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THE DEDUCTIBILITY OF A WORTHLESS RIGHT TO CONTRIBUTION FOR JOINT INCOME TAXES: THE MISTAKEN LINE OF CASES UNDER *RUDE V. COMMISSIONER*

*By Richard C. E. Beck**

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* Associate Professor of Law, New York Law School. The author wishes to thank the following persons who have read earlier drafts and improved this Article through their comments: Edward Beck, Karen Gross, James Lewis, William Natbony, Mark Vogel, and Mary Moers Wenig. Thanks are also due to my former student Cherie Zacker, who did valuable research for this project in an advanced tax seminar course. Errors, of course, remain my own.

I. Introduction

A. *Overview*

Husbands and wives are jointly and severally liable for the entire income tax due on a joint return, no matter who earns the income.[1] The Internal Revenue Service ("Service") has no duty to pursue the earning spouse[2] first, before proceeding against the other. In cases of divorce, these rules operate very unfairly, and often permit the Service to extract money from a divorced woman to pay her ex-husband's taxes.[3] In such situations, the wife has the right to contribution from her husband under common law, and in many states also by statute.[4] The right is rarely exercised, however, prob-

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[1] See I.R.C. § 6013(d)(3). Section 6013(d)(3) of the Internal Revenue Code provides that "if a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several."

[2] Hereinafter, for convenience, the earning spouse will be referred to as the "husband," and the nonearning spouse as the "wife." Unless the context indicates otherwise, the terms will be used to include former spouses, as well as separated spouses and spouses living together.

The statute itself is gender neutral, but its effects are not. The author has estimated that 90% of collections from the nonearning spouse are paid by the wife. See infra note 3 and accompanying text.

[3] The author has elsewhere written at length on the desirability of repealing these rules. See generally Beck, *The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should be Repealed,*" forthcoming in 43 Vand. L. Rev. ____ , (March 1990)(hereinafter Beck, *Joint and Several Liability*).

About 99% of married taxpayers file jointly, because the tax system systematically discourages separate filing (which would avoid the joint and several liability). IRS Statistics of Income—1985 Individual Tax Returns (1988) Table 1.2 at p. 18. The Service keeps no statistics on joint return liability, but the author estimates that wives are unjustly compelled to pay their ex-husbands' income taxes in at least 10,000 cases per year. See Beck, *Joint and Several Liability*.

[4] See Chappell v. Chappell, 253 So. 2d 281 (Fla. 1981). In *Chappell*, the husband had a right to contribution for paying his wife's share of joint taxes, although he could not set off the debt against his alimony obligation to her. Id. at 287. "Contribution is founded upon the equitable principle that no one shall be made to bear more than his fair share of any joint burden." Id. at 293 (citing 18 Am. Jur. 2d Contribution § 4 (1985); 7 Fla. Jur. Contribution §

ably because of the cost of litigation. When such a right to contribution is worthless because it is uncollectible, the wife is denied a bad debt deduction under the authority of *Rude v. Commissioner*[5] and its progeny.[6] Despite apparently settled law, a bad debt deduction should be allowable in these circumstances, and the Tax Court decisions to the contrary are in error.

It is also proposed that the husband should generally be liable for tax on discharge of indebtedness income when his debt to the wife is cancelled for a nongift reason, such as the impracticality of a suit for collection. This is an assertion that the Service has, unaccountably, never made.

Reversal of *Rude* could indirectly provide partial relief from joint return liability for thousands of aggrieved women who do not qualify for full relief under the innocent spouse rules of section 6013(e) of the Internal Revenue Code ("Code").[7] The Treasury's loss could be mitigated in many, if not most cases by taxing the husband on the corresponding discharge of indebtedness income.[8] These results are not as desirable as repeal of joint return liability

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2 (1956). See also Miller v. Miller, 62 Misc. 2d 755, 310 N.Y.S.2d 18 (1970); See Cal. Civil Code § 1432 (West 1982 & Supp. 1989).

[5] 48 T.C. 165 (1967).

[6] See Haynes v. Commissioner, 27 T.C.M. (CCH) 1531, 1532 (1968)(*Rude* cited as controlling the deductibility of worthless right of contribution for taxes on joint return); See also Globe Products Corp. v. Commissioner, 72 T.C. 609, 619-20 (1979)(*Rude* cited in denying deduction for worthless contractual right to contribution for taxes of other affiliated corporations for which taxpayer corporation was jointly and severally liable on consolidated corporate return); Merit Tank & Body, Inc. v. Commissioner, 40 T.C.M. (CCH) 368, 370-71 (1980)(citing *Globe Products* as controlling in similar situation).

The cases involving consolidated returns appear to be incorrectly decided to the extent they rely on *Rude*. However, a discussion of the consolidated return issues is beyond the scope of this article.

[7] See I.R.C. § 6013(e). The rules of § 6013(e) exonerate the wife from liability for her husband's taxes on a joint return if, *inter alia*, she did not know of, and had no reason to know of her husband's grossly erroneous tax items, and if she did not substantially benefit from them. "Grossly erroneous" means unreported income, or claims of deduction "without basis in fact or law." Relief is available only for qualifying items, and even then only if such items total over $500 in amount, net of interest due. The husband's simple nonpayment of tax on a correct return does not qualify for relief.

[8] This would be true in the thousands of instances in which the right to contribution is uncollectible not because the husband is insolvent, but because the amount is too small to be worth the wife's legal costs of collection. The Service could collect where the wife cannot, and the wife would be accorded partial relief. Also, the Service will often be able to collect $.28 or $.33 on the dollar from the husband in cases where the wife's deduction costs it only $.15. This differential may help to offset the loss of revenue from the cases where nothing can be collected because the husband is insolvent.

altogether, but until Congress sees fit to do so, they are preferable to the current state of the law. Moreover, these results are not merely obtainable, but seem required under well-accepted principles of current law without any need for statutory reform.

B. Summary

In *Rude*, the Tax Court disallowed a bad debt deduction for the taxpayer's worthless right to contribution from her husband for his share of income taxes which she was forced to pay because of her joint and several liability on the couple's joint return.[9] The sole ground of decision was that allowing the bad debt deduction would circumvent the prohibition under section 275 against deducting federal income taxes, for which she was jointly and severally liable.[10] The decision was mistaken for several reasons.

First, the *Rude* case is inconsistent with the general principle, embodied in the Treasury Regulations[11] and in case law,[12] that for purposes of the nonbusiness bad debt deduction, the use to which the borrowed funds are put is of no consequence.[13] Thus if the husband in *Rude* had borrowed funds from the wife in order to pay his income taxes, and the debt later became uncollectible, nothing would prevent a bad debt deduction.[14] The economic substance of the *Rude* situation is identical except that the husband's debt arises by operation of law from the wife's compulsory payment rather than from a voluntary loan.[15]

Second, *Rude* was inconsistent with another well-established line of cases beginning with *Clark v. Commissioner*.[16] In *Clark*, the taxpayer needlessly overpaid his taxes due to his tax attorney's mistake, and the issue was whether the tax attorney's reimbursement

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[9] 48 T.C. at 175.

[10] 48 T.C. at 174-75 (relying on section 164(b)(1) of the Internal Revenue Code of 1954 which has been replaced by I.R.C. § 275).

[11] See Treas. Reg. § 1.166-5(b)(2). See infra note 117 for text of the regulation.

[12] See infra notes 72 to 87 and accompanying text.

[13] See infra notes 117 to 121 and accompanying text.

[14] The same treatment would be appropriate if the husband had borrowed funds from the wife to pay any other expense which would be nondeductible if paid by either spouse directly. See id.

[15] 48 T.C. at 174 ("[I]t is clear that [Mrs. Rude] had both a contractual and a statutory claim against [her husband] . . . .")

[16] 40 B.T.A. 333 (1939).

of funds was gross income to the taxpayer.[17] The *Clark* court held that the tax attorney's reimbursement was not an indirect payment of the taxpayer's federal income taxes, which would have been gross income to him under *Old Colony Trust Co. v. Commissioner*,[18] but was a tax-free return of capital intended to compensate the taxpayer for his loss.[19]

In *Rude*, it was ultimately the husband's failure to pay his share of the joint tax obligation which caused the wife's loss, and that breach of duty to his wife was analogous to the attorney's malpractice in *Clark*. In both cases, there was a needless tax payment caused by another's breach of duty which gave rise to an obligation to reimburse the loss. The only difference is that in *Clark* the reimbursement was actually made, but in *Rude* it was not. If the *Clark* analysis had been applied in *Rude*, the wife's right to contribution would have been regarded as a right to restoration of her lost capital. Because an actual reimbursement by the husband would not have been a payment of her taxes, it follows that a bad debt deduction for the husband's failure to make the very same reimbursement cannot be an indirect way for her to deduct her income taxes.[20]

Finally, bad debt status erases the character of the underlying obligation which became worthless. For purposes of section 166(d), one bad debt is like any other. In this respect, the *Rude* decision was inconsistent with prior case law involving underlying obligations both for taxes and for other nondeductible personal expenditures.[21] Subsequent developments in the law confirm this principle.[22] In fact, the Service itself apparently reversed its position only two years after the *Rude* decision, and applied the "erasure" principle in a situation seemingly indistinguishable from *Rude*. In Revenue Ruling 69-411,[23] a worthless right to contribution for an

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[17] Id. at 333-34.

[18] 279 U.S. 716 (1929)(employer's payment of employee's income taxes was additional income to employee).

[19] See *Clark*, 40 B.T.A. at 335.

[20] See infra notes 104 to 121 and accompanying text.

[21] See infra notes 171 to 193 and accompanying text.

[22] Id.

[23] 1969-2 C.B. 177 (taxpayer who received probate assets thereby became secondarily liable for, and paid, the share of estate taxes owed by an insolvent beneficiary of decedent's life insurance; held, because taxpayer was subrogated to the executor's claim against the insurance beneficiary, a valid debt was created by operation of law which was worthless in

otherwise nondeductible estate tax was held to be deductible as a bad debt. The same principle was applied more recently in *First National Bank of Duncanville v. United States*,[24] which held that a worthless right to contribution or indemnity for an otherwise nondeductible tax penalty is nevertheless deductible as a bad debt, despite public policy concerns (absent in *Rude*) which militated against deductibility of the underlying penalty.[25]

The article concludes with a discussion of the equities in favor of reversing *Rude*, and of the procedures for accomplishing reversal. It is argued that the deduction should be granted generously for public policy reasons, and also because the deduction will facilitate collection of debt discharge income from the husband. Taken together, these measures would afford partial relief to the wife, and place the tax burden to that extent on the husband where it properly belongs. Because *Rude* was incorrectly decided, the Service could begin allowing the wife a deduction in *Rude* situations by simply changing its own administrative practice. Similarly, no legislative reform is necessary for the Service to begin taxing the husband on debt discharge income in such situations.

II. *Rude* and its Progeny: Deducting an Uncollectible Right to Contribution For Joint Taxes

A. *Rude v. Commissioner*

The Rudes filed a joint federal tax return for 1951.[26] In May of 1958, the couple was divorced, and the interlocutory judgment of divorce incorporated the couple's written property settlement agreement,[27] which provided *inter alia* that each party would pay his or her share of any tax assessed by reason of the filing of a joint tax return.[28] In December of 1958, the taxpayer's husband, Jack, took up residence in England, after embezzling funds belonging to the receiver in their divorce proceedings.[29] Jack still resided there

taxpayer's hands, and the debt was therefore deductible under § 166(d)).

[24] 481 F. Supp. 633 (N.D. Tex. 1979).

[25] Id. at 638-39.

[26] *Rude*, 40 T.C. at 170.

[27] Id. at 167.

[28] Id. at 174.

