IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Income Tax

A D & R INC.,	)	
	)	
Plaintiff,	)	TC-MD 060633D
	)	
v.	)	
	)	
DEPARTMENT OF REVENUE, State of Oregon,	)	
	)	
	)	
Defendant.	)	**DECISION**

A D & R[1] appeals Defendant's conference decision letter, dated May 31, 2006, affirming and modifying the adjustments of Defendant's auditor for tax year 2002. A trial was held in the Oregon Tax Courtroom, Salem, Oregon, on December 11, 2006. A D & R was represented by Catherine Giovinco, Licensed Tax Consultant. Douglas Trotter (Trotter) testified on behalf of A D & R; Rita McIntyre (McIntyre) was present for the trial but did not testify. Defendant was represented by Mary Addams, Tax Auditor, Department of Revenue.

The court received the following exhibits from the parties: A D & R's Exhibits 1 through 55, and Defendant's Exhibits A through V, with no objection.

Several preliminary issues were raised in reference to A D & R's cover letter dated November 21, 2006, which was submitted with its exhibits. Prior to testimony, Defendant agreed that A D & R's claimed deduction for salaries and wages should be reduced by $11,688. (*See* Ptf's Ltr at 4, Nov. 21, 2006.) Defendant also agreed that a subtraction for social security and medicare tax paid by A D & R, employer, on tips received by Trotter and McIntyre that were above the minimum wage, was incorrect. The deduction in the amount of $894 claimed by

[1] In this case before the court, Plaintiff will be referred to as A D & R to avoid confusion with the individuals, Trotter and McIntyre, each of whom is an A D & R shareholder. Trotter and McIntyre, each, are Plaintiffs in separate cases before the court (*See* TC-MD No 060631D and TC-MD No 060632D).

A D & R as payroll tax expense is disallowed. The parties agreed that this is a federal credit that Oregon does not recognize, therefore, it is a subtraction on both Trotter and McIntyre's individual state income tax returns. (*See* Ptf's Ex 50, 52.) The agreed upon subtraction is $447.00 each, for Trotter and McIntyre. (*See* Ptf's Ltr at 5, Nov. 21, 2006.) The final preliminary issues raised related to the $58,000.00 loan from Trotter to A D & R. (*Id*. at 1; Ex 21.) No agreement was reached on that issue prior to testimony. Additional issues mentioned in A D & R's cover letter relate to the subject of this appeal. (*See* Ptf's Ltr, Nov. 21, 2006.)

I. STATEMENT OF FACTS

In March 1997, Trotter and McIntyre formed A D & R Inc., an Oregon Subchapter S Corporation, with themselves as the sole shareholders. Trotter testified that the corporation was formed to "test the waters to see if [he and McIntyre] wanted to own a restaurant * * *." Concurrent with its formation, A D & R as lessee entered into a one-year "Lease Agreement and Option" (Agreement) with lessor S. K. C., Inc. (SKC). (Def's Ex F at 1.) Carl H. Foss (Foss), President of SKC, signed on behalf of lessor, and McIntyre signed on behalf of lessee, A D & R. (Def's Ex F at 10.) The Agreement granted A D & R the right to lease the real and personal property at 2575 Highway 101 North, Florence, Oregon, and included an option to extend the lease for four additional one-year terms. (*See* Def's Ex F at 1, 2.) Under the Agreement, A D & R agreed to pay $3,500 in rent each month and to pay SKC's monthly obligations to Western Bank, Western Pioneer Title Company, and the City of Florence.[2] (*See* Def's Ex F at 2.) The Agreement specified that "[a]ny holding over after the expiration of the original term" would

[2] The amounts of these obligations as of March 7, 1997, were as follows: (a) Western Bank, $1,902.20 per month with a total balance of $94,443.51; (b) Western Pioneer Title Company, $518.15 per month with a total balance of $18,779.80; and (c) City of Florence, biannual payments of approximately $630.00 each with an account balance of $9,601.44. (*See* Def Ex F at 2.) Note that by 2002, the Western Bank and Western Pioneer Title Company liabilities were carried by Klamath First. (Testimony; Def's Ex L at 4.)

be construed as a month-to-month tenancy. (Def's Ex F at 8.) The Agreement included an "Option to Purchase," which read as follows:

> "So long as this Lease or any extensions remain in effect, Lessor grants to Lessee an option to purchase the premises which includes all real and all personal property covered by this Lease plus the assumed business name for the sum of $575,000.00 less an amount equal to the total combined principal reduction payments made by Lessee on Lessor's three obligations * * * less any outstanding balance(s) then remaining on [the three obligations which] Lessee shall assume as part of the purchase price.
>
> "Lessee must give notice of its intent to purchase during the term of the Lease or any extensions and unless otherwise agreed, the premises must be purchased for cash * * * *."

