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January 1979

## Abdalla v. Commissioner: Shareholders of Bankrupt Subchapter S Corporation Allowed Deduction of Prebankruptcy NOL

David Stieber

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### Recommended Citation

David Stieber, Note, *Abdalla v. Commissioner: Shareholders of Bankrupt Subchapter S Corporation Allowed Deduction of Prebankruptcy NOL*, 32 Sw L.J. 1329 (1979)  
<https://scholar.smu.edu/smulr/vol32/iss5/13>

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# NOTES

## Abdalla v. Commissioner: Shareholders of Bankrupt Subchapter S Corporation Allowed Deduction of Prebankruptcy NOL

Jacob Abdalla was the majority shareholder of two Louisiana corporations, both of which had qualified for subchapter S status pursuant to section 1372 of the Internal Revenue Code.<sup>1</sup> On October 26, 1966, both corporations were adjudicated bankrupt. The combined net operating loss (NOL) of the two corporations for the taxable year ending January 31, 1967, was \$463,995. Abdalla included in his individual income tax return for the calendar year 1967 his pro rata share of that NOL as a deduction from ordinary income in accordance with Internal Revenue Code section 1374. The Commissioner of the Internal Revenue Service assessed a deficiency against the taxpayer, claiming that he was entitled only to capital loss deductions for worthless securities and for nonbusiness bad debts.<sup>2</sup> The Commissioner asserted that these allowable deductions had reduced the taxpayer's basis in the stock of the two corporations to zero, thereby eliminating any basis against which the NOL could be offset. Abdalla, however, argued that his basis in the bankrupt corporations should initially be reduced by his pro rata share of the corporate NOL. Following this reduction, section 165 or section 166 deductions could then be taken to the extent of any remaining basis. Thus, the court faced a timing problem, requiring it to determine whether the NOL deduction or the capital loss deductions should take precedence in time. *Held*: For subchapter S purposes, the onset of worthlessness of a subchapter S corporation is treated as a sale or disposition of the stock and debt by the shareholders. A shareholder may deduct his pro rata share of the NOL up to the amount of his basis as of the day before the bankruptcy, to the extent that it accrued during the corporation's prebankruptcy taxable year. Any remaining basis may then be used in the computation of section 165 or 166 deductions. *Abdalla v. Commissioner*, 69 T.C. 697 (1978).

### I. BASIC OPERATION OF SUBCHAPTER S PROVISIONS

Under subchapter S, an "electing small business corporation" is a small business corporation that has elected, in accordance with section 1372(a) of

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1. I.R.C. § 1372(a). For a general discussion of the taxation of subchapter S corporations, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 6 (3d ed. 1971); J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* § 193 (2d ed. 1973).

2. I.R.C. § 165(g) deals with worthless securities; *id.* § 166(d) deals with nonbusiness bad debts.

the Internal Revenue Code, not to be subject to income taxes at the corporate level.<sup>3</sup> The congressional purpose in creating this classification was twofold. Subchapter S corporations were designed to allow "businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."<sup>4</sup> While preserving the limited liability of the corporate form, a subchapter S corporation serves as a conduit for the flow through of both taxable income and NOL to the shareholders.<sup>5</sup> Secondly, Congress believed that the subchapter S form would benefit small businesses by eliminating double taxation,<sup>6</sup> and by permitting flow through of losses that would otherwise go unused during early unprofitable years.<sup>7</sup>

Any income earned by a subchapter S corporation is taxed to the shareholders in the following manner:<sup>8</sup> ordinary income of the corporation that is distributed to shareholders during the taxable year is included in their gross income; any taxable income undistributed at the conclusion of the corporation's taxable year is included in the gross income of shareholders of record as of the last day of the taxable year.<sup>9</sup> In the same manner, a shareholder of a subchapter S corporation is allowed to deduct a pro rata

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3. Stringent requirements concerning the number and character of shareholders and classes of stock available must be satisfied in order to make a valid election. See I.R.C. § 1371; Treas. Reg. § 1.1371-1, T.D. 6960, 1968-2 C.B. 342. See generally Pennell, *Planning for the Use of Subchapter S Corporations*, 47 TAXES 746 (1969).