[29] Id. at 170.

as of December 1966, the date of the Tax Court hearing.[30]

In 1959 an additional assessment was made against the Rudes for the joint return year 1951 in the amount of $46,533.66.[31] Because the return was joint, each spouse was jointly and severally liable for the entire assessment under section 6013(d).[32] Elizabeth paid the entire assessment out of her own funds in 1961, and deducted Jack's one-half share[33] of the additional obligation, or $23,266.83, as a short-term capital loss from a nonbusiness bad debt under section 166(d).[34] It was undisputed that Elizabeth had both a contractual right to contribution under the terms of her property settlement agreement, and also a statutory right to contribution under California Civil Code section 1432[35] in the same amount. It was also undisputed that the taxpayer's right to contribution was uncollectible.[36]

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[30] Id.

[31] Id. at 171.

[32] Id. at 174.

[33] Id. at 171. The record does not disclose which spouse earned the income responsible for the additional assessment, but under the doctrine of Poe v. Seaborn, 282 U.S. 101 (1930), which interpreted state community property law, each spouse was liable for one-half of the taxes on the couple's aggregate income because the couple was resident in California. Thus, if the couple had filed separately, one-half of the additional assessment would have been due from each spouse.

[34] Section 166(d) provides, in pertinent part:

> (d) NONBUSINESS BAD DEBTS. —
>
> (1) (B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than six months.
>
> (2) Nonbusiness debt defined. — For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than —
>
> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Id.

[35] *Rude*, 48 T.C. at 174-75. Cal. Civil Code § 1432 (West 1982 & Supp. 1989), which deals with contribution among joint obligors, provides: "Except as provided in section 877 of the Code of Civil Procedure, a party to a joint, or joint and several obligation, who satisfies more than his share of the claim against all, may require a proportionate contribution from all the parties joined with him."

This provision was held to apply to joint federal tax returns in Murchison v. Murchison, 219 Cal. App. 2d 600, 604-05, 33 Cal. Rptr. 285, 288 (1963)(husband entitled to contribution from wife for her share of joint tax obligation).

[36] *Rude*, 48 T.C. at 174-75.

Elizabeth therefore had all the elements of a deductible nonbusiness bad debt.[37] There is ample authority for the proposition that a worthless right to contribution will support a bad debt deduction where the underlying joint obligation is other than a joint federal tax return.[38] The sole ground of decision in *Rude* was that because the taxpayer's underlying obligation was to pay the full amount of joint tax due, allowance of the deduction would, directly or indirectly, reduce the amount of tax she owed and circumvent the prohibition of section 275.[39]

The Tax Court cited some cases in support of its reasoning, but the cases are at best only tangentially related to the question at hand. Much better authority was overlooked, as will be seen below.[40] The Tax Court relied principally on *Edwin J. Schoettle Co. v. Commissioner*,[41] in which the taxpayer made a claim for abatement of an additional income tax assessment for the year 1917, and the collector of internal revenue insisted that the taxpayer provide a bond for full payment of the tax before considering the claim.[42] In order to forestall distraint proceedings, the taxpayer posted a bond of $33,786.97, with a bank as surety, for the full amount of the tax.[43] The claim for abatement was partially allowed, but an assessment of $19,991.60 remained, which the collector ultimately collected in 1940 through a judgment in a suit at law for enforcement of the bond.[44] The taxpayer claimed a deduction

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[37] See I.R.C. § 166(d). See supra note 34 for the text of § 166(d).

[38] The problem usually arises in the context of a guarantor of a debt who pays the full amount of the obligation because he is jointly and severally liable, and is unable to obtain contribution from the primary obligor or obligors. The usual issue is whether the guarantor's payment is an ordinary loss (or business bad debt, entitling the guarantor to the same favorable ordinary loss treatment), or, as the Service ordinarily argues, the right to contribution or subrogation is a nonbusiness bad debt entitled to deduction only as a short-term capital loss. See, e.g., Putnam v. Commissioner, 352 U.S. 82, 92-93 (1956), in which the Court held that an individual guarantor of corporate debt was entitled to a nonbusiness bad debt deduction, rather than an ordinary loss, on payment of the insolvent corporation's obligations. The guarantor steps into the creditor's shoes upon payment of debtor's obligation, and the guarantor's loss is, by its very nature, a loss from the worthlessness of a debt.

[39] See I.R.C. § 275. Section 275 provides, in pertinent part, "(a) GENERAL RULE. - No deduction shall be allowed for the following taxes:
(1) Federal income taxes, ..."

[40] See, e.g., infra notes 72 to 91 and accompanying text.

[41] 3 T.C. 712 (1944).

[42] Id. at 713.

[43] Id. at 713-14.

[44] Id. at 715.

in that amount for a "loss on adverse judgment," which was disallowed.[45] The taxpayer argued that the payment was for a contractual liability[46] rather than a tax, but the Tax Court held for the government on the ground that the amount secured by the bond was for payment of income taxes, and collection of taxes by enforcement of the bond rather than through statutory collection procedures made no difference.[47]

The *Rude* court thought the same rationale applied as in *Schoettle*, and that the "alleged nonbusiness bad debt must be treated in a manner consistent with the proper treatment of the underlying obligation, i.e., the Federal tax liability."[48] But in *Schoettle* there was only one obligor and one obligation; the question was whether it made any difference that the obligation was paid on the bond or through the usual collection procedures.[49] In *Rude*, there were two distinct obligations of two different obligors, that of Elizabeth to pay her husband's taxes through joint and several liability, and an entirely separate liability of Jack to reimburse her. The question in *Rude* was whether it mattered that Jack's obligation arose out of the joint return. In order to answer the question, one must consider whether a liability for someone else's taxes is necessarily equivalent to a liability for one's own taxes for purposes of the prohibition under section 275. And because it was the husband's debt which was deducted, it is also necessary to decide whether the husband's debt retains the tax character of the wife's payment for purposes of the bad debt deduction under section 166(d). The court did not consider these questions, which are addressed below.

In *Schoettle*, the issue was essentially an origin-of-the-claim problem. An adverse judgment is deductible *vel non* depending on whether the amount would have been deductible had it been paid without resort to the courts.[50] And the effect of a bond, escrow, or

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[45] Id. at 716.

[46] The taxpayer's argument was buttressed by the fact that the tax could no longer be collected by the usual procedures because the statute of limitations had run in 1923, and therefore the only means of collection was through the bond. See *Schoettle*, 13 B.T.A. 950, 952 (1928)(bond was not consent to extend statute of limitations for assessment and collection).

[47] *Schoettle*, 3 T.C. at 719.

[48] 48 T.C. at 175.

[49] See *Schoettle*, 3 T.C. at 718.

[50] See Lyeth v. Hoey, 305 U.S. 88 (1938) (property received from estate of decedent in

other security arrangement which is no more than a method of guaranteeing payment is altogether irrelevant to the tax character of the underlying obligation which is so secured.[51] The essential question was, in lieu of what was the judgment paid? In *Schoettle*, the answer could only be that the judgment was paid in lieu of the taxpayer's own income taxes.[52] There was no alternative avenue to deductibility which could provide any parallel to the bad debt claim in *Rude*.

Two other cases were cited by the *Rude* court in support of its decision, but were not discussed.[53] Both cases involved disallowance of a double deduction for the same amount paid under different guises, and neither case had any clear relevance to the issues which should have been analyzed in *Rude*. In *Edward Katzinger Co. v. Commissioner*,[54] the taxpayer deducted as a bad debt, uncollectible amounts advanced to a subsidiary,[55] and the deduction was disallowed to the extent that the taxpayer had already enjoyed a deduction for the subsidiary's operating losses on a consolidated return in a prior year.[56] The court found that the prior losses deducted on the consolidated return were directly traceable to the advances made by the taxpayer, and that allowance of the bad debt deduction would result in a double deduction for the same loss.[57] In *Nichols v. Commisioner*,[58] a partnership of which the taxpayer was a partner advanced materials at cost to a corporation, and deducted as a bad debt the value of the materials when the corporation became insolvent.[59] The deduction was disallowed because, *inter alia*, the partnership had already deducted the item in its inventory, and the bad debt deduction would therefore result in duplication of a deduction already taken.[60] Both *Katzinger* and *Nichols* can be explained by a basic principle governing bad debt

compromise of disputed claim as heir was received tax-free just as if the taxpayer's claim had been honored).

[51] *Schoettle* 3 T.C. at 718.

[52] See id.

[53] 48 T.C. at 175.

[54] 129 F.2d 74 (7th Cir. 1942).

[55] Id. at 74.

[56] Id.

[57] Id. at 76.

[58] 29 T.C. 1140 (1958).

[59] Id. at 1142-43.

[60] Id.

deductions: it is necessary for the taxpayer to have a basis in the debt in order to secure a deduction.[61] In both cases, the taxpayer had already enjoyed a deduction for the amount advanced, and therefore had no further basis in the debt, and so nothing to deduct.

Nothing in *Katzinger* or *Nichols* would appear to have any direct bearing on the problem in *Rude*. The taxpayer in *Rude* had a basis in her worthless right to contribution: she paid her husband's share of the joint taxes with after-tax dollars, out of her capital. Therefore, no double deduction would result if the bad debt deduction were allowed.

B. *Haynes v. Commissioner*

A year after the *Rude* decision, the same question was litigated again in *Haynes v. Commissioner*.[62] Mary Haynes had filed jointly with her former husband, Dominic Orsini, for the year 1954, and was divorced from him in 1956.[63] In 1961, a deficiency was assessed.[64] Mary was concededly liable for the entire deficiency under section 6013(d).[65] In 1963, the Hayneses paid, together with penalty and interest, an agreed total amount of $4,619.22 in satisfaction of the entire deficiency.[66] Mary and Frank then filed a joint return for 1963 on which they deducted $3,450[67] as a nonbusiness bad debt for Mary's worthless[68] right to contribution from Orsini.

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[61] See Treas. Reg. § 1.166(d). This regulation provides, in pertinent part: "[T]he basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by sec. 1.1011-1 for determining the loss from the sale or other disposition of property."

See also Treas. Reg. § 1.166-1(e), requiring prior inclusion in income for debts arising from unpaid wages, rents, and other items of taxable income. To the extent they have not been included in income, the taxpayer has no basis in them, and therefore nothing to deduct. See id.

[62] 27 T.C.M. (CCH) 1531 (1968).

[63] Id.

[64] Id.

[65] Id. Frank Haynes, her current husband, was also liable for the same deficiency as a transferee of Mary's assets.

[66] Id. at 1531-32.

[67] Id. at 1532. The facts do not disclose how much of the deficiency was due to Mary's income and how much to her former husband Orsini. Presumably 75% of the Orsinis' taxes in 1954 was due to Dominic's income, which would account for the Haynes' deduction of 75% of their 1963 payment as Dominic's share. The Orsinis filed in Michigan, and therefore the community property rule which applied in *Rude* did not apply in *Haynes*.

[68] The facts do not disclose why the debt was uncollectible from Orsini.

The bad debt deduction was disallowed, and the Tax Court upheld the government, on the explicit authority of *Rude*. The court did express some regret this time, admitting that the "petitioners' case presents a somewhat appealing picture from an equity standpoint . . . ."[69] The court gave almost no discussion to the legal issues involved, but it did mention a case relied upon by the taxpayers, *Gersten v. Commissioner*,[70] which it distinguished in a single sentence.[71] *Gersten* was a complex and interesting case, however, and its relevance to the problem at hand entitled it to a more thorough discussion.