(Def's Ex F at 9.)

At the leased property, A D & R operated a restaurant under the assumed name "Charl's Restaurant." (Def Ex F at 8.) According to Trotter's testimony, McIntyre did the day-to-day work, including writing checks, recording sales, and managing the restaurant; Trotter kept the books. Trotter testified that he and McIntyre were advised to keep corporate and personal records completely separate, and to keep receipts and a distinct paper trail. He testified that A D & R entered into the initial lease in 1997 and subsequently exercised the option to extend the lease four times, each for a one-year term, in 1998, 1999, 2000, and 2001. Following the fifth year, which ended in February 2002, Trotter testified that the month-to-month contingency option was exercised, and continued until May 2002, when the operating assets of the business, land, and building were purchased.

In a letter to Conference Officer Randy Robertson dated July 5, 2005, explaining the events leading up to the purchase, Trotter wrote that "[d]uring these lease / purchase negotiations, SKC Inc. would offer to sell the business to A. D. & R. Inc. at the time of lease

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renewal. We refused to purchase until a later time when we thought it would be to our benefit." (Def's Ex G at 1.) In specific reference to the option to purchase, Trotter wrote that in February of 1999, "[i]t was not the right time to buy the property yet so another lease agreement was entered into * * * until the agreed upon limit of 5, 1-year contracts were (*sic*) reached on 28 February 2002." (Def's Ex G at 1.) At trial, Trotter testified that the "the one-year lease agreements [were] a trial," and that he and McIntyre weren't sure whether they "wanted to stick with the business" or "get out of it and go another direction" with their lives.

A D & R's corporate minutes from February 26, 2002, which noted the conclusion of the fifth one-year lease, states that the purpose for the meeting was "[t]o discuss * * * the corporation purchasing the business and land instead of leasing and the plans for next year." (Ptf's Ex 12 at 1; Def's Ex G at 7.) At trial, Trotter testified that he and McIntyre had a continuing discussion from the end of February 2002 to May 2002, as to how the purchase could be structured. In May 2002, the operating assets of Charl's Restaurant and the real property, including buildings, were purchased from SKC. A D & R purchased the operating assets, including the name, goodwill, furniture, fixtures, and equipment, and negotiated a covenant not to compete, while Trotter and McIntyre purchased the land and building. *(See* Def's Ex H, I.) The final total sale price was $500,000, which allocated $150,000 to the land, $220,000 to the building, and $130,000 to the operating assets. (Def's Ex H at 5; Def's Ex I at 4.) Trotter testified that the $75,000 reduction in price, from $575,000 in the original Agreement, was a "market-value adjustment," and was also based on the relationship with Foss and SKC. Following the purchase, Trotter and McIntyre, who acquired joint title to the land and building, entered into a lease agreement with A D & R.

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Trotter testified that, although SKC had no legal obligation to A D & R, Trotter, or McIntyre, at the end of the fifth one-year lease, and A D & R did not have a right-of-first-refusal on the sale of the business or property, Foss was more motivated to sell to them because of the relationship that had developed over the preceding five years. Trotter testified that SKC had attempted to sell the business at least twice previously to other potential buyers, but that those negotiations had fallen through. According to Trotter's testimony, Foss was motivated to sell the business because he wanted to retire. Neither Foss nor SKC had any objection to the division of the assets purchased between the corporation, which was the lessee on the Agreement, and its shareholders Trotter and McIntyre. Trotter testified that a lawyer advised him and McIntyre that the land and buildings should be titled in their name, and that the corporation, A D & R, should buy the operating assets of the business.

