Van Wyk v. Commissioner, T. C. Memo 1996-585 (1996)

A shareholder is not considered at risk for amounts borrowed from another shareholder to loan to an S corporation under section 465(b)(3)(A).

Summary

In Van Wyk v. Commissioner, the Tax Court held that a shareholder was not at risk under section 465 for a loan he made to his S corporation, which was funded by a loan from another shareholder. The court determined that the loan did not qualify as an at-risk amount under section 465(b)(1)(A) or (B) because it was borrowed from a related party with an interest in the activity. The court also found that the exception in section 465(b)(3)(B)(ii) applied only to corporations, not to individual shareholders. Additionally, the court ruled that the taxpayers were not liable for substantial understatement penalties under section 6662 due to the complexity of the law and their good faith.

Facts

Larry Van Wyk and Keith Roorda each owned 50% of West View of Monroe, Iowa, Inc. , an S corporation involved in farming. On December 24, 1991, Van Wyk borrowed $700,000 from Roorda and his wife, Linda, and immediately loaned it to West View. Van Wyk claimed he was at risk for this loan under section 465(b)(1). The IRS disallowed West View's losses claimed by Van Wyk for 1988-1993, asserting he was not at risk for the loan. The IRS also assessed substantial understatement penalties under section 6662 for 1991-1993.

Procedural History

The case was submitted to the U. S. Tax Court on stipulated facts. The court was tasked with determining whether Van Wyk was at risk under section 465 and whether the taxpayers were liable for penalties under section 6662.

Issue(s)

1. Whether Larry Van Wyk is at risk with respect to a loan he made to West View, funded by a loan from Keith and Linda Roorda, under section 465(b)(1)(A).
2. Whether Larry Van Wyk is at risk with respect to the same loan under section 465(b)(1)(B).
3. Whether the taxpayers are liable for substantial understatement penalties under section 6662.

Holding

1. No, because the loan does not constitute money contributed to the activity under section 465(b)(1)(A) as it was funded by a loan from a related party with an interest in the activity.

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2. No, because the loan is not excepted under section 465(b)(3)(B)(ii), which applies only to corporations, not individual shareholders.
3. No, because the complexity of the law and the taxpayers' good faith negate the imposition of penalties under section 6662.

Court's Reasoning

The court reasoned that section 465(b)(1)(A) applies to money contributed by the taxpayer, not money borrowed from a related party. The proposed regulations under section 465(b)(1)(A) were deemed inapplicable because they did not contemplate funds borrowed from parties with an interest in the activity. Regarding section 465(b)(1)(B), the court found that the loan was subject to the general prohibition in section 465(b)(3)(A) against borrowing from parties with an interest in the activity, and the exception in section 465(b)(3)(B)(ii) applied only to corporations. The court relied on statutory construction, legislative history, and prior case law to reach these conclusions. For the penalty issue, the court found that the complexity of section 465 and the taxpayers' good faith provided reasonable cause to avoid the penalty under section 6662.

Practical Implications

This decision clarifies that individual shareholders are not at risk under section 465 for loans made to an S corporation if the funds are borrowed from another shareholder. Tax practitioners must carefully consider the source of funds when advising clients on at-risk rules. The case also highlights the importance of understanding the nuances of tax law to avoid unintentional noncompliance. The ruling on the penalty underscores the court's willingness to consider good faith efforts and the complexity of the law in penalty determinations. Subsequent cases may reference Van Wyk when addressing at-risk determinations and penalty assessments in similar factual scenarios.

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