4. S. REP. NO. 1983, 85th Cong., 2d Sess. 87, reprinted in [1958] U.S. CODE CONG. & AD. NEWS 4791, 4876. Instead of simplifying the choice between corporate and noncorporate forms of business, subchapter S has become so complicated and unwieldy that at least one commentator has suggested that it be excised from the Internal Revenue Code. See Fischer, *Proposals to Revamp Subchapter S*, 49 TAXES 407, 409 (1971).

5. Subchapter S corporations are taxed basically like partnerships with respect to periodic income and losses. See 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 41B.01 (1976). There are, however, many differences between taxation of partnerships and subchapter S corporations. For example, in a partnership the character of income and deductions at the partnership level flows through to the partners, while in a subchapter S corporation taxable income is computed at the corporate level with no flow through of income or deduction characteristics except as to net long-term capital gain. See generally Crumbley & Davis, *Subchapter S: A Fresh Look at a Planning Tool Which is Still Useful*, 33 J. OF TAX. 312 (1970); Grant, *The Relative Tax Advantages of Partnership and Subchapter S Corporations*, 21 S. CAL. TAX INST. 409 (1969).

6. See S. REP. NO. 1983, 85th Cong., 2d Sess. 87, reprinted in [1958] U.S. CODE CONG. & AD. NEWS 4791, 4876. It was thought that "the one great deterrent to the incorporation of a very small business [was] the . . . federal tax structure"; Congress sought to minimize that deterrence by enacting subchapter S. *Hearings on Tax Problems of Small Business Before the Select Committee on Small Business*, 85th Cong., 1st Sess., pt. 2, at 944 (1958).

7. Congress enacted § 1244 in the same year as subchapter S, giving shareholders of qualifying small business corporations two means of deducting corporate operating losses. See Technical Amendments Act of 1958, Pub. L. No. 85-866, § 202(b), 72 Stat. 1606, 1676 (codified at I.R.C. § 1244).

8. Taxable income of a subchapter S corporation is determined in the same manner as that of a nonselecting corporation, with the exception that a subchapter S corporation may not avail itself of a § 172 NOL deduction. See I.R.C. § 1373(d); Treas. Reg. § 1.1373-1(c) (1960).

9. See I.R.C. § 1373(b); Treas. Reg. § 1.1373-1(a)(1) (1960). The subchapter S corporation, however, has the option of making a tax-free distribution of this previously taxed income within two and one-half months of the end of its previous tax year. See *Benderoff v. United States*, 270 F. Supp. 87 (S.D. Iowa 1967), rev'd on other grounds, 398 F.2d 132 (8th Cir. 1968); Rev. Rul. 72-152, 1972-1 C.B. 272.

share of the NOL of the corporation.<sup>10</sup> This deduction, however, does not accrue solely to the shareholders of record on the last day of the taxable year of the corporation.<sup>11</sup> Taxpayers who were shareholders at any time during the corporation's taxable year may take a deduction based on both the percentage of stock ownership and the portion of the taxable year during which the stock was held.<sup>12</sup> The size of the NOL deductible by the shareholder is limited by section 1374(c)(2) to the combined total of the shareholder's adjusted basis<sup>13</sup> in the stock of the corporation and of the debt owed him by the corporation,<sup>14</sup> determined as of the close of the taxable year of the corporation.<sup>15</sup> The NOL of a subchapter S corporation that does not flow through to the shareholders in the year in which it was incurred is lost forever.<sup>16</sup>

## II. PRIOR RESOLUTION OF NOL PROVISIONS IN A BANKRUPTCY PROCEEDING CONTEXT

The question of assimilating the subchapter S NOL provisions with sections 165(g) and 166(d) has never been directly confronted by the Tax

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10. See I.R.C. § 1374(a). The shareholder may use the NOL deduction in the taxable year which includes the end of the corporation's taxable year. See Treas. Reg. § 1.1374-1(b)(2) (1960).