The "Owner's Sale Agreement and Earnest Money Receipt" for Trotter and McIntyre's purchase of the land and building lists $100.00 paid as earnest money, with $87,750.00 as a "credit against sales price for payments made under existing lease with Seller. Balance of $282,150.00 to be paid via Promissory Note with monthly payments of $2,080.00 * * *." (Def's Ex H at 3.) In the sale agreement for A D & R's purchase of the operating assets of the business, $100.00 was paid as earnest money, with a $47,250.00 credit "for payments made under existing lease with Seller," and "[b]alance of $82,650.00 to be paid via Promissory Note with monthly payments of $1,120.00." (Def's Ex I at 3.) Those sale agreements were signed on April 9, 2002. (Def's Ex H at 3; Def's Ex I at 3.)

During tax year 2002, A D & R recorded two loans from stockholders. On March 4, 2002, A D & R borrowed $7,000 from Trotter at 8.5 percent, payable in monthly installments of

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$143.62 beginning on May 4, 2002. (*See* Def's Ex J at 1.) Trotter and McIntyre both signed the "Installment Promissory Note." (Def's Ex J at 2.)

On May 8, 2002, Trotter and McIntyre borrowed $58,000.00 from Siuslaw Valley Bank (Bank) at eight percent, Loan number 1000058326, with monthly payments of $438.36. (Def's Ex K at 4.) That same day an "Installment Promissory Note" (Note) for $58,000.00, with annual interest at six percent from June 8, 2002, and monthly payments of $489.44 was signed. (Def's Ex K at 1, 2.) The Note listed A D & R, Inc. as the borrower (McIntyre signed in her capacity as President) and Trotter as the lender, although Trotter did not sign it. (*See* id.) Seven payments of $438.36 per month were made on the Bank loan between June and December 2002. (*See* Def's Ex K at 5.) Defendant concluded that A D & R made the payments directly to the Bank, rather than Trotter, and there was no evidence to the contrary. (*See* Def's Ex K at 3.) Further, Defendant concluded that the loan issued by the Bank was to both Trotter and McIntyre, making McIntyre a party to the loan. (Def's Ex L at 13, 19.)

The issues before the court are based on Defendant's audit of A D & R's 2002 income tax return. On its 2002 federal income tax return, A D & R reported income of $263,650 and deductions of $342,426, resulting in an ordinary income loss of $78,776. (*See* Def's Ex C at 1.)

Defendant challenges A D & R's claimed deductions for rent. Defendant alleges that the Agreement between A D & R and SKC was a conditional sale agreement rather than a lease. Defendant wrote that "[b]ased on Revenue Ruling 55-540, and the specific facts of this case [most significant, SKC's allocation of "a portion of the periodic payment to an equity in the property"], it is determined that the Lease Agreement and Option between SKC, Inc. and AD&R, Inc., was a conditional sales contract, not a lease." (Def's Ex L at 6.) Payments made by A D & R to SKC over the five years of the Agreement were deducted as rent expense.

Defendant concluded that "AD&R Inc. erroneously reported total payments as rent expense from March of 1997 to April of 2002. Years 1997 through 2001 are closed, and no action will be taken to correct the entries for those years." (Def's Ex L at 6.)

For tax year 2002, A D & R deducted rent expenses totaling $89,926.00. (*See* Def's Ex C at 1.) The following payments make up that total:

A D & R RENT DEDUCTIONS 2002	
Lease payments to SKC (4 x $3,200)	$12,800
Klamath First (business obligation)	$13,100*
Klamath First (building obligation)	$37,284*
Real estate taxes due before purchase	$ 427
City of Florence (business obligation)	$ 1,843*
City of Florence (building obligation)	$ 5,246*
Lane County real estate taxes	$ 3,826
Lease payments to Trotter	$15,400
TOTAL	$89,926*

* Defendant proposes adjustments to those claimed deductions.

(Def's Ex C at 19; Def's Ex L at 10.)

Defendant disallowed payments claimed as rent expense to Klamath First and the City of Florence for two reasons. (Def's Ex L at 10.) First, A D & R did not purchase the land and buildings and, therefore, was not obligated to satisfy obligations to Klamath First and the City of Florence, which were allocated to the land and buildings. Second, under the terms of the purchase agreement, those obligations allocated to the equipment which was assumed by A D & R were part of the cost of the asset and must be capitalized. (*Id*.)