C. *Gersten v. Commissioner*

Gersten was a 50% shareholder of Homes Beautiful, Inc., a dissolved corporation, and received 50% of its assets in liquidation, the other 50% being received by one Theodore Robbins, the other shareholder.[72] In 1947, Homes Beautiful (by then already dissolved), was adjudged liable for deficiencies in income tax in an amount (including interest) of $44,721.60.[73] Each shareholder had received more than that amount in liquidating distributions from the corporation,[74] and both shareholders thereby became jointly and severally liable as transferees for the entire deficiency.[75] In 1947, Gersten paid $40,000 of the corporation's tax liability, and in 1949, Gersten paid the remaining $4,721.60 in complete satisfaction of the federal tax liabilities of Homes Beautiful.[76] Robbins was bankrupt and paid nothing,[77] although he was jointly and severally liable as a transferee for the entire amount.[78] On his 1949 joint return, Gersten deducted in full, as an ordinary loss, the $4,721.60[79] he paid on behalf of Homes Beautiful.[80]

[69] *Haynes*, 29 T.C.M. (CCH) at 1532.
[70] 28 T.C. 756 (1957).
[71] *Haynes*, 29 T.C.M. (CCH) at 1532. See infra note 88 and accompanying text.
[72] *Gersten*, 28 T.C. at 768.
[73] Id. at 765.
[74] Id.
[75] Liability was imposed under the predecessor of I.R.C. § 6901.
[76] *Gersten*, 28 T.C. at 765.
[77] Id. at 768.
[78] See id.
[79] The facts do not disclose how Gersten treated the $40,000 payment on his 1947 tax return.
[80] *Gersten*, 28 T.C. at 768.

The Service disallowed the ordinary loss, and asserted that half the amount paid, or $2,360.80, was deductible only as a short-term capital loss from a bad debt, representing the amount Gersten paid on behalf of Robbins.[81] Of the remaining $2,360.80, $630.57 was allowed as a deduction for interest, and $1,730.23, representing Gersten's share of the transferee liability from Homes Beautiful, was deductible only as a long-term capital loss, under the doctrine of *Arrowsmith v. Commissioner*.[82] The court upheld these determinations.[83]

The *Gersten* case is a step more complicated than the *Rude* problem. In *Gersten*, there were three obligors: Homes Beautiful for its taxes; Gersten as transferee secondarily liable for Home Beautiful's debts; and Robbins, liable for contribution to Gersten. The decision is noteworthy in at least two respects.

First, the Service did not argue, and the court did not decide, that Gersten's payment should be nondeductible altogether on the ground that it was a payment of federal income taxes and therefore nondeductible under section 275. It was not even an issue that the underlying obligation was Home Beautiful's federal taxes which Gersten was forced to pay as transferee. It was apparently understood, and correctly, that the specific nature of the corporate obligation was irrelevant. The important fact is that Gersten, by compulsion to pay Home Beautiful's taxes, in effect made an additional investment in the corporation. What was done on the corporation's behalf with that investment had nothing to do with Gersten's own tax treatment of the item. It lost its character as taxes.

Moreover, the Service's (and the court's) treatment of Robbins' conceded obligation to reimburse Gersten for his share of their joint liability is equally illuminating. The tax characterization of Robbins' share of the joint obligation which, if he had paid it himself, would have been an interest expense and a long-term capital

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[81] Id.

[82] *Gersten*, 28 T.C. at 769 (citing Arrowsmith v. Commissioner, 344 U.S. 6 (1952). In *Arrowsmith*, the Court held that a shareholder, who was liable as transferee and paid defunct corporation's judgment, was not entitled to ordinary loss treatment. Further, the payment of judgment was a capital loss, which related back to capital gain treatment enjoyed by shareholder in prior years upon receipt of the corporation's assets in liquidation).

[83] *Gersten*, 28 T.C. at 769. The Commissioner's original determinations were upheld despite the fact that the government had by then changed its mind, and argued on brief that nothing had been paid on Robbins' account, so that the entire payment (except interest) was a long-term capital loss under *Arrowsmith*. Id.

loss, were completely erased when Robbins' share of the obligation was viewed as a debt to Gersten.[84] Both Robbins' interest expense and his long term capital loss became from Gersten's point of view an undifferentiated bad debt, deductible under section 166(d) as a short-term loss.[85] If the same "erasure" principle were applied to *Haynes* and *Rude*, the tax character of the underlying joint liability would vanish as soon as the debt is viewed from the wife's point of view as a right to contribution from her ex-husband.[86] For purposes of deductibility under section 166(d), one debt is like any other.[87] The *Haynes* court distinguished *Gersten* in a single cryptic sentence:

> We find that case to be distinguished from this case based upon the conclusive fact that there, Gersten had *no* liability for the portion of an income tax of another paid by him which he sought to deduct as a worthless debt loss, while here the personal liability therefor of Mary and Frank's transferee liability is conceded.[88]

Despite the court's statement to the contrary, Gersten was without doubt personally liable for Robbins' share of the liability to Homes Beautiful. It is true that liability as a transferee is limited by the amount of assets which the transferee receives,[89] but to the extent of that amount, the liability is as personal as any other tax liability, and may be collected from any of the transferee's assets.[90]

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[84] See id. ("[S]uch portion of the payment as was made by Gersten on behalf of Robbins, and for which he had a claim against Robbins, was a nonbusiness bad debt . . . .").

[85] This observation is still true even under the Service's revised theory advanced at trial that the whole of Gersten's payment was for his own account. See id. at 769. Under this theory, the Service allowed Gersten an interest deduction of $1,261.63, including Robbins' share of the interest, and treated the balance of $3,460.47 as a long-term capital loss. Thus, the portion of the bad debt representing Robbins' share of the interest was recharacterized as interest the moment that the amount ceased to be the subject of a bad debt loss.

[86] To be sure, Gersten was entitled to some kind of deduction in any event, and the bad debt characterization merely converted one kind of deduction into another. But a worthless right to contribution can also convert an otherwise personal expenditure which is nondeductible altogether into a deductible bad debt. See infra note 109 and accompanying text.

[87] See I.R.C. § 166(d). See supra note 34 for the text of section 166(d).

[88] *Haynes*, 27 T.C.M. (CCH) at 1532.

[89] See Phillips v. Commissioner, 283 U.S. 589 (1931).

[90] Section 6901 provides, in pertinent part:

> TRANSFERRED ASSETS.
>
> (a) METHOD OF COLLECTION. - The amounts of the following liabilities shall . . . be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred:

Gersten's joint and several liability for the entire obligation was incontestable, as was his right to contribution from Robbins.[91]

It may be that the court was trying to assert that the nature of Gersten's liability was not that of a tax within the meaning of section 275, because Gersten's liability was that of a transferee, in contrast to Mary Haynes' liability as a taxpayer on a joint return. If so, the supposed distinction is untenable. Gersten had no initial liability for Homes Beautiful's income taxes because he was not the taxpayer who earned the income; he became liable for them only after the subsequent events of corporate dissolution and his receipt of sufficient corporate assets to pay the taxes rendered him a transferee. But Mary Haynes' situation is indistinguishable in this respect. She too was not initially liable for the taxes on her husband's income because she was not the taxpayer who earned it. It was only the subsequent event in the following year of electing to file jointly which rendered her liable; without that election, she would have had no liability at all. Nor will the voluntary nature of Mary's election and assumption of liability under section 6013(d) serve to explain any difference; Gersten's acceptance of corporate assets and the resulting assumption of transferee liability was no less voluntary.

III. An Uncollectible Right to Contribution as a Nonbusiness Bad Debt

A. *The Scope of Section 275*

1. *What is an Income Tax Under Section 275?*

The prohibition against deducting federal income taxes under section 275 extends to income taxes on income and gains from business, investment, and personal transactions alike.[92] The evident

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(1) INCOME, ESTATE, AND GIFT TAXES-

(A) TRANSFEREES: - The liability, at law or in equity, of a transferee of property -

(i) of a taxpayer in the case of a tax imposed by subtitle A (relating to income taxes).

I.R.C. § 6901.

[91] See Phillips-Jones Corp. v. Parmley, 302 U.S. 233, 236 (1937)(shareholder transferee who is compelled to pay more than his fair share of income taxes owed by corporation is entitled to contribution from the other shareholders under the general law and there is no need for the other shareholders to be assessed for the tax).

[92] See I.R.C. § 275(a)(1). See supra note 39 for the text of I.R.C. § 275.

reason for the rule is to simplify calculation of the tax. If taxes were deductible, they would reduce initial taxable income and yield a new, smaller tax. This amount in turn would also be deductible, reducing the tax again, and so on. A limit would be reached, to be sure, but the nuisance of such calculations is apparent. The problem is avoided by simply setting the tax rates at such levels initially as to yield the desired final amounts of tax, and denying any deduction therefor. If this explanation is correct, there is no policy reason to apply the prohibition of section 275 against anyone except the person whose tax liability is to be calculated under the tax tables.

There is little direct authority for a definition of what constitutes a federal income tax for the purpose of interpreting the ban on deductibility under section 275. It is clear, however, that in many situations mere liability for an income tax will not preclude a deduction. The critical factor is whether the payor is the person who earned the income which triggers the tax in the first instance, *viz.*, the person whose liability must be calculated under the tax tables.[93] An initial taxpayer is never permitted to deduct his taxes.[94] A derivative taxpayer may deduct the tax only if the reason for his derivative liability fits within a category of otherwise deductible items.[95] This second step requires an analysis of the relationship between the initial and the derivative taxpayers.

The most familiar example is perhaps the employer's liability for

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[93] The terms "initial taxpayer" and "initial liability" will be used here to refer to the person whose liability must be calculated under the tax tables, and "derivative liability" will refer to all other cases in which one person may be required to, or does pay the initial tax liability of another. These terms have been chosen in order to avoid confusion with the terms "primary liability" and "secondary liability", which usually signify an order of priority in collection. For example, in order for transferee liability to apply, it is necessary to show that the taxpayer who earned the income cannot pay the tax; that is, remedies must be exhausted against him first, and only then can liability be imposed "secondarily" against his transferee. On the other hand, for purposes of collection through joint and several liability on a joint return, there is no obligation on the part of the Service to proceed first against the husband who earned the income, and only then against the wife. Similarly, there is no obligation under § 3403 to proceed first against an employee who earned income, and only afterwards against his employer for failure to withhold or pay over withheld taxes. See infra note 96 and accompanying text. In practice, it may be the other way around.

In all these cases, the term "derivative" will be used to characterize the liability of a person required to pay taxes on income earned by someone else, whether or not the Service is entitled to proceed against the derivative taxpayer first.

[94] See id.

[95] See infra notes 96 to 103 and accompanying text.

withholding and paying over the income taxes of his employee under section 3403.[96] There has never been any question of the employer's right to deduct such amounts under section 162(a)(1) as a business expense for wages or salary. Although the employer is liable for the payment of the employee's withheld income taxes, the employer is nevertheless not the initial taxpayer with respect to them, and is acting merely as an involuntary collection agent. The reason the employer incurs the liability for withholding is that he makes payments of compensation. And it is the employer's reason for paying that compensation which determines deductibility: if the compensation is for services in the employer's trade or business, the compensation, including withheld taxes, is deductible.[97] If the services are for personal living expenses of the employer, however, such as for a personal housekeeper, tutor, or chauffeur, the compensation is nondeductible, including any taxes withheld under section 262.[98]

All this follows from a still more general principle that the characterization for federal tax purposes of any item of payment, both to the payor and the payee (or beneficiary, if the payment is an indirect one), depends exclusively upon the payor's reason for payment.[99] Some further examples will be instructive. If a corporation pays a shareholder's income taxes, the payment should be treated as a non-deductible dividend by the corporation on its own return, and as dividend income by the shareholder.[100] If a father pays a

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[96] See I.R.C. § 3403. Section 3403 provides, in pertinent part, "LIABILITY FOR TAX. The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment."

[97] See I.R.C. § 162(a)(1).

