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Characterization of Shareholder-Creditor Bad Debt: *United States v. Generes* Sounds tbe Kuell for Deductions from Ordinary Income

I. Introduction

The fluctuating financial needs of close corporations frequently compel shareholders either to advance money to their corporations in the form of loans or to provide adequate assurances to third-party lenders in the form of personal guaranty or indemnity agreements. A credit-based economy, moreover, exerts extraordinary pressure upon controlling shareholders to satisfy the demands of disappointed corporate creditors in order to preserve or enhance the credit leverage of other corporations in which the shareholders have controlling interests. One result of these exigencies of current business practice has been that considerations of the tax attributes available to shareholder losses are becoming a principal determinant for structuring business transactions.

The tax relief available to an individual shareholder who, as lender or guarantor, suffers personal economic impoverishment as a consequence of the insolvency of a corporate debtor is governed by sections 165 and 166 of the Internal Revenue Code of 1954. Section 166 entitles an individual to a bad debt deduction for economic losses resulting from the partial or total worthlessness of a debt obligation. If the loss is characterized as a business bad debt, the entire loss amount may be offset against the taxpayer's ordinary income under section 166(a). Otherwise, the bad debt will receive short-term capital loss treatment under section 166(d), which allows a maximum deduction from ordinary income of only 1,000 dollars.[1] Short-term capital loss treatment will also follow a determination that the evidence of indebtedness is in fact a security within the meaning of section 165(g)(2)(c). Other losses sustained by an investor entering into a transaction for profit, even though that transaction is not part of a trade or business, may be fully offset against ordinary income under section 165(c)(2).

The proper classification of shareholder losses on loans to, or on behalf of, related corporations has been extensively litigated. Predictably, taxpayers have contended for full ordinary loss deductions while the

1. This limited availability of nonbusiness bad debt deductions from ordinary income is provided only derivatively by § 166(d). Section 166(d) provides that "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 6 months." Section 1211(b), in turn, provides in susbstance that losses from the sale or exchange of capital assets may never be applied against ordinary income in an amount greater than $1,000.

Commissioner has insisted that short-term capital loss treatment is required. The courts have experienced considerable difficulty in characterizing losses on bad debts in the varied factual situations presented by these cases.[2] Nevertheless, certain basic doctrines have been developed to dispose of the most common of the factual patterns from which bad debt claims have arisen. In the course of this development, the courts have centered their inquiry on the ambiguity inherent in the dual role of a shareholder-creditor: was his advance to the corporation that of an adventurer in the corporate business who hopes to be rewarded for his risk by a share of the profits, or was it rather that of a lender who seeks direct repayment from the capital of the corporation regardless of its success?

The primary focus of this Note is on the development of the judicial doctrines interpreting the provisions of section 166 as applied to shareholder losses on loans to related corporations. Whether, in any given case, advances by shareholders will be considered loans or capital investments is beyond the scope of this work. For purposes of this study, the existence of a valid debtor-creditor or debtor-guarantor relationship between the corporation and its shareholder will be assumed. A brief description of the statutory scheme of the bad debt and loss provisions will be followed by a discussion of the origins and development of the judicial doctrines interpreting the trade or business requirement in the context of bad debt claims. The Note will then examine the problem of current significance: under what circumstances will a loan be deemed proximately related to the trade or business of the shareholder-creditor? This examination will center on an analysis of the recent decision of the Supreme Court in *United States v. Generes*[3] and the implications of that decision for future shareholder-creditors who suffer losses on loans to their corporations.

II. Statutory Scheme

A. Distinction Between Bad Debts and Other Losses

The progenitor of the present loss and bad debt provisions of the Internal Revenue Code was Section II(B) of the Revenue Act of 1913.[4] Section II(B) allowed the taxpayer to claim deductions for losses sus-

2. In the past 16 years the Supreme Court on 3 occasions has granted certiorari to resolve conflicts in the circuits on the proper characterization of alleged bad debts. United States v. Generes, 405 U.S. 93 (1972); Whipple v. Commissioner, 373 U.S. 193 (1963); Putnam v. Commissioner, 352 U.S. 82 (1956).

3. 405 U.S. 93 (1972).

4. Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167.

tained in trade or resulting from fire, shipwreck, or storm, as well as for "debts due to the taxpayer actually ascertained to be worthless and charged off within the year."[5] All bad debts and other losses were fully deductible from ordinary income for both corporations and individuals. The statutory treatment of bad debts differed from that accorded other losses only in the extent to which the taxpayer could control the timing of the deduction. Because losses were expressly made deductible in the year sustained,[6] the timing of the deduction was usually determined by a specific, identifiable occurrence in the regular business year of the taxpayer. The statutory emphasis on the necessarily subjective "actual ascertainment" of the worthlessness of a bad debt, however, effectively allowed the taxpayer to claim this deduction whenever he pleased.