Because Defendant concluded that deductions claimed as rent expense in prior years were taken in error, Defendant determined that a portion of the reduction in the acquisition price of the

land and buildings purchased by Trotter and McIntyre should be reported as "[d]istribution to shareholders." (Def's Ex L at 13.) Defendant explained that "[t]he bargain sale of the corporate equity in the restaurant to the shareholders resulted in a distribution to the shareholders." (Def's Ex L at 6.) The parties agree that Trotter and McIntyre were allowed to reduce the purchase price of the land and building by $87,750, which was labeled "payments made under lease" on the Buyer's Final Closing Statement. (Def's Ex H at 1.) "Payments made under lease" were originally claimed as rent expense by A D & R. A portion of the allocated reduction ($42,530) was determined to be debt obligations to Klamath First and the City of Florence, which were assumed by Trotter and McIntyre. (*See* Def's Ex L at 13.) According to Defendant, the difference, $45,220, was to be equally divided between the two shareholders (Trotter and McIntyre) and reported as a distribution to shareholders. (*Id.*)

A D & R agreed to pay $58,000 to Trotter in an Installment Promissory Note, dated May 8, 2002. (*See* Def's Ex K at 1.) A loan in the same amount, $58,000, was issued by Suislaw Valley Bank to Trotter and McIntyre on May 8, 2002. (*See* Def's Ex K at 4.) Defendant determined that a part of the proceeds was loaned to A D & R to purchase a portion of the operating assets in the amount of $15,713.18, and pay property taxes dues to Lane County in the amount of $3,825.78. (Def's Ex H at 1; K at 6.) According to Defendant, the balance of the loan proceeds in the amount of $38,461 was "used by the shareholders for their personal use." (Def's Ex L at 13.) A D & R made seven payments in the amount of $3,068.52 on the $58,000 loan. Defendant allocated a portion ($38,461/$58,000 x $3,068.52) to Trotter and McIntyre as a shareholder distribution. (*Id.*)

A D &R and its shareholders dispute Defendant's proposed adjustments. A timely appeal was filed.

II. ANALYSIS

A D & R is an Oregon corporation, taxed under the Subchapter S provisions of the federal Internal Revenue Code. *See* IRC § 1361 *et seq.*[3] In general, "the taxable income of an S corporation shall be computed pursuant to section 1363(b) of the Internal Revenue Code, with the modifications, additions and subtractions provided in this chapter [ORS 314] and ORS chapter 316." ORS 314.732(2)(a).[4]

A. *Agreement: Lease or Conditional Sale*

The first issue before the court is whether the agreement between A D & R and SKC was a lease or a conditional sale agreement. In defining the term sale, it is "given its ordinary meaning for Federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money." *Commissioner v. Brown*, 380 US 563, 570-571 (1965). In determining whether an agreement between parties is a sale, the question of fact is answered based on the "intention of the parties as evidenced by the written agreements read in the light of the attending facts and circumstances." *Haggard v. Commissioner*, 24 TC 1124, 1129 (1995), aff'd 241 F2d 288 (9th Cir 1956). Courts have considered the following factors in making this determination: (1) Transfer of legal title; (2) Treatment of the transaction by the parties; (3) Acquisition of an equity interest in the property; (4) Binding obligation on seller to transfer title and purchaser to make payments; (5) Vested right of possession by the purchaser; (6) Payment of expenses related to the property including taxes and insurance; and (7) Receipt of profits from operation and sale of the property. *See Grodt & McKay Realty, Inc. v. Commissioner*, 77 TC 1221, 1237 (1981) (citations omitted). In looking at the acquisition of an equity interest factor,

[3] All references to the Internal Revenue Code (IRC) are to year 2001.

[4] All references to the Oregon Revised Statutes (ORS) are to year 2001.

the transaction is tested by addressing the following questions: (1) Is the transaction genuinely multiple-party; (2) Does it have economic substance; (3) Is it "compelled or encouraged by business realities," and; (4) Is the transaction "imbued with tax-independent considerations that are not shaped solely by tax-avoidance features." *Lieber v. Commissioner*, TC Memo 1993-391 (1993), citing *Frank Lyon Co. v. United States*, 435 US 561 (1978); *Hilton v. Commissioner*, 74 TC 305, 347 (1980), aff'd 671 F2d 316 (9th Cir 1982).

