the U. S. Tax Court after receiving a notice of deficiency from the Commissioner. The Tax Court heard the case and issued its opinion on January 10, 1983, deciding the issue in favor of the Crooks.

### **Issue(s)**

1. Whether the operating income of a Subchapter S corporation, when included in the shareholders' gross income as dividends, constitutes investment income for the purposes of the investment interest deduction limitation under Section 163(d).

### **Holding**

1. Yes, because the income included in the shareholders' gross income as dividends under Sections 316(a) and 1373(b) qualifies as investment income under Section 163(d)(3)(B)(i), allowing the Crooks to increase their investment interest deduction

limitation.

### **Court's Reasoning**

The court reasoned that Section 163(d)(4)(C) does not attribute the character of a Subchapter S corporation's operating income to its shareholders. Instead, it only attributes investment items of the corporation to the shareholders. The court emphasized that the income at issue was treated as dividends under the Internal Revenue Code, and without specific statutory language to the contrary, it should be considered investment income for the purposes of the investment interest deduction. The court also noted that the separate existence of corporations and the distinct nature of their business from that of shareholders supported its decision. Furthermore, the court rejected the Commissioner's argument that the decision could lead to tax avoidance, stating that clear statutory language and congressional intent must guide the interpretation.

### **Practical Implications**

This decision clarifies that shareholders of Subchapter S corporations can treat income included as dividends as investment income for the purposes of the investment interest deduction limitation. It impacts how tax practitioners and shareholders should analyze and report income from Subchapter S corporations, especially before the 1982 revisions to the tax treatment of these entities. The ruling may encourage the use of Subchapter S corporations to increase investment interest deductions, although subsequent legislative changes in 1982 have altered the treatment of such income. This case also underscores the importance of specific statutory language in determining tax treatment and the potential for differing interpretations based on the timing of legal changes.