[98] Section 262 provides, in pertinent part, "PERSONAL, LIVING, AND FAMILY EXPENSES. Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

[99] This principle can be found exemplified in many areas of the tax law. See, e.g., United States v. Gilmore, 372 U.S. 39, 49, 52 (1963)(litigation costs of contesting divorce property settlement held not deductible expenses of defending title to investment property because "origin of the claim" was personal, arising out of marital relationship); I.R.C. §§ 163(d) and (h)(special limitations on deductibility of interest if paid for investment or personal reasons, respectively); I.R.C. §§ 7872(a) and (c)(imputed interest on below-market interest rate loans deemed as transferred from lender to borrower and tax character of deemed transfer as gift, dividend, compensation, or other character depends on relation of lender to borrower, i.e., on lender's reason for making the interest-free loan).

[100] See I.R.C. § 301.

son's income taxes (whether directly to him, or to the government), the amount will be treated as a nondeductible gift from the father and an excludable (tax-free) gift to the son.[101] If an ex-husband pays an ex-wife's income taxes pursuant to a divorce decree (and the other requirements of section 71(b) which define alimony are met), the amount would be treated as deductible alimony by the husband and includible (taxable) alimony by the wife.[102] If a buyer pays a seller's income taxes due to capital gains from the sale of the property, the amount would be capitalized into basis (and potentially depreciable) by the buyer as additional purchase price, and treated by the seller as an additional amount realized on the sale of the property.[103] It was under the same principle that Gersten's payment of his share of corporate income taxes as a transferee was properly treated as a long-term capital loss from an additional investment in the corporation.

One could multiply examples indefinitely, and the conclusion would always be the same: a derivative taxpayer's payment is never treated as the initial tax itself, because nobody except the initial taxpayer has any reason to pay the income tax *qua* income tax. There is always some other reason for payment, and it is that reason which is controlling.

2. *Was Rude's Payment a Tax Under Section 275?*

There are many reasons why the wife might pay the husband's income taxes on a joint return. The critical distinction, however, is between voluntary and involuntary payment. If the wife voluntarily overpays her share, the overpayment should be viewed analytically as a gift to her husband, and therefore nondeductible to her. Thus it should make no difference whether she gives him cash to pay his taxes, or pays his taxes directly to the Service.[104]

Why the wife is required to make involuntary payment of her husband's taxes through compulsion of section 6013(d)(3) presents a more difficult question. At first blush, the answer is that the wife is forced to make payment simply because section 6013(d)(3) em-

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[101] See I.R.C. § 102.

[102] Rev. Rul. 58-100, 1958-1 C.B. 31.

[103] See I.R.C. §§ 1001, 1012.

[104] The amount is clearly nondeductible by the husband in any event under I.R.C. § 275 because he is the initial taxpayer. See supra note 39 for text of I.R.C. § 275.

powers the Service to insist upon it.[105] The more relevant question, however, is why the wife chooses to file jointly, because it is only as a consequence of that decision that she assumes the liability.[106] It is the wife's reason for giving the guarantee (or quasi-guarantee) in the first place which is controlling.[107] The usual reason for the wife to make the guarantee (which is automatic upon filing jointly) is that her husband asked her to sign the return in order to reduce his taxes.[108] Sometimes, the reason is just convenience. If the wife earned no income in her own right, and filed a joint return solely as an accommodation to her husband, it seems clear that any resulting loss should be viewed as arising from a personal transaction. Even if the wife's principal purpose in filing jointly is to reduce her own share of taxes, however, a loss arising out of her assumption of liability is ultimately still personal in nature, because it arises out of the preparation of her personal tax return.[109] Thus the reason why the wife cannot deduct an involuntary payment of the husband's taxes in the first instance has nothing to do with section 275; it is nondeductible under section 165(c)[110] be-

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[105] See I.R.C. § 6013(d)(3). See supra note 1 for the text of § 6013(d)(3). Absent this provision, she would not become liable merely by filing a joint return. Before the enactment of § 6013(d), the government sought to impose joint and several liability without statutory authority, and lost in Cole v. Commissioner, 81 F.2d 485, 489 (9th Cir. 1935). The purpose of § 6013(d), the predecessor of which was first enacted in 1938, is obscure and should probably be regarded as simply a collection device enabling the government to hold each spouse liable as a sort of guarantor of the other's taxes. See also Beck, *Joint and Several Liability*, supra note 3.

[106] It may be safely assumed that in the vast majority of cases, however, the wife is not aware of that liability at the time of filing, and first learns of it only when her husband's taxes are assessed against her. See Beck, *Joint and Several Liability*, supra note 3.

[107] See United States v. Generes, 405 U.S. 93, 94 (1972)(whether taxpayer's losses from payments on loan guarantees are entitled to business or nonbusiness bad debt treatment depends on taxpayer's dominant motive in giving the guarantee).

[108] See Beck, *Joint and Several Liability*, supra note 3.

[109] It is in any event not a transaction entered into for profit. If the sole motive of a transaction is tax reduction, this negates a profit motive, and any resulting losses are nondeductible under § 165(c). See I.R.C. § 165(c). See Fox v. Commissioner, 82 T.C. 1001, 1019 (1984)(tax straddle using over-the-counter options on U.S. Treasury bills).

[110] Section 165 provides, in pertinent part:

> LOSSES (a) General Rule.- There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. . . .
>
> (c) Limitation on losses of individuals.- In the case of an individual, the deduction under subsection (a) shall be limited to-
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

cause it is a personal loss, and not because it is a payment of tax.

As a matter of substance, the wife's payment in *Rude* is a payment on a guarantee of her husband's income taxes rather than on her own income tax.[111] As a formal or technical matter, the conclusion must be the same. The literal language of section 6013(d) says only that "the liability for the tax shall be joint and several."[112] This language cannot meaningfully distinguish liability under section 6013(d) from (for example) an employer's "liability for the payment of such tax" as is required to be withheld from his employee under section 3403, which liability is unquestionably outside the reach of section 275.[113]

If the wife's payment of her husband's taxes in *Rude* was not a tax payment at all for purposes of section 275, the *Rude* court's reasoning was seriously defective. The Service could have maintained an analogous argument based on the nondeductibility of the wife's payment under section 165(c); *viz.* that such a personal loss should not be allowed to form the basis of a bad debt deduction, lest a loss prohibited under section 165(c) be indirectly permitted under section 166(d). But the argument would probably not have been successful, because there was clear authority to the contrary in the case law. In *Martin v. Commissioner*,[114] the Tax Court held that a worthless right to reimbursement for payments which are otherwise nondeductible personal losses will nevertheless support a bad debt deduction.[115]

> (3) . . . losses of property. . . if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

I.R.C. § 165.

[111] The innocent spouse rules under § 6013(e) tacitly acknowledge that the argument as to substance is correct. These rules exonerate the wife from liability for her husband's taxes on a joint return if, among other things, she did not know of, and had no reason to know of, her husband's grossly erroneous tax items, and if she did not substantially benefit from them. See I.R.C. § 6013(e). It is quite clear that a taxpayer can never avoid liability for his own initial taxes just because he is not aware that he has earned an item of income, or because he has not benefitted from the item.

The right to contribution itself is also predicated on the assumption that the tax is not the wife's. See supra notes 106 to 110 and accompanying text. The right arises only when the wife is forced to pay the husband's share of the tax. See Phillips-Jones Corp. v. Parmley, 302 U.S. 233, 236 (1937).

[112] See supra note 1.

[113] See supra notes 92 to 103 and accompanying text.

[114] 38 T.C. 188 (1962), acq. 1963 C.B. 4.

[115] Id. In *Martin*, the taxpayer was compelled to pay materialman liens on his personal residence in order to prevent a foreclosure sale of his home. The liens were for obligations of

Thus, even if the husband's taxes could somehow be regarded as the wife's own taxes for purposes of section 275, the *Rude* and *Haynes* decisions would still be in error, because the tax or other character of the underlying obligation is erased as soon as it is regarded as a bad debt.[116] Therefore, no matter whether the wife's involuntary payment is nondeductible under section 275 as an initial matter, or under section 165(c), her right to reimbursement of such payment should still be allowable as a bad debt deduction when it becomes worthless.

B. *Bad Debts and Nondeductible Items*

It has always been the law that for purposes of the bad debt deduction it does not matter what use the borrower makes of the funds.[117] It follows that the borrower could use the borrowed funds for a purpose which is nondeductible both to him and to the lender, and if the debt became uncollectible, there would be no bar to the deduction under section 166.[118] The wife could therefore loan the husband funds with which he pays nondeductible family living expenses, or income taxes,[119] and if the loan is *bona fide*,[120] a

the building contractor to the materialmen, and the taxpayer was subrogated to the materialmen's claims against the building contractor, who was bankrupt. The Service argued that the taxpayer's payments to the materialmen were personal losses incurred in the course of construction of his residence, and were therefore nondeductible under § 165(c) or any other provision of the Code. The Tax Court allowed a bad debt deduction for the taxpayer's worthless right to reimbursement from the contractor; it made no difference that the payments to the materialmen, absent the right to subrogation, would have been nondeductible personal expenditures. Id. at 190-92.

[116] See supra notes 72 to 87 and accompanying text.

[117] Treas. Reg. § 1.166-5(b)(2). The regulation states, in pertinent part, "The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph."

The "paragraph" is concerned with distinguishing business debts, which are deductible in full as ordinary losses, from nonbusiness debts, which are deductible only as short-term capital losses. See id.

[118] But see infra notes 173 to 193 and accompanying text.

[119] Even the wife's own share of the income taxes would become deductible. See infra notes 122 to 136 and accompanying text.

[120] See Treas. Reg. § 1.166-1(c). Loans between family members must be strictly scrutinized to screen out disguised gifts. There must be a genuine intention to create an enforceable debtor-creditor relationship. This requirement prevents abuse of the provision in the example given in the text because if the true intent is to avoid taxes by expecting the husband to default, there is no expectation of repayment, and no bad debt deduction is allowable. This is obviously not an issue in the *Rude* situation because the wife's payment is involuntary.

bad debt deduction presumably would be allowable when it becomes worthless. There is no economic difference between such a transaction and the situation in *Rude*. The only difference of substance is that in *Rude* the "loan" arises involuntarily by enforcement of joint return liability, which in turn creates the husband's obligation by operation of law. Transactions which are identical in economic substance should not be taxed differently.[121]

C. *Clark v. Commissioner*

The *Rude* decision was inconsistent with another, and entirely different line of cases beginning with *Clark v. Commissioner*.[122] In *Clark*, the taxpayer needlessly overpaid his taxes due to his tax attorney's mistake, and the issue was whether the tax attorney's reimbursement of funds was gross income to the taxpayer.[123] Coincidentally, the tax lawyer's error involved the Clarks' election to file a joint return.[124] The tax lawyer deducted from income in full on Clark's 1932 joint return certain losses sustained from assets held for more than two years, without applying the limitations on deductibility then in effect under section 101(b) of the Revenue Act of 1932.[125] If the Clarks had filed separately, their taxes would have been $19,941.10 less than the amount finally assessed and paid.[126] Then, as now, the election to file jointly, once made, cannot be revoked, so there was no way to amend and file separately

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[121] See Putnam v. Commissioner, 352 U.S. 82 (1956). The Supreme Court allowed a bad debt loss, rather than an ordinary loss from a transaction entered into for profit, to a shareholder guarantor of a corporate obligation. Id. at 87. The holding was grounded in the Court's belief that there should be no difference in tax treatment depending on whether the taxpayer made a direct loan to the corporation, or guaranteed the corporation's debt. Id. at 92.

[122] 40 B.T.A. 333 (1939), nonacq., 1939-2 C.B. 45. The Treasury published a revenue ruling using the facts of *Clark* and approving the *Clark* decision, whereby it also revoked its earlier nonacquiescence in *Clark*. See Rev. Rul. 57-47, 1957-1 C.B. 23 (revoking the earlier nonacquiescence).