Considering the factors and questions set forth above, the court concludes that the agreement between A D & R and SKC was not a conditional sale. The intent of the parties was clearly stated to be a rental of the property by A D & R. Each party reported the agreement as a rental transaction. Legal title to the entire property did not transfer at the end of the short term lease, and there was no obligation set forth in the agreement requiring SKC to deliver title in exchange for only the rental payments paid by A D & R. The final purchase price was less than stated in the original Agreement, and the allowable credits against the purchase price exceeded the total principal amounts credited to the obligations and the outstanding balances of the obligations assumed by the purchasers. A D & R had no vested right of possession as evidenced by the month-to-month rental of the property after the term of the lease expired. Trotter testified that, during the time it occupied the premises, SKC attempted to sell the property to two other parties. A D & R did have responsibility for paying property taxes and insuring the property against loss; those are common negotiated provisions of a triple net lease agreement. A D & R received the profits from the operations of the business using both the leased operating assets and the structure located on the property, but A D & R was not entitled to receive any profit from the sale of the property.

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Under the terms of the Agreement, A D & R did not acquire an equity interest unless the purchase option was exercised. A D & R had a strong incentive to exercise the purchase option because a portion of each monthly payment could be credited against the purchase price. However, A D & R did not exercise that option as set forth in the Agreement. A D & R successfully negotiated a lower purchase price and only purchased the operating assets of the business. The negotiated purchase price was credited with a portion of the rental payments as outlined in the original Agreement.

Even though the Agreement between the parties was not a conditional sale agreement, a portion of A D & R's total rental payment could, and in fact did, result in a benefit to A D & R and its shareholders, specifically a reduction in the purchase price of the acquired property. The court agrees with Defendant that A D & R incorrectly recorded the entire rental payment as an expense. A portion of each rental payment made in payment of SKC's loan obligations should have been recorded as a Prepaid Asset, with an explanation similar to the following: Potential Credit to Purchase Price of Property.

Each month a payment in the amount of $2,420.35 was made by A D & R in payment of SKC's bank loans and biannual payments were made to the city of Florence. (Def's Ex F at 2.) Because tax years prior to the current year under appeal were closed to audit, Defendant allowed those rental payments as deductions. For the tax year under appeal, A D & R's schedule of rents did not include a deduction for payments made on the SKC bank loans or to the city of Florence.[5] (Def's Ex C at 19.) If A D & R had reported a current year deduction, that deduction would have

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[5] For the first four months of 2002, the reported lease payments to SKC totaled $12,800. (*See* Def's Ex L at 10.) Defendant concluded that A D & R made four monthly payments in the amount of $3,200 per month. There is no explanation why the payments were significantly less than the monthly payment amount specified in the Agreement.

been denied with a portion charged to the shareholders for the assets they purchased from SKC. However, because there is no recorded deduction, no adjustment is required.

For the tax year under appeal, Defendant capitalized a portion of the total payoff amount of the SKC bank loans. (*See* Def's Ex L at 10.) A portion of the total payoff amount of the lien held by the City of Florence was also capitalized. (*Id.*) Both amounts were deemed a portion of the total purchase price of the operating assets and were correctly included by Defendant in the "calculation of depreciation." (*Id*.) On December 20, 2006, Defendant wrote to the court stating that it incorrectly calculated "the depreciation." Defendant will need to recalculate the allowable depreciation based on the court's decision.

B. *Distribution to A D & R's Shareholders*

The second issue raised by Defendant is distributions or dividends to A D & R's shareholders. Distributions are defined as amounts paid by a corporation to a shareholder in his or her capacity as a shareholder from the earnings and profits of the corporation. *See* IRC § 301(c)(1).[6] Defendant concluded that the lease payments made by A D & R, which were credited against the purchase price of the land and building, must be recorded as dividends to A D & R's shareholders who purchased those assets.

In concept, the court agrees with Defendant that amounts paid by a corporation, which accrue to the benefit of its shareholders, must be recorded as distributions. The court does not agree with the distribution amount computed by Defendant. (*See* Def's Ex L at 7.)

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[6] "A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) [S corporation having no earnings or profits] or (c) [S corporation having earnings and profits], whichever applies." IRC § 1368(a).

