Taxpayer Name:	Signer, Donald R.	**Examiner:**	Mar, Cas
TIN:	[redacted]		
Tax Form:	1040	**Date:**	6/15/2010, 7/27/10
Tax Year (s):	200512		

401- Claim for Bad Debt

Tax Period	Per Return	Per Exam	Adjustment	Reference
200512	.00	(329,250.00)	(329,250.00)	

Conclusion: *(Reflects the final determination on the issue.)*

Per IRC § 166 bad debt deductions have been allowed as claim has stated, as originally filed by the taxpayer.

The following techniques are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.

Audit Steps: *(Document audit steps taken or to be taken.)*		Workpaper Reference
1.	Review prior agent lead sheets and case file.	401-1
2.	Review taxpayer's rebuttal.	401-2
3.	Interview taxpayer on issue.	125-2
4.	Review loan documents and payment substantiation.	401-3
5.	Research court cases and determine factors of bad debt vs. losses.	401-4
6.	Review court cases cited by taxpayer.	650
7.	Research other court cases and issues that may apply.	401-5
8.	Review of GM "Operating Report" and LIFO valuation	401-6
9.	Determine timing of the bad debt, consider ownership in corporation and authorization of payments.	401-7
10.	Determine adjustment of previous audit.	401-8
11.	Apply facts to research and respective IRC sections.	401-1

Facts: *(Document the relevant facts.)*

Prior lead sheet had the following facts:

"Taxpayer's controlled corp was incorporated on February 27, 1980. The shareholder contributed about $275,000 in cash for capitalization.

Don Signer individual is the 100% shareholder of Don Signer Buick, Inc a C-corporation. The first auto dealership opened around February 1980 across the Street from Washington High School in Fremont, CA. The primary business of the company was the buying and selling of new and used cars. In 1988 the company tried to sell Subarus/Saabs. TP's controlled corporation paid $175,000 to buy the right to use the Subaru Saab name. Tp loaned the company the funds for the acquisition. The company suffered severe losses which were funded by loans from Don Signer individually which were carried as mortgage note payables on the C-Corporation balance sheet. These were actually loans from shareholder made several years earlier and carried on the C-corporate balance sheet per Mr. Signers statement. In 1990 the company abandoned the Subaru line and stayed with Cadillacs. In 1990 the company made a down payment of $166,000 on a location at the proposed Auto Mall in Fremont, CA. Again the company borrowed the money from the shareholder. The company continued to have losses through 1994 tax year where the dealership income & expenses were reported.

In 1992 General Motors through Motors Holding wanted the dealership to relocate to Newark/Fremont. The shareholder wanted to be at the auto mall as one possible location. Motors Holding wanted the building and lot to be owned by the corporation. The location selected was near New Park Mall in Newark, CA. More over Motor Holdings wanted a new corporation that would start out clean with out any of the debts or assets of the old corporation. Mr. Signer claimed that Motors Holding did not trust the liabilities reported on the old corporation and wanted a fresh start with a new entity. On 01/10/1994 Motors Holding invested in Preferred Shares in the new Corporation Don Signer Buick-Cadillac Inc a C-Corporation

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mall. The Corporation had to drop the Fremont Auto Mall investment because GM would not approve and had him moved to Newark in 1993. Throughout the events the taxpayer had to loan money to keep the business going since it had lost money on the Fremont Auto Mall investment that did not come to fruition and the Subaru-Saab line that the Corporation was forced to drop in order to get the Cadillac brand.

Timing of the Worthlessness of the bad debt must also be determined. We must refer to Reg. §1.166-2 for the timing of being fully worthless and Reg. § 1.166-3 for the treatment of such debt. When considering timing, Reg. § 1.166-2(a) states that "all pertinent evidence" be considered and that "the financial condition of the debtor" also must be taken into consideration. In Mr. Signer's case he had realized the inability to pay off the debt when the vehicle for the payment, the old corporation through its consulting agreement, did not have the means of earning income to pay back its liability (the loan to Mr. Signer). Since the old corporation had switch from a car dealership to a consulting in 1995 and the old corporations assets were taken by the new corporation. The only thing left in the old corporation was the debt it owed Mr. Signer because Motors Holding, the majority shareholder, did not want to assume the liability.

Mr. Signer was a minority shareholder in the new corporation when the consulting agreement was made. Motors Holding was the majority shareholder and had the last say in allowing expenses. Mr. Signer was unaware that his old C-corporation could not be a consultant as well and be the president, offering the same services, for the new S-corporation. Also since Motors Holding had agreed to and had full knowledge of the expense shows that Mr. Signer did not create this consulting arrangement by himself, which is evident by the indemnification letter written by Mr. Signer in 1995. By 2000 Mr. Signer had bought back all the shares and was the 100% shareholder of the S-Corporation.