[123] *Clark*, 40 B.T.A. at 333-34.

[124] Id. at 334.

[125] Id. Section 101(b) of the Revenue Act of 1932 is analogous to the current restrictions under section 1211(b). Compare id. with I.R.C. § 1211(b).

[126] Id. The facts do not disclose how much income each of the Clarks earned individually, but the wife presumably earned some substantial amount in her own right, so that when the disallowed losses were added to the couple's other aggregate income, their taxes were pushed up into a higher bracket than if they had filed separately.

Income-splitting on joint returns was not enacted until 1948; and so, for the year in question, 1932, there was only one rate structure no matter which filing status was elected.

to apply for the appropriate refunds.[127]

The tax lawyer acknowledged his error, and in 1934 he voluntarily reimbursed Clark the amount of $19,941.10.[128] The Commissioner insisted on including this amount in Clark's income for 1934 on the authority of *Old Colony Trust Co. v. Commissioner.*[129] The Board of Tax Appeals held that the tax attorney's payment was not an indirect payment of the taxpayer's federal income taxes, which would have been gross income to him under *Old Colony Trust*, but was in essence damages for a loss caused by the tax lawyer's negligence.[130] Such damages did not make Clark economically wealthier than before the injury, but merely compensated him for his loss and made him whole again.[131] The damages were therefore treated as a tax-free return of capital.[132] It is well established that awards of damages are taxable only if the amounts in lieu of which the damages are awarded would have been taxable income.[133]

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[127] See Treas. Reg. § 1.6013-1(a)(1).

[128] *Clark*, 40 B.T.A. at 334.

[129] Id. at 334-35 (citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929)(Employer's payment of employee's income taxes was additional income to employee.)).

Note, however, that the only reason the payment of the employee's taxes was income to the taxpayer in *Old Colony* was that the payment was in effect compensation for services. See id. The result in *Old Colony* would have been the same if the corporation had paid any other debt of the taxpayer employee.

[130] *Clark*, 40 B.T.A. at 335. The tax lawyer was undoubtedly entitled to a deduction for a loss sustained in the course of his trade or business of practicing law because he was in essence paying damages caused by his malpractice. He had no motive to pay Clark's taxes as such. As always, it is the payor's purpose in making payment which controls the tax treatment of any item both for payor and payee. See supra note 107 and accompanying text.

[131] The court also noted that the loss had not been deducted in any prior year, so that no tax benefit argument precluded tax-free exclusion of the amount in 1934. *Clark*, 40 B.T.A. at 335. If Clark had already deducted the amount in a prior year, which he could not do because it was his own initial income tax, he would have had no basis in the debt, and no deduction would have been allowable. See supra note 58 and accompanying text.

[132] Note here that the extra $19,941.10 represented taxes owed by the Clarks (considered together) as initial taxpayers, not derivatively. It would have made no difference, as cases subsequent to *Clark* were to show, if Clark had been an individual taxpayer filing separately, and the tax counsel's irremediable error had been of a different point of tax law. See, e.g., Gen. Couns. Mem. 37697 (Sept 29, 1978). See also infra notes 152 to 154 and accompanying text.

[133] Thus, damages in lieu of lost business profits are taxable, but damages in lieu of destroyed goodwill, a capital asset, are tax-free, at least to the extent of cost basis. See Raytheon Production Corporation v. Commissioner, 144 F.2d 110 (1st Cir.), cert. denied. 323 U.S. 799 (1944). Antitrust damages for lost profits are income, but damages for destruction of goodwill are nontaxable return of capital to the extent of cost basis, and thereafter taxa-

The *Clark* case presents the same problem as *Rude*, but considered from another angle. If the tax lawyer had been insolvent and could not pay the acknowledged debt, the *Rude* situation would have arisen. But under the *Clark* court's reasoning, Clark's worthless right to reimbursement would have supported a bad debt deduction. The deduction would have been allowed because the *Clark* court stated quite specifically that the tax lawyer's payment was not paid *qua* taxes, but by way of reimbursement for a loss of capital. Thus the tax lawyer's debt was the restoration of Clark's capital, which is simply another way of saying that Clark had a basis in the reimbursement.

The debt in *Rude* was exactly analogous. Ultimately, the right to contribution arose in *Rude* because the husband failed to pay his share of the joint taxes, and so breached a duty to his wife.[134] In both *Clark* and *Rude*, the taxpayer was forced to pay taxes needlessly because of another person's breach of duty, and in both cases an obligation arose to make good the loss.

Under the *Clark* analysis, if the husband in *Rude* had honored his obligation of contribution, the reimbursement would not have been treated as a payment of the wife's tax obligation, but rather as a tax-free replacement of her capital.[135] It follows that if the same right to a return of her capital becomes worthless, deduction of that amount as a bad debt cannot be disallowed by regarding it as a deduction of a federal income tax.[136] There is no reason to treat the character of the husband's obligation any differently depending solely on whether it is paid or unpaid.

D. *Subsequent Developments Supporting the Deduction*

1. *Administrative Rulings*

Only one year after the *Haynes* decision, the Service in effect conceded the *Rude* issue altogether, in Revenue Ruling 69-411.[137] The issue there involved deductibility of the estate tax as a bad

ble gain. Id. at 113-14.

[134] See supra notes 35 to 36 and accompanying text.

[135] There are no reported cases in which the Service has claimed that where the wife succeeds in obtaining contribution from her husband, the reimbursement should be treated as an item of income to her.

[136] See supra notes 111 to 121 and accompanying text.

[137] 1969-2 C.B. 177.

debt.[138] In Revenue Ruling 69-411, the executor of a decedent's estate was unable to enforce his right under section 2206[139] to collect the share of estate tax owed to him by B, the named beneficiary of a life insurance policy on the decedent's life, because B had squandered the insurance proceeds and was insolvent.[140] As a result, A, the beneficiary who received all the probate property under the decedent's will, was forced to pay the entire estate tax, including B's share.[141] This was because each person receiving property from the decedent that is included in the gross estate is personally liable under section 6324,[142] to the extent of the value of such property at the date of the decedent's death, for any unpaid tax. The ruling concluded that A was entitled to a bad debt deduction for the amount of tax A was forced to pay on B's behalf:

> In the situation described, the payment of the Federal estate tax attributable to the inheritance of B out of property inherited by A entitled A to be subrogated to the executor's claim against B who then, by operation of law, became a creditor of B. Accordingly, A is entitled to a bad debt deduction under the provisions of section 166(d)(1) of the Code in the year he acquired the debt, which was also the year it became worthless.
>
> The fact that there was never any reasonable possibility of A being reimbursed by B for the payment is irrelevant in considering the deductibility of the amount inasmuch as the debtor-creditor

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[138] Id.

[139] Section 2206 provides, in pertinent part:

> Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate.

See I.R.C. § 2206.

[140] See Rev. Rul. 69-411, 1962-2 C.B. at 177.

[141] Id.

[142] Section 6324(a) provides, in pertinent part:

> (1) Upon gross estate. — Unless the estate tax imposed by chapter 11 is sooner paid in full, or becomes unenforceable by reason of lapse of time, it shall be a lien upon the gross estate of the decedent for 10 years . . .
>
> (2) Liability of transferees and others. — If the estate tax imposed by chapter 11 is not paid when due, then the . . . beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. . . .

I.R.C. § 6324(a).

relationship between A and B arose involuntarily on the part of A. See *Martin v. Commissioner*, 38 T.C. 188 (1962), acquiescence, C.B. 1963-1, 4.[143]

There is no question that A's own share of the estate tax is nondeductible for income tax purposes under section 275(a)(3),[144] and that A's payment of B's share is also nondeductible as such when A paid it.[145] Thus A's right to contribution from B for the very same amount converted a nondeductible tax[146] into a deductible bad debt. This is identical to the *Rude* situation in all relevant respects.[147] With its analysis in Revenue Ruling 69-411, the Service in effect reversed its stand in *Rude*. The *Rude* issue has not been relitigated since publication of Revenue Ruling 69-411, but if it were to be relitigated, the ruling would be strong authority for reversal of the decisions in *Rude* and *Haynes*.

Other developments since the *Rude* and *Haynes* decisions only confirm the above analysis. On the issue of includibility of reimbursements of taxes, the Service recently confirmed the continuing validity of *Clark* in General Counsel Memorandum (GCM) 39697.[148] There the issue was whether amounts received in settle-

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[143] Rev. Rul. 69-411, 1962-2 C.B.at 177.

[144] See, e.g., Rippey v. Commissioner, 25 T.C. 916 (1956) (beneficiary of a testamentary trust who reimbursed executor of estate pursuant to agreement whereby executor paid federal estate tax could not deduct the reimbursement as business expense, because such reimbursement constituted a nondeductible payment of the federal estate tax). Id. at 919-20.

[145] See L.B. Foster Co. v. United States, 248 F.2d 389 (3d Cir. 1957). In *Foster*, the corporate beneficiary of life insurance proceeds under a shareholder buy-sell agreement, who was charged with estate tax liability under § 826(c) of the Internal Revenue Code of 1939 (predecessor of § 2206 of the current Code), could not deduct his payment to the executor under an agreement with the executor to share final estate tax liability, even where the Commissioner ultimately withdrew his contention that the life insurance proceeds in question were includible in decedent's estate. Id. at 393.

[146] Note that A's payment might have been regarded as a nondeductible personal loss, or a nondeductible expense of receiving tax-free insurance proceeds, rather than a nondeductible tax. See notes 107 to 112 and accompanying text, regarding the payment in *Rude*.

[147] See Rev. Rul. 69-411, 1969-2 C.B. at 178 (citing Martin v. Commissioner, 38 T.C. 188 (1962). By using this authority, the ruling perhaps indicates awareness that A's payment might be a nondeductible personal loss rather than a nondeductible tax payment. However, either interpretation would contradict the *Rude* decision. The ruling did not cite *Rude*.

In *Martin*, a loss incurred in the course of construction of the taxpayer's residence, which was therefore an expenditure which was otherwise nondeductible as a personal loss under § 165(c), was rendered deductible nevertheless in its character as a bad debt. See 38 T.C. at 192.