The court was not provided with evidence to determine whether A D & R had, or does not have, earnings and profit. Plaintiff alleges without submitting any evidence that A D & R "has no qualified earnings and profits to distribute." (Ptf's Cov Ltr at 2.) With no evidence to the contrary, the court accepts Defendant's determination that the distribution is ordinary taxable income to each shareholder.

The purchase price Trotter and McIntyre paid for the land and buildings was reduced because A D & R previously made payments on the outstanding obligations of the seller, SKC. Those payments directly benefitted shareholders, Trotter and McIntyre, because the price they paid to acquire the land and buildings was credited for those payments. At trial, A D & R's representative emphasized that A D & R and its shareholders carefully segregated business transactions from personal transactions. Unfortunately, that segregation was not maintained when A D & R purchased the operating assets of the business and Trotter and McIntyre purchased the land and building. At the time of the purchase, A D & R and its shareholders were unaware of the tax consequences resulting from the prior payments made by A D & R that ultimately resulted in a reduction in the purchase price for its shareholders. If A D & R had purchased the land and building in addition to the operating assets, the credit for prior payments would have reduced the depreciable basis of the property without a benefit to the individual shareholders. However, A D & R did not purchase all the assets from SKC. The result is the benefit that accrued to Trotter and McIntyre was a deemed distribution to each of them.

Defendant correctly concluded that A D & R, not its shareholders, made the "payments under the lease." In support of its computation, Defendant's proposed audit adjustment for the distribution stated that, in accordance with the original lease agreement between the parties, the purchase price was to be reduced by "an amount equal to the principal amounts paid during the five year Lease Agreement and Option on the three debt obligations belonging to S.K.C. Inc. (named above), less any outstanding balances then remaining on these same obligations, which Lessee shall assume as part of the purchase price." (Def's Ex L at 4.) Given the terms of the Agreement, the purchaser could be credited only with payments made to reduce the principal plus the outstanding balance (loan or lien principal) assumed at the date of the purchase. Therefore,

under the terms of the Agreement, the maximum credit that a purchaser could receive would be the principal balance of the obligations at the date the original Agreement was signed. The outstanding balances of the obligations which totaled $122,824.95 were:

Western Bank:	$94,443.51;
Western Bank:	$18,779.80; and
City of Florence	$ 9,601.64

(Def's Ex F at 2.) However, at the time of purchase, A D & R and its shareholders were credited $135,000. (*See* Def's Ex H at1; I at 1.) The excess amount, $12,175.05, must be allocated among the purchasers, using the percentage of total assets purchased by A D & R and its shareholders. There is no evidence to show that the excess amount resulted from payments made by A D & R. Therefore, the excess amount is deemed a purchase discount, and is not a distribution to A D & R's shareholders.

At the time A D & R's shareholders purchased the land and building from SKC, the closing statement listed a credit in the amount of $87,750 for "payments made under lease." (Def's Ex H at 1.) When computing the distribution amount received by the shareholders, Defendant reduced the credit by the amount of the liabilities assumed ($42,530). (Def's Ex L at 7.) The credit must be further reduced for the additional discount ($12,175.05) allocable to A D & R's shareholders (74 percent). After that reduction ($9,009.54), the distribution amount is $36,210.46, which must be split equally between the shareholders, Trotter and McIntyre.

C. *Shareholder Loans to Plaintiff*

A loan is defined as the "unconditional and legally enforceable obligation for the payment of" money. *Noguchi v. Commissioner*, 992 F2d 226, 227 (1993) (citing *Howlett v. Commissioner*, 56 TC 951, 960, 1971 WL 2506 (1971)). From time to time, A D & R borrowed

money from its shareholders. Loans documents were signed and amortization schedules maintained to record principal and interest payments. For example, *see* Ptf's Exs 28-74.

In an Installment Promissory Note, dated May 8, 2002, A D & R stated that it received $58,000 from shareholder Trotter. (*See* Def's Ex K at 1.) The same amount, $58,000, appeared on a closing statement prepared by Western Pioneer Title Company of Lane County issued to Trotter and McIntyre on May 9, 2002. (*See* Def's Ex H at 2.) Another document labeled "Note 1000058326 - Douglas A. Trotter" set forth payments made through August 17, 2005, and credited to the loan. (Ptf's Ex 21 at 3.) McIntyre's name appeared on the document below Trotter's. (*Id.*)

Defendant concluded that only a portion of the $58,000 was loaned to A D & R at the time it purchased the operating assets. (Def's Ex L at 13.) Further, Defendant concluded that, because the loan was issued to both Trotter and McIntyre, the promissory loan and A D & R's payments on the promissory loan must be split between the two shareholders.