11. See I.R.C. §§ 1374(b),(c). The NOL is computed on a daily basis to preclude the tax avoidance potential of a sale of subchapter S stock bearing a large NOL. See Treas. Reg. §§ 1.1374-1(b)(1),(3) (1960). Undistributed taxable income, on the other hand, is taxed to shareholders as of the last day of the corporation's taxable year.

12. For example, a taxpayer who, for 30 days, has been a 70% shareholder of a corporation with a \$50,000 NOL would be entitled to deduct \$410.94 as his pro rata share. Daily NOL [ $\$50,000 \div 365$ ] x term of ownership [30 days] x percentage of ownership [70%] = \$410.94.

13. See Treas. Reg. § 1.1374-1(b)(4) (1960). While "adjusted basis" is not defined within subchapter S, courts have held that the general basis provisions of the Internal Revenue Code will control. See generally Richard Lee Plowden, 48 T.C. 666, 670 (1967), *aff'd sub nom. Roberts v. Commissioner*, 398 F.2d 340 (4th Cir.), *cert. denied*, 393 U.S. 936 (1968); John E. Byrne, 45 T.C. 151 (1965), *aff'd*, 361 F.2d 939 (7th Cir. 1966).

14. Indebtedness of a corporation has been strictly construed by the courts. See Milton T. Raynor, 50 T.C. 762 (1968) (loan of credit from shareholder to corporation is not corporate indebtedness to shareholder); William H. Perry, 47 T.C. 159 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968) (corporate debt guaranteed by shareholder is not corporate indebtedness to shareholder). But see Rev. Rul. 70-50, 1970-1 C.B. 178 (shareholder's payment of the corporate debt guaranteed by him is corporate indebtedness to shareholder).

15. See I.R.C. § 1374(c)(2). If stock is sold or otherwise disposed of during the corporation's taxable year by the shareholder, adjusted basis is determined as of the day before the sale or other disposition. *Id.*

16. See I.R.C. § 172(f); Treas. Reg. § 1.1374-1(b)(4)(i) (1960). A bill which would have permitted the carryover of NOL's not deductible because of § 1374(c)(2) was introduced in the Ninety-Third Congress; it was not acted upon. See H.R. 12287, 93d Cong., 2d Sess. (1974). The Treasury Department has also proposed that losses should be available to shareholders at any time that basis allows; *i.e.*, to permit subchapter S corporations to carry losses over to other tax years. See U.S. TREASURY DEPT., 90TH CONG., 2D SESS., TAX REFORM STUDIES AND PROPOSALS 271, 288 (Comm. Print 1969). Commentators have repeatedly claimed there is no apparent reason for denial of carryover treatment to subchapter S corporations. See Landon, *An Approach to Legislative Revision of Subchapter S*, 26 TAX L. REV. 799, 820 (1971); White, *Recurring and New Problems Under Subchapter S*, 27 N.Y.U. INST. FED. TAX. 755, 782 (1969).

Court. In *Herbert Levy*<sup>17</sup> the petitioner-taxpayer, a shareholder of a corporation that had filed an election for subchapter S standing after involuntary bankruptcy proceedings had been initiated, attempted to deduct the corporation's NOL on his personal return. The Tax Court disallowed the deduction on the ground that the purported subchapter S election was ineffective,<sup>18</sup> and then, as a dictum, discussed the treatment of subchapter S NOL provisions as they relate to bankruptcy. The court rejected the petitioner's contention that section 1376(b) requires the NOL to be deducted before determining worthless security and bad debt deductions as clearly contrary to the plain meaning of the statute.<sup>19</sup> Section 1374(c)(2) specifies that the portion of corporate NOL deductible by the shareholder shall not exceed the shareholder's basis in the corporation, determined as of the close of the corporation's taxable year.<sup>20</sup> As the shareholder's basis in stock and debt of the corporation was consumed by capital losses occasioned by the bankruptcy,<sup>21</sup> the court concluded that no basis remained at year-end with which to transfer the NOL from the corporate to the shareholder level.<sup>22</sup>