[148] See Gen. Couns. Mem. 39,697 (Aug. 19, 1987), I.R.S. Positions (CCH) P 2009, p. 6937 (Jan. 27, 1988).

ment of a contractual claim were gross income, where the claim was for reimbursement of additional taxes incurred by breach of contractual assurances, or misrepresentation, that certain Puerto Rican mortgage certificates were eligible for favorable tax treatment under section 936.[149] The Service concluded that the amounts were a return of capital measured by the tax loss, and not a payment of tax.[150] Nor did it matter that reimbursement was for taxes properly owed, rather than for erroneous advice causing taxes to be owed needlessly, as in *Clark*.[151]

In GCM 37697,[152] the Service concluded that even a penalty under section 6654[153] incurred due to a tax preparer's mistake was not income to the taxpayer when paid directly to the Service by the preparer. The summary of GCM 37697 provided in GCM 39697 is worth quoting in full:

> In . . . GCM 37697, . . . we considered whether payment of a penalty under section 6654 by a tax return preparer was a discharge of the taxpayer's indebtedness so as to cause the amounts to be included in the taxpayer's gross income. In a letter dated September 8, 1977, PLR 7749029 had concluded, on similar facts, that payment of the penalty by the party doing the damage was not a return of capital. The letter distinguished Clark and Rev. Rul. 57-47 because, in the case under consideration, the preparer paid an addition to the tax under section 6654, an amount in the nature of a penalty for which the taxpayer was directly responsible. Upon considering the issue, GCM 37697 concluded that the distinctions did not warrant differing treatment. The fact that the tax preparer's error resulted in a penalty assessment rather than a tax does not negate the fact that, but for the error, the taxpayer would not have been burdened with the additional debt.[154]

2. *Litigation*

Recent litigation over the issue of a bad debt deduction similarly confirms the "erasure" principle that the tax or other nondeductible character of the underlying obligation does not bar deduction

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[149] Id. at 6938.
[150] Id. at 6940.
[151] Id. at 6939.
[152] Gen. Couns. Mem. 37,697 (Sept. 29, 1978).
[153] Section 6654 imposes a penalty for failure to pay one's individual estimated tax.
[154] Gen. Couns. Mem. 39697, at 6940.

under section 166. In *First National Bank of Duncanville v. United States*,[155] it was held that a pre-existing contractual right to contribution or indemnity converts an otherwise nondeductible tax penalty into a deductible bad debt.[156] There the taxpayer bank financed a construction company which ran into difficulties, leading the bank to decide to participate directly in managing the debtor's payroll obligations for 1972.[157] The Service assessed a 100% penalty under section 6672,[158] and in 1974, the bank paid $34,738.18 in complete satisfaction of that liability.[159] The bank deducted the same amount on its 1974 tax return as a bad debt, based upon its security agreement requiring the debtor to reimburse the bank for all costs of preserving its collateral, including taxes and assessments.[160] The Service disallowed the deduction on the ground that it would frustrate an alleged public policy which prohibits deduction of such tax penalties, and would violate the intent of section 162(f).[161]

The court held that a valid debt was created by the indemnification provisions of the bank's security agreement, and that no public policy would be frustrated by allowing the bad debt deduction.[162] The court noted that for the doctrine of frustration of public policy to prevent an otherwise allowable deduction to be taken requires that "*such deduction would severely and immediately frustrate a sharply defined national policy*,"[163] citing *Tank Truck Rentals v. Commissioner*,[164] and *Commissioner v. Tellier*.[165]

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[155] 481 F. Supp. 633 (N.D. Tex. 1979).

[156] See id. at 637-38.

[157] Id. at 634-35.

[158] Section 6672(a) provides, in pertinent part:

> GENERAL RULE. Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

I.R.C. § 6672(a).

[159] See *First Nat'l Bank of Duncanville*, 481 F. Supp. at 635.

[160] Id.

[161] Id. at 636. See I.R.C. § 162(f) which provides, "FINES AND PENALTIES. No deduction shall be allowed for any fine or similar penalty paid to a government for the violation of any law."

[162] *First Nat'l Bank of Duncanville*, 481 F. Supp. at 638.

[163] Id. (emphasis in original).

[164] 356 U.S. 30 (1958)(to allow deduction of fine imposed for violation of maximum weight

The court balanced the policy of deterring willful failure to pay taxes against an equally strong national policy in favor of lenders not foreclosing immediately on delinquent accounts.[166] Finally, the court noted that the Service could have collected the same tax under section 3505(a),[167] which was specifically enacted in order to enable the Service to proceed against lenders in just the taxpayer's situation. That provision, however, is not designated as a penalty.[168] The court refused to allow the Service to invoke a "sharply defined public policy" through a mere election of remedies, one of which is labeled a penalty, and the other a simple liability.[169]

Returning to the *Rude* situation, there is no question that the right to contribution creates a valid and enforceable debt, nor any question that the debt, if worthless, would support a deduction under section 166(d) but for the government's argument that the deduction would undermine the section 275 prohibition against deducting income taxes. Neither section 275 nor section 165(c) rests upon any "sharply defined public policy" which the bad debt deduction would "severely and immediately frustrate." These provisions are simply the basic structural rules of the tax law. There is no issue of deterring wrongdoers; the only issue is whether a tax is owed.

Even if some public policy were invoked against the deduction, it should still be balanced against other policy considerations, as in

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laws would take the "sting" out of the penalty).

[165] 383 U.S. 687 (1966)(legal fees expended to defend against Securities Act charges held deductible because they would not frustrate sharply defined public policy).

[166] *First Nat'l Bank of Duncanville*, 481 F. Supp. at 638.

[167] Section 3505(a) provides:

> DIRECT PAYMENT BY THIRD PARTIES.- For purposes of sections 3102, 3202, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, . . . such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

I.R.C. §3505(a).

[168] *First Nat'l Bank of Duncanville*, 481 F. Supp. at 639.

[169] Id. at 639. The existence of the security agreement in *Duncanville* distinguishes that case from Arrigoni v. Commissioner, 73 T.C. 792 (1980), in which the taxpayer, an individual, was prohibited from deducting amounts he paid under § 6672 for his insolvent corporation's tax liabilities. The Tax Court found that the taxpayer had no right to contribution or indemnity from the corporation, either by contract or by operation of law, and that therefore *Duncanville* did not apply. No valid debt supported the deduction. See id. at 800-01.

Duncanville. But the equities are all on the side of the taxpayer. As the *Haynes* court admitted, the taxpayer in question had an appealing case from an equity standpoint.[170] It hardly needs pointing out that there is no public policy reason for collecting a husband's taxes from his ex-wife in the first place. The only reason for such collections is that the statute, unfortunately, allows them.

E. Regulatory and Statutory Changes Since Rude

There are two potential obstacles to the bad debt deduction under current law, and ironically, neither was in existence at the time of the *Rude* and *Haynes* litigation. These are section 1.166-9 of the Treasury Regulations, introduced in 1979,[171] and section 1041 of the Code, enacted in 1984.[172] Neither should prevent the bad debt deduction in *Rude*-type situations, but a long detour will now be required to assess the potential applicability of the new rules.

1. Loan Guarantees

Section 1.166-9 of the Treasury Regulations requires that bad debts from losses of a guarantor, endorser, indemnitor (or other secondary obligor) must result from an agreement entered into either in the course of business or for profit in order to be deductible.[173] Also, the guarantor must receive reasonable consideration for entering into the agreement, and in the case of husbands and wives, such consideration must be paid directly in the form of money or other property.[174]

These new regulations should not prevent deduction of a worthless right to contribution in *Rude*-type situations for two reasons. First, the regulations are themselves of doubtful validity; and second, the right to contribution does not appear to be a "guarantee" within the meaning of the regulations.

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[170] 27 T.C.M. (CCH) 1531, 1532 (1968).

[171] T.D. 7657, 1980-1 C.B. 48, amended by T.D. 7747, 1981-1 C.B. 141 and T.D. 7920, 1983-2 C.B. 69.

[172] Section 1041 was enacted as part of the Tax Reform Act of 1984, Pub. L. No. 98-369, Div. A, Title IV, § 421(a), 98 Stat. 793 (1984), amended by Pub. L. No. 99-514, Title XVIII, § 1842(b), 100 Stat. 2853 (1986).

[173] See Treas. Reg. § 1.166-9(d)(1).

[174] Treas. Reg. § 1.166-9(e).

The regulations are derived from a section of the General Explanation of the Tax Reform Act of 1976 which explained the repeal of former section 166(f).[175] That provision permitted a business bad debt deduction, rather than nonbusiness bad debt treatment, for individual taxpayers who guaranteed debts of an individual who used the proceeds in his trade or business.[176] Former section 166(f) reintroduced a disparity in tax treatment between direct loans and guarantees which had earlier been set to rest by the Supreme Court in *Putnam v. Commissioner*.[177]

The General Explanation states that the reason for repeal of former section 166(f) was to restore parity of treatment between direct loans and guarantees, so that if an individual is restricted to nonbusiness bad debt treatment for a direct loan (because the loan does not arise out of the lender's own trade or business), he will be accorded the same treatment if he suffers a loss on a guarantee of a loan for the same purpose.[178]

The General Explanation then goes on to an entirely different subject, and introduces the rules which were subsequently promulgated in section 1.166-9 of the Treasury Regulations:

> Also, in the case of a guaranty agreement which is not entered into as part of the guarantor's trade or business, or as a transaction entered into for profit, no deduction is to be available in the event of a payment under the guarantee.
>
> Generally, in the case of a direct loan, the transaction is entered into for profit by the lender, who hopes to realize interest on the loan. However, this may not be true in the case of loans made between friends or family members, and in these cases the Internal Revenue Service will generally treat any loss resulting from such a "loan" as a gift, with respect to which no bad debt deduction is available. (Reg. sec. 1.166-1(c)).
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> In the case of a guaranty agreement, however, it is not always easy to tell whether the transaction has been entered into for profit on the part of the guarantor. It is not uncommon for guaranty

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[175] See H.R. 10612, 94th Cong. 2d Sess., reprinted in 1976-3 (vol. 2) C.B., General Explanation of the Tax Reform Act of 1976, at 168-70 [hereinafter General Explanation].

[176] Former § 166(f) was without discernable rationale, and was apparently enacted as an ad hoc favor "reportedly designed to meet the problems of a Texas father who had made advances to his son's business." See Surrey, *The Congress and the Tax Lobbyist -How Special Tax Provisions Get Enacted*, 70 Harvard L.Rev. 1145, 1149 n.4 (1957).

[177] See 352 U.S. 82 (1956).

[178] See *General Explanation*, supra note 175 at 168-70.

> agreements to provide for no direct consideration to be paid to the guarantor. Often this may be because the guarantor is receiving indirect consideration in the form of improved business relationships. On the other hand, many other guaranties are given without consideration as a matter of accommodation to friends and relatives.
>
> The Congress believes that a bad debt deduction should be available in the case of a guaranty related to the taxpayer's trade or business, or a guaranty transaction entered into for profit. However, no deduction should available for a "gift" type of situation. Thus, the Congress intends that for years beginning in 1976 (in the case of guaranties made after 1975) and thereafter, the burden of substantiation is to be on the guarantor, and that no deduction is to be available unless the guaranty is entered [sic] as part of the guarantor's trade or business, or unless the transaction has been entered into for profit, as evidenced by the fact that the guarantor can demonstrate that he has received reasonable consideration for giving the guaranty. For this purpose, consideration could include indirect consideration; thus, where the taxpayer can substantiate that a guaranty was given in accordance with normal business practice, or for *bona fide* business purposes, the taxpayer would be entitled to his deduction even if he received no direct monetary consideration for giving the guaranty. On the other hand, a father guaranteeing a loan for his son would ordinarily not be entitled to a deduction even if he received nominal consideration for giving the guaranty.[179]

No statutory change was enacted to give effect to the above rules, despite the fact that they reverse established case law.[180] Moreover, the rules announced have little or nothing to do with repeal of former section 166(f), which was purportedly being explained, and are actually inconsistent with its purpose. Repeal of former section 166(f) was designed to eliminate a disparity of

[179] Id. at 169-70.

[180] See, e.g., Ortiz v. Commissioner, 42 B.T.A. 173, 186-88 (1940), acq. on this point 1940-2 C.B. 6, nonacq. on other issues 1940-2 C.B. 13, rev'd. on other grounds sub nom., Helvering v. Wilmington Trust Co., 124 F.2d 156 (3d Cir. 1941), rev'd on other grounds 316 U.S. 164 (1942)(taxpayer guaranteed her husband's stock brokerage accounts without expectation of loss, and when ultimately compelled to pay under the guarantee, she collected partial reimbursement from husband to the extent of his assets; held, no gift was intended, and the bad debt deduction was allowed). No fee or other consideration was apparently received for providing the guaranty. See id. at 180.

treatment between direct loans and loan guarantees,[181] but the announced rules create a new disparity of exactly the same kind. For example, a father making a *bona fide* nongift direct loan to his son would apparently still be entitled to a nonbusiness bad debt deduction upon its becoming worthless, but a loss on the father's guarantee of a bank loan for the same purpose would be nondeductible.

