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G. Thomas Ball

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Ball: Taxation: Treatment of Bad Debts to be Determined by Taxpayer's M

TAXATION: TREATMENT OF BAD DEBTS TO BE DETERMINED BY TAXPAYER'S MOTIVES

United States v. Generes, 427 F.2d 279 (5th Cir. 1970), *cert. granted,* 401 U.S. 972 (1971)

The taxpayer, a substantial stockholder and officer-employee of a closely held corporation, was required to pay damages resulting from the corporation's nonperformance of construction contracts on which he was the guarantor. When the corporation went into receivership, the taxpayer was left with what he contended was a business bad debt that would allow him to receive the tax benefits of a net operating loss carryback.[1] When the Government disallowed the carryback the taxpayer paid the assessed deficiency and sued for a refund. The Commissioner asserted that since the taxpayer, in assuming the liability, was primarily motivated by his interest in his investment in the corporation, the bad debt was not proximately related to the taxpayer's trade or business of being a corporate employee.[2] Upon a verdict for the taxpayer the Commissioner appealed, contending the trial court erred in instructing "[a] debt is proximately related to the taxpayer's trade or business when its creation was significantly motivated by the taxpayer's trade or business . . . ."[3] Upholding this significant motivation test, the Court of Appeals for the Fifth Circuit HELD, the payment was a business bad debt since it was significantly, although not primarily, motivated by the taxpayer's trade or business.

The current distinction between business and nonbusiness bad debt losses first appeared in the Internal Revenue Code in 1942.[4] Nonbusiness bad debts are treated by the Code[5] as short-term capital losses and are therefore deductible only to the extent of capital gains, whereas a business bad debt constitutes an ordinary deduction if the debt is incurred "in connection with a trade or business of the taxpayer . . . ."[6] The primary intent of this legislation was to discourage the deduction of intra-family loans by treat-

1. INT. REV. CODE of 1954, §172 [hereinafter cited as CODE].

2. Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961), is the leading case holding that a corporate employee is in a trade or business.

3. 427 F.2d 279, 282 (5th Cir. 1970), *cert. granted,* 401 U.S. 972 (1971).

4. H.R. REP. No. 2333, 77th Cong., 2d Sess. 76-77 (1942). For a critical analysis of these distinctions see Note, *Aspects of the Bad Debt-Loss Dichotomy,* 18 TAX L. REV. 121, 123 (1962).

5. CODE §166. Section 166 provides in part: "(a) GENERAL RULE — (1) WHOLLY WORTHLESS DEBTS — There shall be allowed as a deduction any debt which becomes worthless within the taxable year. . . . (d) NONBUSINESS DEBTS — (1) GENERAL RULE — In the case of a taxpayer other than a corporation — (A) subsection[s] (a) . . . shall not apply to any nonbusiness debt . . . . (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."

6. CODE §166 (d) (2) (A).

Florida Law Review, Vol. 24, Iss. 1 [1971], Art. 11

ing them as short-term capital losses.[7] However, in *Putnam v. Commissioner*,[8] the Supreme Court broadened the application of section 166 concluding that its purpose was "to put non-business investments in the form of loans on a footing with other non-business investments."[9] The Court reaffirmed this view in *Whipple v. Commissioner*[10] and appeared to suggest a strict analysis of each situation by warning: "Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor . . . ."[11]

The legislative history of section 166 indicates that the creation of a business debt must be "proximately related" to the taxpayer's trade or business.[12] Without defining the term, the Supreme Court has judicially approved the use of "proximately related" in characterizing bad debts as either business or nonbusiness.[13] To make this determination the courts look to the taxpayer's motives in creating the debt.[14] The meaning of "proximately related" in relation to the taxpayer's motives has created a conflict among the circuits.

The Seventh Circuit has adopted a dominant or primary motivation test to define this term. As in the instant case, the taxpayer in *Niblock v. Commissioner*[15] was a shareholder-employee of a closely held corporation. Although recognizing the taxpayer could have both an investment and a trade or business motivation, the court held the debt must be primarily or dominantly motivated by his trade or business as a corporate employee to qualify as a business bad debt.[16] The Tax Court has also adopted this test.[17]

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7. H.R. REP. No. 2333, 77th Cong., 2d Sess. 45 (1942): "C. NONBUSINESS BAD DEBTS. The present law gives the same tax treatment to bad debts incurred in nonbusiness transactions as it allows to business bad debts. An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for nonbusiness bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. . . . This situation has presented serious administrative difficulties because of the requirement of proof."

