

Loan From One Corporation to Another Was Reclassified as Dividend

James Povolny (James) owned three companies, all taxed as S corporations:

- 1) Archetone Limited (Ltd).
- 2) Archetone International LLC (International).
- 3) Povolny Group (PG).

International had a contract to build a new hospital in Tablat for the government of Algeria. The government quit making payments on the project when International refused to make under-the-table consideration to the representative in charge of authorizing the payments.

PG paid bills for International in order to allow International to continue the Algerian project. PG also paid bills for Ltd when Ltd was short of funds.

During 2010 PG lent a little more than \$70,000 to International and LTC to cover expenses. PG showed these as loans on its books but claimed these amounts as cost of goods sold on its tax return, offsetting roughly \$879,000 in sales. PG also issued a Form W2 to James for \$74,000 in wages, later correcting it to \$29,000.

During 2011 PG lent a little over \$74,000 to International and LTC to cover expenses. This year the loans were recorded as loans on PG's books and as bad debts on its tax return.

Since the companies were related entities, James "didn't see the merit" in creating formal documentation to show a loan existed.

IRS denied the cost of goods sold deduction in 2010 and reclassified these "loans" as dividends paid to James, and subsequently contributions to capital to International and Ltd. Tax Court agreed with IRS' determinations.

Povolny Group, Inc., TC Memo 2018-37. This case can be found by going to ustaxcourt.gov, clicking on the Opinions Search tab, then entering Povolny in the Case Name Keyword box.

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