### III. ABDALLA V. COMMISSIONER

Jacob Abdalla, petitioner, was the majority shareholder of two bankrupt subchapter S corporations with large amounts of NOL.<sup>23</sup> The issue presented to the Tax Court was whether the petitioner should be allowed to use any of the corporate NOL as a deduction from gross income on his individual tax return, and, if so, how that amount should be computed. The petitioner argued that his entire bases in the bankrupt corporations were available for the purpose of deducting the corporate NOL.<sup>24</sup> The taxpayer reached this conclusion by construing section 1016(a)(18), dealing with adjustments to the basis of subchapter S shareholders, as a comprehensive rule that excludes application of section 1016(a)(1).<sup>25</sup> Under this construction, no adjustment to basis should be made for any losses occurring in the subchapter S context. The Commissioner used reasoning identical to that used in *Herbert Levy*, contending that capital losses occasioned

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17. 46 T.C. 531 (1966).

18. The trustee appointed by the bankruptcy court as fiduciary of the corporation had failed to file the election for subchapter S status in accordance with I.R.C. § 6062.

19. 46 T.C. at 538. The petitioner reasoned that § 1376(b), which dealt with adjustments to basis arising out of NOL deductions, should take precedence over the general basis adjustment provisions contained in § 1016.

20. I.R.C. § 1374(c)(2).

21. *Id.* § 1016(a) requires that adjustments to basis be made in all cases for "losses, or other items, properly chargeable to the capital account." This is true whether or not a deduction has been claimed. See generally *Boehm v. Commissioner*, 326 U.S. 287 (1945); *Treas. Reg. § 1.1016-2(a)* (1958).

22. 46 T.C. at 538.

23. 69 T.C. at 699.

24. *Id.* at 701.

25. I.R.C. §§ 1016(a)(1), (18). The court found this approach inconsistent with legislative intent. The court looked to the legislative history of § 1016 and concluded that §§ 1016(a)(1) and 1016(a)(18) were "designed to function as parts of an integrated whole." 69 T.C. at 702 (quoting *Markham v. Cabell*, 326 U.S. 404, 411 (1945)).

by the bankruptcy absorbed the petitioner's entire basis, thereby precluding any NOL flow through.<sup>26</sup>

Taking what one dissenting judge labeled a "Solomonic" approach,<sup>27</sup> the court held that the onset of worthlessness caused by the bankruptcy amounted to a sale or disposition of the stock and debt of the corporation for purposes of section 1374(c)(2), as well as a capital loss trigger for sections 165 and 166 purposes.<sup>28</sup> In support of this characterization, the court observed that as the taxpayer could no longer vote the stock nor control the affairs of the bankrupt corporation,<sup>29</sup> bankruptcy had effectively deprived him of all economic benefits of stock ownership.<sup>30</sup> The petitioner was allowed to deduct from ordinary income his pro rata share of the NOL attributable to the prebankruptcy portion of the corporate taxable year to the extent of his basis in the corporation as of the day before the bankruptcy.<sup>31</sup> The remaining basis was then used to compute his capital loss deductions.<sup>32</sup>

The court, citing *AMBAC Industries, Inc. v. Commissioner*,<sup>33</sup> noted that this result produced tax treatment similar to that afforded affiliated corporations.<sup>34</sup> In *AMBAC* the parent corporation liquidated its nearly wholly owned subsidiary and attempted to deduct from gross income both the subsidiary's NOL and a capital loss for worthless securities. The Second Circuit held that the parent corporation was required to adjust its basis in the subsidiary to reflect the amount of NOL incurred by the subsidiary during its taxable year up to the time of its dissolution.<sup>35</sup> Any remaining basis was then available to the parent corporation for purposes of a worthless investment deduction. Analogously, Abdalla was permitted to reduce his basis in the subchapter S corporations to reflect the NOL attributable to prebankruptcy operations before taking his capital loss deductions.<sup>36</sup>

*AMBAC*, however, seems to be of doubtful value as precedent in this context as the holding in *AMBAC* was formulated in response to a problem unique to affiliated corporations. As a result of court interpretation of

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26. See text accompanying notes 17-22 *supra*.