The validity of section 1.166-9 of the Regulations has not yet been litigated. The weight of learned commentary is that the regulations go beyond statutory authority.[182] Section 1.166-9 appears to be vulnerable on the same ground as were the temporary regulations governing the treatment of wrap-around mortgages for purposes of the installment sales rules under section 453. The temporary regulations were invalidated in a recent Tax Court decision on the ground that the issues addressed in the regulations, which were published purportedly to interpret amendments made by the Installment Sales Act of 1980, were not in fact revised by that Act.[183] The temporary regulations had the effect of repealing longstanding case law without any statutory amendment as authority for the change.[184]

Whatever may be the validity of the new regulations, however, it

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[181] This is true unless the authors of the General Explanation intended to disallow losses from all intra-family direct loans as gifts as well, which would go still farther beyond any actual statutory authority, and would reverse longstanding case law to the contrary. See, e.g., Rodgers v. Commissioner, 49 T.C.M. (CCH) 1434, 1438 (1985)(wife overcame presumption that intrafamily transfers were gifts in 3 out of 5 advances to husband supported by written promissory notes).

The question whether an interest-free loan between family members would support a bad debt deduction if it were uncollectible has apparently not been litigated. This litigation would squarely pose the question whether a profit-motive is required under § 166(d) because the interest on an interest-bearing loan is always regarded as profit. However, if the interest-free loan were valid and enforceable, nothing in the current Code or Regulations would appear to prevent the bad debt deduction under such circumstances.

[182] See Bad Debts, Tax Mgmt. (BNA) Portfolio 19-7th, A-9 (1989); See also 2 B. Bittker, Federal Taxation of Income, Estates, and Gifts ¶ 33.7.1 (1981); Fleming, Has the 1976 Tax Reform Act Injected a Gain-Seeking Requirement into Section 166?, 55 Taxes 686 (1977)(discussing possible interpretations of Congressional actions with respect to § 166 and noting that some interpretations seem to overturn settled caselaw).

[183] See Professional Equities Inc. v. Commissioner, 89 T.C. 165, 180 (1988).

[184] See id. at 174, 180. (Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) purportedly implementing amendments to § 453 of the Code enacted by the Installment Sales Act of 1980 was invalid because the Act did not revise the issues addressed in the regulations, and the regulations reversed longstanding caselaw of Stonecrest Corp. v. Commissioner, 24 T.C. 659 (1955), and its progeny which had at least tacit approval of Congress).

does not appear that the wife's right to contribution in the *Rude* situation should be considered a "guarantee" within the meaning of the regulations or the above-quoted General Explanation. In the first place, the regulations indicate that only secondary liabilities are meant to be covered by the new rules.[185] For this purpose, "secondary" liability appears to have its usual meaning of a liability which arises only after the primary obligor's default.[186] The wife's joint and several liability on a joint return is not of this kind, since she can be called upon to pay the husband's taxes before any demand is made upon the husband, even if it is obvious that the husband can pay. She is, as the Service has often insisted in other contexts, primarily liable.[187]

It seems clear on other grounds as well that the wife's joint return liability is not the sort of obligation envisaged. The Treasury's intent underlying the new rules was expressly to strengthen the government's defenses against deductions for loan transactions which are essentially intended to be gifts.[188] The guarantees contemplated seem to be ones which are deliberately given, and for which an equally deliberate direct loan would be an effective alternative.[189] But none of this seems applicable to the *Rude* situation. At the time of joint filing, neither spouse is borrowing anything. The "loan" upon which the wife's bad debt rests is quite involuntary, and arises only when the wife is required to make payment under section 6013(d). Thus the wife's "quasi-guarantee" under section 6013(d) can never be a substitute for a gift loan.

It seems implausible for other reasons as well to consider the wife's election and promise of joint liability as a gift. It may be that the wife's election to file jointly is often a matter of accommodation to her husband, but it is not without consideration. The

[185] See Treas. Reg. § 1.166-9(b). The section governs worthless nonbusiness debts and applies to taxpayers who "act as (or in a manner essentially equivalent to) a guarantor endorser, or indemnitor of (or other secondary obligor upon) a debt obligation." See id.

[186] Black's Law Dictionary 1212 (5th ed. 1979) defines "secondary liability" as "a liability which does not attach until or except upon the fulfillment of certain conditions; as that of a surety, or that of an accommodation endorser."

[187] See, e.g., Cohen v. Commissioner, 54 T.C.M. (CCH) 944, 947 (1987)(wife assessed for husband's taxes under § 6013(d) and denied innocent spouse status; to wife's complaint that the husband was solvent and present in court but had not been assessed, the court cited her right to contribution from him).

[188] See supra note 171 and accompanying text.

[189] See id.

election is in effect a mutual promise, because each spouse guarantees to pay the other's taxes. The wife's promise is therefore not a gift at the time of filing, but is given in exchange for the husband's promise. The husband's promise has value to her even if the wife reports no income, because the Service may later assert a deficiency for income attributable to her that the husband is not aware of at the time of filing, and he will be liable for the deficiency. It is obvious that viewed as of the time of enforcement, the (ex-) wife's involuntary payment pursuant to section 6013(d) is anything but a gift.

The General Explanation and the regulations do not require that the guarantor receive consideration if the guarantee is given in accord with "normal business practice."[190] It is certainly normal practice[191] to file jointly; 99% of married taxpayers do so.[192] It is for the government's benefit as well as the taxpayers', because the government is relieved of the chore of processing millions of additional tax returns. Congress has actively promoted joint filing by making the tax benefits of the election an offer too good to refuse.[193] It should be concluded that the quasi-guarantee of section 6013(d) in the *Rude* situation is outside the reach of section 1.166-9 both as to the letter and the spirit.

2. *Nonapplication of Section 1041*

Section 1041 was designed in large measure to reverse the result in *United States v. Davis*,[194] which required the taxpayer to be taxed as if he made a sale or exchange when he transferred appreciated stock to his wife as part of a property settlement incident to divorce.[195] The reach of section 1041 is broader than that however. On its face, the provision requires any transfer of property to a

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[190] See id., Treas. Reg. § 1.166-9(d)(1).

[191] It may not be normal *business* practice to file jointly, but *c.f.* Martin v. Commissioner, 38 T.C. 188 (1962), where the court used the phrase "sound business judgment" to describe the taxpayer's preservation of his personal residence by paying off the materialman liens. Id. at 190-91.

[192] See supra note 3 and accompanying text.

[193] There are many tax disadvantages to separate filing by married persons, which seem aimed at encouraging taxpayers to file jointly. For details, see Beck, *Joint and Several Liability*, supra note 3.

[194] 370 U.S. 65 (1962), reh'g denied, 371 U.S. 854 (1962). See infra note 196.

[195] See id. at 70-73.

spouse to be treated as a gift. The provision applies to ex-spouses as well, if the transfer is made within one year of the cessation of the marriage, or incident to divorce.[196] If the wife's payment of the husband's taxes in the *Rude* situation is governed by section 1041, it will be for tax purposes a gift and no bad debt deduction will be allowed.[197] Also, no income from debt discharge would arise to the husband when the right to contribution is forgiven, if the involuntary loan is for tax purposes a gift.[198]

Section 1041 will not apply in the *Rude* situation because (i) the wife's payment is not a "transfer" within the meaning of section 1041, (ii) her payment of cash is probably not "property" for such purposes, and (iii) her payment to a third party (the Service) does not meet the requirements for third-party transfers under the temporary regulations.

Loans would appear to be outside the ambit of section 1041. The temporary regulations state that:

> Section 1041 applies to any transfer of property between spouses regardless whether the transfer is a gift or is a sale or exchange of property at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code.)[199]

Only transfers of outright ownership, and only transfers of property of a kind which could trigger gain or loss, appear to be contemplated. Both criteria would exclude the *Rude* situation. In Revenue Ruling 87-112,[200] the Service ruled that an assignment of

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[196] Section 1041 provides:

> (a) GENERAL RULE.- No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)-
> (1) a spouse, or
> (2) a former spouse, but only if the transfer is incident to the divorce.
> (b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.- In the case of any transfer of property described in subsection (a)-
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

I.R.C. § 1041.

[197] See id.

[198] See infra Section V discussing discharge of indebtedness income.

[199] Temp. Treas. Reg. § 1.1041-1T(a)(A-2).

[200] 1987-2 C.B. 207. Deferred, accrued interest on United States savings bonds is includible in the transferor's gross income when transferred to a former spouse in a transaction

interest income incident to a transfer of a United States savings bond is not governed by section 1041 on the ground that the interest assignment is not a sale or exchange of property.[201] The wife's forced payment is neither a gift nor a sale or exchange; nor is it a transfer of ownership of any kind. Properly considered, the wife's payment is in the nature of a loan because it creates an immediate obligation on the part of the husband to repay it.

It seems unlikely that Congress intended to prevent spouses (or ex-spouses) from making loans to each other which are treatable as such for tax purposes. Nor does it seem likely that Congress would change established law in this respect without indicating that it was doing so. Moreover, such a rule would have nothing to do with the purpose of section 1041, which was, in essence, to recharacterize interspousal sales and exchanges as gifts in order to prevent immediate taxation and to carryover the transferor's basis.[202] Nor is there any other apparent reason for such a rule.[203] The *Rude* payment is not taxable in the first place, nor is there any basis issue. Such a payment should therefore not be regarded as a "transfer" for purposes of section 1041.

It also seems doubtful that cash should be considered "property" within the meaning of section 1041.[204] There would be no purpose

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otherwise described under § 1041. See id. at 208. The Ruling explained: "Although section 1041(a) of the Code shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer." Id. at 208.

Interest and other forms of ordinary income not resulting from sales or exchanges would therefore appear generally to be outside the reach of § 1041. Thus, the husband's discharge of indebtedness income on the wife's cancellation of his liability for contribution (discussed below) would not be covered under § 1041, even under the improbable supposition that a mere forgiveness of debt, which is not in exchange for other property, could be termed a "transfer of property." See infra notes 204 to 207 and accompanying text.

[201] 1987-2 C.B. at 208.

[202] The House Report explaining the enactment of § 1041 indicates that the principal purpose of the provision was to reverse the rule of United States v. Davis, 370 U.S. 65 (1962)(husband's transfer of appreciated stock to wife pursuant to divorce property settlement is taxable event). See H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2 at 1491 (1984).

[203] In fact, such a rule might have bizarre consequences. For example, interest on a loan between former spouses which is secured by the borrower's residence, which would otherwise be deductible under § 163(h), would arguably become nondeductible on the ground that the "interest" paid is not for the use or forbearance of money. This would seem to follow if the loan principal is a gift for tax purposes, despite the creation of an enforceable obligation under state law.

[204] This conclusion seems reasonable despite the fact that many commentators have stated that cash is "property" for purposes of a section 1041 "transfer". See, e.g., Fam. L.

in doing so, because there is no issue of taxing the transferor of cash. A taxpayer's basis in cash is always equal to face value. For that reason, there is no basis issue to the transferee of cash.[205] Moreover, if cash were "property" for purposes of a section 1041 transfer, all cash payments to an ex-spouse incident to divorce would be gifts for tax purposes, and therefore excludable from the transferee's income under section 102.[206] Section 1041 would thus flatly contradict section 71(a), which requires alimony to be included in the payee's gross income.[207] Congress could not possibly have intended such a result.

Even if the wife's involuntary cash payment of the husband's taxes were a "transfer" of "property," it would still not be subject to section 1041 gift treatment under the Temporary Regulations governing transfers to third parties:

> There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other

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Tax Guide (CCH) ¶ 1551 (1985); Pollack, *Qualifying for Nonrecognition on Transfers Between Spouses or as Part of a Divorce*, 17 Tax'n for Law. 292, 293 (1989).