The evidence presented to the court supports Defendant's conclusion that the $58,000 loan was issued to both Trotter and McIntyre. There is no evidence that the shareholders entered into their own loan agreement such that Trotter borrowed from McIntyre her share of the loan proceeds. Further, at trial, there was no evidence to show that the full amount ($58,000) was loaned to A D & R. In fact, the evidence states that a portion of the loan proceeds were used by A D & R's shareholders as a deposit on the purchase of the land and buildings. (*See* Def's Ex H at 1, 2.) Defendant's proposed audit adjustment is upheld. (*See* Def's Ex L at 13.)

In addition, the evidence supports Defendant's allegation that A D & R made seven monthly payments to Western Pioneer Title Company of Lane County on the $58,000 loan. Defendant proposed an audit adjustment to allocate the monthly payments between the

obligations of the corporation (A D & R) and the personal obligations of its shareholders. (Def's Ex L at 13.) Defendant concluded that the "noncorp. portion of loan" was $2,034. (*Id.*) Having concluded that the $58,000 loan was obtained jointly by shareholders Trotter and McIntyre, and a portion of the loan was used by each of them to acquire title to the land and buildings, the remainder of the loan proceeds was loaned to A D & R. The court accepts Defendant's proposed adjustment. Defendant's proposed adjustment ($2,034) must be equally split between the shareholders.

D. *Salaries and Wages and Payroll Tax Deductions*

A D & R stated that it erroneously deducted $11,687.63 on its originally filed income tax return. (*See* Ptf's Ltr at 4, Nov, 21, 2006.) Defendant accepts A D & R's adjustment. Defendant also agreed that the claimed deduction for social security and medicare tax paid by A D & R on tips received by Trotter and McIntyre above minimum wage, is incorrect. The agreed upon subtraction results in a reduction in the amount of $894 for the payroll tax deduction claimed by A D & R. Each shareholder, Trotter and McIntyre, is entitled to a pass-through deduction in the amount of $447.

E. *A D & R's proposed other adjustments*

In its letter dated November 21, 2006, A D & R proposed other adjustments to its filed income tax return that were submitted on amended returns for A D & R, Trotter, and McIntyre. Some of the proposed adjustments may need to be changed given the court's decision. The parties are encouraged to discuss the proposed adjustments after reviewing the court's decision. **Any agreements reached by the parties should be provided to the court no later than 60 days from the date of this decision**. If an appeal of the court's decision is not filed and a

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judgment is filed by the court in this matter, the tax year will be closed in accordance with the court's decision.

III. CONCLUSION

After careful review of the testimony, evidence and applicable law, the court concludes that A D & R and its shareholders incorrectly reported its purchase of the business known as Charl's Restaurant. As a result, the purchase of the assets, loans from shareholders, and distributions to shareholders were not properly reported. Now, therefore,

IT IS THE DECISION OF THIS COURT that Defendant's adjustments for tax year 2002 are upheld, with the exception of the distribution amount related to the purchase of the land and buildings by the shareholders, which the court computes to be $36,210.46, to be split equally between the shareholders, and the depreciation expense that Defendant will recalculate; and

IT IS FURTHER DECIDED that A D & R's proposed salaries and wages and payroll tax adjustment are accepted.

Dated this _____ day of March 2006.

_____
JILL A. TANNER
PRESIDING MAGISTRATE

If you want to appeal this Decision, file a Complaint in the Regular Division of the Oregon Tax Court, by <u>mailing</u> to: 1163 State Street, Salem, OR 97301-2563; or by <u>hand delivery</u> to: Fourth Floor, 1241 State Street, Salem, OR.

Your Complaint must be submitted within <u>60</u> days after the date of the Decision or this Decision becomes final and cannot be changed.

This document was signed by Presiding Magistrate Jill A. Tanner on March 20, 2007. The Court filed and entered this document on March 20, 2007.