27. 69 T.C. at 710 (Hall, J., dissenting).

28. *Id.* at 703.

29. By operation of law the trustee in bankruptcy is vested with the title of the bankrupt as of the date of the filing of a petition of bankruptcy. See 11 U.S.C. § 110(a) (1976). See generally Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Income Tax Liabilities of the Estate and the Debtor*, 72 MICH. L. REV. 935 (1974).

30. 69 T.C. at 704.

31. *Id.*

32. *Id.* at 705-06. Dissenting Judge Wiles criticized the majority's opinion, stating that its characterization of bankruptcy as a disposition is supported neither by the Internal Revenue Code nor by legislative intent. 69 T.C. at 714. Judge Wiles observed that the sale or exchange treatment of §§ 165 and 166 is a rule of constructive disposition designed to establish tax parity between taxpayers who sell stock at a loss and taxpayers whose stock becomes worthless without actual disposition. In his opinion, courts should not expand the scope of constructive disposition statutes. *Id.* at 713 (citing *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 251 (1941)).

33. 487 F.2d 463 (2d Cir. 1973).

34. 69 T.C. at 705.

35. 487 F.2d at 467.

36. 69 T.C. at 705.

the applicable Treasury regulation,<sup>37</sup> parent corporations were reaping an unintended double tax benefit.<sup>38</sup> Parent corporations were using their subsidiary's NOL to offset their own taxable income without reducing their basis in the subsidiary. The parent corporation then deducted that same loss when it disposed of its investment in the subsidiary.<sup>39</sup> The *AMBAC* court required the parent to reduce its basis in the subsidiary by the amount of the NOL of the subsidiary up to the date of dissolution in an attempt to terminate this unintended double tax benefit.<sup>40</sup> No such inconsistency exists in the subchapter S context, as both NOL and worthless securities deductions operate to reduce basis. It is the order in which these deductions should be taken that was the issue in *Abdalla*. For this reason, tax treatment of affiliated corporations should have no bearing on solutions to the problems discussed in *Abdalla*.

By allowing shareholders the partial flow through of corporate NOL in the year of a bankruptcy,<sup>41</sup> the court's decision effectively removes the incentive that once existed for sustaining a failing subchapter S corporation. Prior to *Abdalla*, postponement of an impending bankruptcy until the beginning of a new corporate tax year enabled the shareholders to realize all of the prior year's NOL.<sup>42</sup> *Abdalla* permits the shareholders to deduct all of the NOL that has accrued up to the date of the bankruptcy to the extent of their basis, thus eliminating any incentive to extend artificially the normal life of a corporation solely for the realization of tax benefits.<sup>43</sup>

37. Treas. Reg. § 1.1502-34A(b)(2) (1956) states:

From the combined aggregate bases . . . [of the parent corporation in its subsidiary] there shall be deducted the sum of (i) All losses of [subsidiary] sustained during taxable years for which consolidated income tax returns were . . . required . . . after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as . . . net operating loss . . . if it had made a separate return for each of such years . . . .

38. Prior to *AMBAC* courts had interpreted this section as not requiring the parent corporation to account for any part of a subsidiary's NOL in the year of dissolution. See *Henry C. Beck Builders, Inc.*, 41 T.C. 616 (1964). As a result, the parent corporation's nondecreased basis in the subsidiary enabled it to claim a larger worthless investment deduction.

39. *AMBAC Indus., Inc. v. Commissioner*, 59 T.C. 670, 675, *aff'd*, 487 F.2d 463 (2d Cir. 1973).

40. 487 F.2d at 467. The Code should not be interpreted to allow the taxpayer the practical equivalent of a double deduction. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1933); Treas. Reg. § 1.1016-6(a) (1960).