This view is apparently based on a misinterpretation of the statement in the committee reports that, "[t]his nonrecognition rule applies whether the transfer is . . . *for cash* or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged." H.R. Rep. No. 432, 98th Cong. 2d Sess., pt. 2, at 1492 (1984)(emphasis added).

In the above language, cash is mentioned not as the property transferred, but as the consideration *for* the transferred property.

[205] And in addition, there has never been any issue of taxability as to the wife who gives up marital rights in exchange for cash or other property, despite the fact that her basis in such rights is apparently zero. See Rev. Rul. 67-221, 1967-2 C.B. 63 (wife not taxable on receipt of apartment building from husband in exchange for relinquishing her marital rights because such rights are equal in value to property received; wife's basis in the building is fair market value).

[206] See I.R.C. § 102. Section 102 provides, in pertinent part, "(a) GENERAL RULE.—Gross income does not include the value of property acquired by gift, bequest, or inheritance."

[207] Section 71(b)(1) *requires* that a payment be in cash in order to qualify as alimony (deductible to the payor and includible to the payee). This should probably be read together with § 1041, which would by necessary implication *exclude* cash as "property" which is "transferred" (and thus a nonincludible gift) in order to avoid the conflict.

> spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 . . . .[208]

It is evident that the wife's transfer of cash to the Service will not qualify under any of the third party situations listed above, because they all require agreement between the spouses. Needless to say, no wife in the *Rude* situation would make any such agreement.

IV. WORTHLESSNESS

In order to secure a bad debt deduction, it is necessary to demonstrate that the debt is worthless, and that it became worthless during the year for which the deduction is claimed.[209] Both elements are the subject of frequent controversy. It is beyond the scope of this article to consider the vast case law on these subjects, but it is worth pointing out that the bad debt deduction should be of value to thousands of women in the situation of Rude, even though the majority of such cases probably involve small amounts.[210] Many of these will be ones in which the wife would have been eligible for innocent spouse relief but for the $500 and percentage of income limitations under sections 6013(e)(3) and (4).[211]

It is well-established that where a debt is too small to justify the legal costs of collection, the debt is worthless and will support a

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[208] Temp. Treas. Reg. § 1.1041-1T(c)(A-9).

[209] See Treas. Reg. § 1.166-2.

[210] The Service keeps no statistics on collections via joint return liability under § 6013(d), and therefore estimates are necessarily inexact.

[211] Section 6013(e)(3) limits relief to "substantial understatements", defined as items totally over $500, net of interest. For grossly erroneous items other than omissions from gross income, for example, erroneous claims of deduction, credit, or basis, there is an additional ability to pay limitation under § 6013(e)(4). If the wife's adjusted gross income (AGI) is $20,000 or less for the year immediately preceding assessment, the liability must exceed the greater of $500 or 10% of such AGI, and if the wife's AGI for the preadjustment year exceeds $20,000, her liability must exceed 25% of such AGI in order to qualify for relief. See I.R.C. § 6013(e)(4).

In addition, if the wife has remarried as of the close of the year immediately preceding assessment, her new husband's income must be included in the 10% and 25% tests, whether or not they filed a joint return. See I.R.C. § 6013(e)(4). The unfairness of these rules seems clear.

bad debt deduction.[212] No legal action need be taken in such a situation, and there should be no need to show that the husband is insolvent or incapable of payment. If the husband refuses to pay after written demand for payment, that should be sufficient in cases where the amount is too small to justify collection costs.[213]

There will be instances where the wife might be able to collect if the matter were purely commercial, but she hesitates to press enforcement in order to avoid further friction in an already tense situation. In cases where the wife has already experienced difficulty in collecting amounts of alimony or child support due, and she reasonably fears that attempts to enforce the claim for contribution will endanger her other financial rights, a claim of worthlessness should certainly be allowed.

Determinations of worthlessness in all situations involving separation or divorce should be made with great lenience. It is in the public interest that fathers honor their support obligations, and also that they should maintain parental relations with their children. The government should not give the wife a Hobson's choice between renouncing the deduction and fanning the flames of family discord.[214]

Also, it may often be advantageous for the Service to show lenience. When the wife is allowed to deduct the debt, that should be sufficient evidence that the debt has been cancelled, which would give the Service the right to assess a tax against the husband for cancellation of indebtedness income.[215] Even where the husband's debt is for practical purposes worthless to the wife, the Service may still be able to collect the tax on debt discharge income. The tax to be collected on the debt discharge is necessarily a smaller amount than the original debt, and the Service's collection powers

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[212] See, e.g., Appeal of Townsend Lumber Co., 1 B.T.A. 894 (1925); Appeal of United States Tool Co., 3 B.T.A. 492 (1926); Johnstone v. Commissioner, 17 B.T.A. 366 (1929).

[213] The argument may be more difficult for wives who are separated but do not yet have a final property settlement because small items presumably can still be adjusted in the final settlement without the additional expense of separate litigation.

[214] The dilemma seems especially unfair because the tax problem was caused by the Service in the first place by collecting the tax from the wife rather than the husband. It seems unconscionable for the Service to deny the worthlessness of a debt originating out of a tax which, if collectible, the Service should have collected from the husband in the first instance.

[215] For a discussion of cancellation of indebtedness income, see infra notes 218 to 224 and accompanying text.

are of course incomparably greater than those of any individual.[216]

In many of these cases, the deduction will cost the Treasury only $.15 on the dollar, but if the husband is solvent, the Service should often be able to collect $.28 or $.33 on the dollar for the same amounts from the husband by taxing him on discharge of indebtedness income. The differential is due to the fact that women's earnings average only about 65% of men's earnings,[217] and therefore women can be expected on average to be in a lower tax bracket than men. This fact will tend to offset the losses which the Treasury can expect in those cases where the husband is insolvent or unavailable, and could even result in an overall profit to the government.

V. Discharge of Indebtedness Income

There appears to be no legal obstacle to assessing the husband for taxes on debt discharge income[218] in the *Rude* situation, although the Service has apparently never attempted to do so. When the wife pays the husband's taxes, her payment discharges the husband's *tax* obligation. Having received its taxes, the Service has looked no farther. And in fact it is not the wife's payment which causes the debt discharge income, because an offsetting debt for contribution arises in the wife's favor in the same amount by operation of law,[219] so that the husband's economic position is not yet improved. He has merely substituted one debt for another in the same amount.

When the debt to the wife is forgiven for a nongift reason, such as because the cost or other consequences of litigation makes collection impractical, the husband is enriched by discharge from the debt, and he should be taxed as a result. Nothing in the statute or case law prevents this result, and it is clearly desirable as a matter of equity. The husband should pay at least part of the taxes arising from his own income.

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[216] If the wife is required to put her ex-husband's social security number on the return where the bad debt deduction is claimed, the Service will have an information reporting system which can simply add the same amount to the husband's income for the year.

[217] See Rand Corporation Survey, reported in New York Times, February 9, 1989 at p. C-11.

[218] Section 61(12) provides, in pertinent part, "[G]ross income includes . . . (12) Income from discharge of indebtedness."

[219] See supra notes 106 to 110 and accompanying text.

Collections from the husband would present no practical difficulties in many, if not most cases. The case law under section 6013(e) contains many instances in which the husband was available and solvent,[220] and most tax practitioners are familiar with other such cases which are not reported. The Service will have no trouble collecting taxes on debt discharge income from the husband in many cases where the wife could not, or would not realize on her right to contribution, particularly when the amounts involved are small. The Service is in the business of such collections, and is unhampered by any fears of resentment.

Ironically, the Service may actually be advantaged by allowing a bad debt deduction to the wife because until she writes off the debt,[221] the husband can argue that his debt has not yet been cancelled. Generally, if the bad debt deduction is allowed, cancellation of indebtedness income should automatically arise on the ground that the wife has conceded she will make no further efforts at collection. The reverse is not necessarily true, however, since cancellation of indebtedness income could arise even where the wife may not be entitled to, or has not claimed a bad debt deduction. She may, for example, effectively cancel the debt by allowing the statute of limitations to lapse for a nongift reason, such as a distaste for confrontation, inadvertence, or ignorance that the right to contribution exists. Thus in some cases the Service might be in a position to deny the wife's bad debt deduction, but at the same time to assess the husband for cancellation of indebtedness income.[222] In many cases the wife may not claim the deduction at all, but the husband would nevertheless be liable in principle for cancellation of indebtedness income.

If the Service were to collect a tax from the husband in such situations without allowing the corresponding deduction to the wife, the Service would, to the extent of the tax on debt cancella-

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[220] See, e.g., Cohen v. Commissioner, 54 T.C.M. (CCH) at 946-47.

[221] See supra notes 215 to 216 and accompanying text.

[222] The Service might do this routinely when a bad debt deduction is claimed in order to take a protective position against whipsaw. The Service often takes a contradictory position in the analogous situation under § 71, by claiming that a payment is nondeductible child support in order to deny the husband's alimony deduction, but simultaneously claiming that the same payment is taxable alimony to the wife, in order to deny her the tax-free treatment accorded to child support.

The results obtained under the rules proposed in this article are just as if the wife paid deductible alimony to the husband, to whom the payment is gross income.

tion, collect the same tax twice. The result would be, in effect at least, an overpayment of the original tax liability, which hardly seems justifiable unless the Service were to refund the excess tax to the wife.[223] Of course, such a system would make the collection effort pointless from the Service's point of view. In general, it would seem both fair and administratively simple to tax the husband only when the deduction has been allowed to the wife.[224]

VI. Conclusion

The Service should collect its taxes only from the spouse who earned the income in the first instance.[225] But even where section 6013(d) of the Code has caused a shifting of tax liability from husband to wife, it seems clear that part of that liability can be shifted back again to where it originally belonged via the suggested devices of a bad debt deduction to the wife and debt discharge income to the husband. These results appear to be compelled under current law, and they should be implemented for equitable reasons as well until Congress sees fit to do away with the underlying problem by repealing joint return liability.

The Service appears to have the authority to put the proposed rules into effect administratively without legislative reform. The Service could simply withdraw its opposition to the bad debt deduction in *Rude*-type situations, and announce that it will allow

[223] There would also be an effective overpayment in cases where the benefit of the wife's bad debt deduction is worth less than the husband's corresponding tax from debt cancellation. Thus if the wife is assessed and pays $100 of her husband's taxes, and by means of a $100 bad debt deduction reduces her tax by $15, but the husband's $100 of debt cancellation income yields $33, the Service will have collected in all $118, which is greater than the original $100 liability.

This result is less troubling than the overpayment which would result from denial of the wife's deduction because it provides some relief to the wife, and because the discrepancy arises solely from the rate structure. Taxing the husband but denying the wife's deduction seems a questionable heads-I-win-tails-you-lose interpretation of the rules.

Compare this result to the rules for alimony. The amount of tax benefit from the deduction of alimony by the payor is not necessarily equal to the amount of tax payable by the payee of alimony. This is because husband and wife may be in different tax brackets. Also, the wife will have gross income from alimony if a payment meets the alimony definition under § 71(b), even if the husband fails to claim the deduction. However, a payment cannot be alimony for tax purposes as to one spouse and not to the other.

[224] If the Service reverses its current position and begins allowing the bad debt deduction in *Rude*-type situations, at the time of collection from the wife it should routinely advise her of her right to contribution, and to the bad debt deduction if she cannot collect on it.

[225] See Beck, *Joint and Several Liability*, supra note 3.

the bad debt deduction in appropriate cases, and at the same time charge the husband with debt discharge income. Such a change of administrative procedure would be more fair than current practice, and would be unlikely to cost the Treasury much, if anything, in lost revenue. Indeed, the Treasury might even profit. Finally, it is suggested that if the Service does not voluntarily undertake a review of its position, it may find itself compelled to do so if the *Rude* issue is relitigated.

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