8. 352 U.S. 82 (1956).

9. *Id.* at 91-92.

10. 373 U.S. 193 (1963).

11. *Id.* at 202.

12. H.R. REP. No. 2333, 77th Cong., 2d Sess. 77; S. REP. No. 1631, 77th Cong., 2d Sess. 90 (1942). The Commissioner has adopted this test in Treas. Reg. §1.166-5(b) (1959).

13. Whipple v. Commissioner, 373 U.S. 193, 204 (1963).

14. Stratmore v. United States, 420 F.2d 461 (3d Cir.), *cert. denied,* 398 U.S. 951 (1970); Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969); Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963); Oddee Smith, 55 T.C. No. 26 (Nov. 3, 1970).

15. 417 F.2d 1185 (7th Cir. 1969).

16. *Id.* at 1187.

17. Oddee Smith, 55 T.C. No. 26 (Nov. 3, 1970). Under the tax court approach the taxpayer must first prove the debt was related to his business before the question can be raised of whether a proximate relationship exists. *E.g.*, Ross D. Hogue, 30 CCH Tax Ct. Mem. 311, 316-17 (1971). However, since the decision in Jack E. Golsen, 54 T.C. No. 742

Both the Seventh Circuit and the Tax Court justify adoption of the primary or dominant motivation test on the theory that only this test would give certainly to section 166.[18] In *Oddee Smith*[19] the Tax Court stated: "Since we have no scales sufficiently sensitive to be able to ascertain the exact percentage of motivations . . . we look to the main and dominant reason for their [the taxpayers'] actions."[20] Admittedly, a significant motivation test would create difficulties in distinguishing between what is significant or insignificant; however, under the dominant test the same difficulty arises in trying to distinguish between primary and significant motives. The task of determining, with any degree of certainty, where to draw the line between primary and significant motives would seem to be at least as difficult as drawing the line between significant and insignificant motives. Since the question of motivation is one of fact to be determined by the circumstances of each case,[21] neither the primary test nor the significant test would seem to be superior in helping to avoid litigation in this area.[22]

The taxpayer in the instant case was allowed a business bad debt deduction by the Fifth Circuit although his trade or business was not the primary motivation behind creation of the debt but merely a significant one. The court stated that the debt qualified as a business bad debt even though the nonqualifying investment motive was primary.[23] In adopting the significant motivation test, the instant court relied heavily upon *Weddle v. Commissioner*[24] for its analysis of the ordinary meaning of "proximate" as used in tort law:[25]

> In the law of torts, where the notion of "proximate" causation is most frequently encountered, a cause contributing to a harm may be found "proximate" despite the fact that it might have been "secondary" to another contributing cause . . . . So here, particularly in view of the back-handed wording of §166, it suffices for deduction that the creation of the debt should have been significantly motivated by the taxpayer's trade or business, even though there was a non-qualifying motivation as well.

(April 19, 1970), the Tax Court will apply the precedent set by the court of appeals of the circuit to which appeal from that case may lie.

18. Niblock v. Commissioner, 417 F.2d 1185, 1187 (7th Cir. 1969); Oddee Smith, 55 T.C. No. 26 (Nov. 3, 1970).

19. 55 T.C. No. 26 (Nov. 3, 1970).

20. *Id.*

21. Higgins v. Commissioner, 312 U.S. 212 (1941).

22. *See* Stratmore v. United States, 420 F.2d 461, 467 (3d Cir.), *cert. denied,* 398 U.S. 951 (1970).

23. 427 F.2d at 282; *cf.* Whipple v. Commissioner, 373 U.S. 193, 204 (1963). The Court remanded this case to investigate the possible existence of a qualifying motive even though the Commissioner had already established that the taxpayer had a substantial nonqualifying motive as an investor. Arguably this disposition of the case indicates that a significant business motive is sufficient for a business bad debt deduction, even though the investment motive was of greater significance.

24. 325 F.2d 849 (2d Cir. 1963).

25. *Id.* at 851.