41. In contrast, the rule proposed in *Levy* would prevent a taxpayer from utilizing any of the corporate NOL in the year of a bankruptcy, unless, of course, his basis in the corporation exceeds his allowable capital loss deductions.

42. For example, taxpayer is a 50% shareholder in a calendar year subchapter S corporation, with a basis of \$15,000 in the corporation. By December 1 of year 1, the corporation has accumulated a NOL of \$20,000. If the corporation is declared bankrupt on December 1, the taxpayer will be entitled to deduct \$15,000 of capital losses. If, however, the corporation is not adjudicated bankrupt until January 1 of year 2, taxpayer will have a \$10,000 NOL deduction from year 1 and a \$5,000 capital loss arising from the bankruptcy in year 2.

43. Such an artificial extension made solely for the realization of tax benefits conflicts with general congressional policy that taxpayers not be permitted to reduce taxes by means of a transaction that has no substance, utility, or purpose beyond the tax deduction. See generally *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

The dissenting opinion of Judge Hall appears to be more consistent with probable congressional intent. Judge Hall noted that the interaction of subchapter S NOL provisions with the general Code capital loss provisions turns on a determination of which deduction takes priority in time. Observing that Congress had neglected to address itself to the question of "stacking order," she looked to general congressional intent.<sup>44</sup> Congress did not intend subchapter S provisions, which were intended to simplify tax law, to be subjected to overly technical judicial interpretations that would transform them into traps for the unwary.<sup>45</sup> Congress enacted the limitations on NOL deductions in section 1374(c)(2) to prevent shareholders from claiming as deductions more than they had actually lost and not to penalize shareholders in the year of a bankruptcy.<sup>46</sup> While the majority's holding was a step in the right direction, Judge Hall concluded that subchapter S NOL provisions should preempt the remainder of the Code, resulting in the flow through of the full amount of corporate NOL before computation of capital loss deductions.<sup>47</sup> Judge Hall's conclusion, however, is grounded more on a generous reading of general congressional principles underlying subchapter S than on a straight forward analysis of applicable code sections.

A fourth approach was neither presented to the court by the parties nor considered by the court independently.<sup>48</sup> Read together, a plain meaning analysis of the relevant bankruptcy and subchapter S provisions would completely preclude any NOL flow through to the shareholders in the year of a bankruptcy. This result should arise because an election under subchapter S terminates when the corporation ceases to be a small business corporation.<sup>49</sup> While a small business corporation may have an estate as a shareholder, this definition only encompasses estates of deceased shareholders.<sup>50</sup> An estate in bankruptcy is created when the petition for bankruptcy is filed, with the bankrupt estate taking title to all assets of the corporation.<sup>51</sup> As a result, the subchapter S election is terminated due to the presence of an ineligible shareholder, that is, the estate in bankruptcy.<sup>52</sup> This termination relates back to the first day of the corporation's taxable year.<sup>53</sup> Clearly, by this analysis, none of the corporation's NOL for that year is available for flow through.

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44. 69 T.C. at 710. Judge Hall reasoned that if Congress had considered the problem of stacking order, "it would surely have incorporated far more precise directions in the statute, or at least in committee reports." *Id.*

45. See S. REP. NO. 1535, 91st Cong., 2d Sess. 1, reprinted in [1970] U.S. CODE CONG. & AD. NEWS 6098; H.R. REP. NO. 1735, 91st Cong., 2d Sess. 1 (1970); 116 CONG. REC. 43360 (1970) (remarks of Rep. Byrnes).

46. See note 4 *supra*.

47. 69 T.C. at 709.

48. See Brief for Petitioner, Respondent's Brief in Answer, *Abdalla v. Commissioner*, 69 T.C. 697 (1978).

49. I.R.C. § 1372(e)(3).

50. Rev. Rul. 66-266, 1966-2 C.B. 356.

51. 11 U.S.C. § 110(a)(1976); Rev. Rul. 74-9, 1974-1 C.B. 241, 242.

52. I.R.C. § 1372(e)(3).

53. Treas. Reg. § 1.1372-4(b)(3) (1960).