Amounts for consulting were being paid to the old corporation and the old corporation was paying back the loan to Mr. Signer until 2005 when an IRS tax audit had declared the expense unreasonable and disallowed it. Payments to the old Corporation had stopped in 2005, hence ceasing the ability for the old Corporation to pay off it's debt. The old corporation had NOL's and was not showing any taxable income for the years of the repayments to Mr. Signer.

Since the 2005 examination the taxpayer had made adjustments to his 2003 and 2004 individual tax returns for the follow through income that was realized by him for the disallowance of expense in the 2003 and 2204 S-Corp returns. The taxpayer had been including taxable interest on his returns since the creation of the loans as well as the reduction in loan principals from the payments from the S Corp to the C Corp for the loan repayments.

Worthlessness of the loans would be 2005 when payments had stopped and realized by both parties and not 2003 since the taxpayer had not amended or had adjustments made to his amount of interest reported from the loans.

Questions:

- Is the loan a bone fide loan?
- Is the loan a business or personal debt?
- When is the debt allowable?

Government's Position:

It is the Government's position that the taxpayer did partake in actually debt loan and not an equity contribution. The taxpayer and related corporation had been treating the loaned amount as a loan and not equity. The taxpayer was reporting interest and the loan had a fixed amount and a rate comparable to the loans being issued to the Corporation.

It has also been determined that the taxpayer had the dominant motive that the loans were business related and not personal. Although the taxpayer was not in the business of loaning money, we can see that the Corporation had need for working capital to keep doing business and thereby protecting the taxpayer's employment.

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The time of the bad debt deduction was determined to be 2005 when funds stopped being paid from the C-Corp to the taxpayer due to the disallowance of 2003 and 2004 consulting expenses from the S-Corp. It had been shown that the C-Corp had lost it's ability to pay it's debt to the taxpayer in 2005 since it's principle source of funds were no longer being paid. Due to the recognition of income and interest on the taxpayer's level until 2005 and the original consulting agreement being instated when the taxpayer was not a controlling shareholder, the bad debt was determined as incurred in 2005 when funds seized to be produced.

Law: *(Tax Law, Regulations, court cases, and other authorities. If Unagreed, include Argument.)*

IRC Section: 166, 165
Reg Section: 1.166-3 & 5
Court Case: Joseph Lupowitz Sons, Inc. V Comm, US V Henderson, Fin Hay Realty Co V US, Garner v. Commissioner, Wallice V. Commissioner, Hutchinson v. Commissioner, and Young v. Commissioner

Specific citations:

- IRC § 166 provides a deduction for bad debt when the debt is totally and partially worthless. It also defines non-business bad debt and how that bad debt should be treated.
- Reg § 1.166-5(b) provides more detail on business and non-business losses. The business losses are supposed to be treated in accordance with IRC § 165(c)(1).
- IRC § 165(c)(1) provides that losses incurred in a trade or business be allowed if deduction occurred in the taxable year and not compensated for by insurance or otherwise.
- Original position of thin capitalization was supported by court case of Joseph Lupowitz Sons, Inc. V Comm (where the taxpayers had not been reporting the income or carrying the assets on the books), Fin Hay Realty Co V US. (where it was a capital contribution made before the business had started), and US V Henderson (which deals with the unlikely chance that money would be paid back). Taxpayer had shown that there were LIFO reserve and that the corporation could pay the shareholder back if assets were liquidated and based on previous earnings.
- The issue has become not whether the loans were thinly capitalized, but whether the loans were business or non-business loans, which is more clearly defined through Court cases relating to "Dominant Motive," which is used in Garner v. Commissioner, Wallice V. Commissioner, Hutchinson v. Commissioner, and Young v. Commissioner.
- Per Garner v. Commissioner, takes into account whether wages was the primary source of income and that "evidence of the corporation's potential earnings shows that Garner hoped to receive a good return on his investment."
- Per Wallice V. Commissioner, shows that the "petitioner had no salary from AAA" and investments in AAA meaning he was not an employee and he only had investment interest.
- Per Hutchinson v. Commissioner, we are informed that his wages were roughly 60% of his gross income and that salary was his primary source of income and was allowed the business bad debt.
- Per Young v. Commissioner, the court brings up the petitioner's previous employment history and his history of being self employed as a factor that sways the determination of business vs. non-business.
- Reg. 1-166-3 determines "total worthlessness" as being deductible in the year incurred.
- Reg. 1-166-2 provide evidence of worthlessness where it is defined under section (a) of the regulation as considering "all pertinent evidence" and "the financial condition of the debtor."

Taxpayer Position: *(If applicable)*