Florida Law Review, Vol. 24, Iss. 1 [1971], Art. 11

This analysis was unequivocally rejected by *Niblock* as leading to uncertainty in construing section 166.[26]

As the taxpayer's brief in the instant case pointed out, the reference in *Weddle* to tort law was merely to show that several motives may exist, just as several causes may exist.[27] The use of "proximate" originated in the law of torts as a means of delineating between remote causes and those causes upon which liability could be sufficiently based.[28] Since only remote causes are excluded, when two concurring causes exist both can be proximate even though one may have been more dominant in bringing about the final result.[29] In this situation either cause need only make a significant contribution to the end result to be a basis of liability.[30]

Under the 1939 Code, a business debt was defined as "a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."[31] However, the 1954 Code broadens this definition to include a debt "created or acquired in connection with a trade or business of the taxpayer . . . ."[32] Obviously, this additional definition requires a less direct relationship with a taxpayer's trade or business. Furthermore, in several other code sections[33] Congress has used the term "principally" to indicate that the application of those sections requires the existence of a primary or dominant purpose.[34] The omission in section 166(d) of such an unequivocal term would appear to indicate an intent to require only a substantial or significant connection with a taxpayer's trade or business.

If the congressional purpose behind section 166, as the Court in *Putnam v. Commissioner*[35] stated, is to equalize the treatment of investment loans with other types of investments, then the legislation failed to completely accomplish the intended result.[36] Under section 166(d)(1) investment loans are given short-term capital loss treatment, but stock and worthless securities are normally to be deducted as long-term capital losses. Thus, the Government's objection to the significant motivation test that "it permits the business consideration to control the tax result where the nonbusiness consideration is the predominant motivating factor . . . ."[37] may be rejected without fear of destroying uniformity of treatment under section 166. Even if parity

26. 417 F.2d 1185, 1187 (7th Cir. 1969).

27. Brief for Appellees at 28.

28. W. PROSSER, TORTS §49, at 282 (3d ed. 1964). "*In jure non remota causa, sed proxima, spectatur.* [In law the near cause is looked to, not the remote one."] *Id.* n.4.

29. *Id.* §41, at 243.

30. *Id.* §41, at 244.

31. Int. Rev. Code of 1939, §23(k)(4).

32. CODE §166(d)(2)(A).

33. *E.g.*, CODE §§269(a), 357(b)(1), 355(a)(1)(B); *see* §§1221(1), 1231(b)(1)(B).

34. *Id.* In Malat v. Riddell, 383 U.S. 569 (1966), the Court has defined "primarily" to mean "of first importance" or "principally." *Id.* at 572.

35. 352 U.S. 82 (1956).

36. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 133 n.39 (1966); Note, *Section 166(f) of the Internal Revenue Code: Bad Debts and Confusion Guaranteed,* 65 YALE L. REV. 247 n.4 (1955).

37. Brief for Petitioner at 16.

Ball: Taxation: Treatment of Bad Debts to be Determined by Taxpayer's M

were the original purpose, a more recent trend toward aiding small businesses has developed. The addition of section 1244 and the Subchapter S provisions of the Small Business Act of 1958 has indicated a congressional policy of encouraging the development of small businesses,[38] even at the cost of creating greater disparity in the treatment of investment activities.

Although investment motives and business motives may occur simultaneously in other situations, these motives will most likely occur together in transactions of closely held corporations.[39] The taxpayer, upon entering such a transaction, is likely to be significantly motivated by a desire to perpetuate both his employment and his investment.[40] Depending upon the circumstances and the criteria used to evaluate them, it is possible that neither motive would be clearly dominant, but this alone should not exclude a debt from later being considered a business bad debt. When the employment motive is not significant, clearly the bad debt is nonbusiness.[41] However, when the employment motive is significant it should be classified as a business bad debt in view of the accepted meaning of "proximately related," the congressional policy of aiding small businesses, and the omission of the word "primarily" in section 166 (d).

G. THOMAS BALL

38. *See generally* Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1, 49-50 (1961); Comment, *Loss on Employee's Loan to Corporation Deductible as Business Bad Debt*, 37 N.Y.U.L. REV. 143, 149 (1962); Comment, *Aspects of the Bad Debt-Loss Dichotomy*, 18 TAX L. REV. 121, 123 (1962). Section 1244 and the Subchapter S provisions of the Small Business Act of 1958 have provided tax relief to taxpayers who, as in the principal case, are shareholders in closely-held corporations. Under certain circumstances §1244 allows ordinary loss treatment on investments in the stock of small business corporations.

39. Comment, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code*, 75 HARV. L. REV. 589 (1962).

40. *Id.* at 601.

41. Ross D. Hogue, 30 CCH Tax Ct. Mem. 311 (1971).