Although the taxpayer's ability to control the timing of bad debt deductions is much diminished under the Internal Revenue Code of 1954, the structural distinction between bad debts and other losses has been carried forward into sections 165 and 166. Taxpayers seeking to maximize their chances for a deduction often plead these two provisions in the alternative. In *Spring City Foundry Co. v. Commissioner*,[7] however, the Supreme Court declared the provisions mutually exclusive, reasoning that the enactment of specific provisions covering bad debts indicates that these economic losses are to be excepted from the operation of the general loss deduction provisions.

B. Business v. Nonbusiness Bad Debt

The distinction between business and nonbusiness bad debts first appeared in the Code in 1942.[8] Motivated both by the increased revenue needs of the World War II economy[9] and by a desire to end abuses resulting from full deductibility from ordinary income of worthless intrafamily "loans,"[10] Congress in 1942 enacted the Ways and Means

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5. *Id.* at 167.

6. 50 CONG. REC. 506, 3846-50, 4613 (1913).

7. 292 U.S. 182 (1934). For a critical analysis of the distinction see Note, *Aspects of the Bad Debt—Loss Dichotomy*, 18 TAX L. REV. 121, 123 (1962). A taxpayer may still, however, claim both a loss and a bad debt in the alternative. Larry E. Webb, 23 T.C. 1035 (1955); Lidgerwood Mfg. Co., 22 T.C. 1152 (1954).

8. Revenue Act of 1942, § 124(a), 56 Stat. 820.

9. *Hearings on H.R. 7378 Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 1 (1942).

10. Congress felt that detection of fraudulent deductions under existing law for gifts disguised as loans had entailed prohibitive administrative expense. H.R. REP. No. 2333, 77th Cong., 2d Sess. 44-45 (1942). The impressive number of pre-1942 cases in which the Treasury challenged the good faith of alleged loans demonstrates that the congressional concern was justified. *See, e.g.*, Ezra H. Jones, 13 B.T.A. 1271 (1928); Richard M. Page, 2 B.T.A. 1316 (1925).

Committee's proposal that bad debts of a nonbusiness character be accorded short-term capital loss treatment.[11]

Initially, the courts interpreted the legislative history of this amendment as requiring only that suspect loan transactions between relatives or friends be characterized as nonbusiness debts.[12] In *Putnam v. Commissioner*,[13] however, the Supreme Court greatly expanded the operation of the nonbusiness bad debt provision in reliance upon a perceived congressional intent to place nonbusiness investments in the form of loans on an equal footing with other nonbusiness investments. In *Whipple v. Commissioner*,[14] the Court buttressed and expanded this position, interpreting the nonbusiness bad debt provision as refusing full deductibility to losses incurred by a taxpayer on loans not made in connection with that limited class of activities which the tax law recognizes as a trade or business.

Section 166(d)(2) substantially reflects the *Whipple* Court's statement of the basis for distinguishing nonbusiness from business bad debts. A nonbusiness debt is defined as any 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."[15] Under this definition, every taxpayer must satisfy two criteria in order to qualify a worthless obligation for the greater tax benefits accorded a business bad debt: the taxpayer must have been engaged in a trade or business when

11. Revenue Act of 1942, § 124(a)(4), 56 Stat. 821, provides: "Non-Business Debts—In the case of a taxpayer, other than a corporation, if a non-business 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 6 months . . . . "

12. *See, e.g.*, Robert Cluett, 3d, 8 T.C. 1178, 1179-80 (1947), *acquiesced in*, 1947-2 CUM. BULL. 2: "The legislative history of Section 23(k)(4) indicates that its principal purpose was to place a limitation upon losses from bad debts, such as loans to relatives or friends which had no connection with the business of the lender. . . . The debt here in question was not the result of a loan by the petitioner to a friend or relative or an isolated transaction which bore no relation whatsoever to the business in which he was engaged . . . ." (paragraphing omitted).

13. 352 U.S. 82 (1956). The taxpayer in *Putnam* had personally guaranteed a loan to a corporation in which he was a stockholder. The corporation liquidated its assets and ceased doing business. Putnam was obligated to repay the loan and sought to deduct it as a loss. The Court held that taxpayer was limited to a nonbusiness bad debt deduction, emphasizing that friendly and intrafamily loans were merely examples of the type of loan contemplated by the amendment.

14. 373 U.S. 193 (1963). "The 1942 amendment of § 23(k), therefore, as the Court has already noted, *Putnam v. Commissioner* . . . was intended to accomplish far more than to deny full deductibility to the worthless debts of family and friends. It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls short of reaching every income or profit making activity." *Id.* at 201. *See* notes 29-36 *infra* and accompanying text.

15. INT. REV. CODE OF 1954, §§ 166(d)(2)(A), (B).

the loan was made; and he must have advanced the loan in connection with that trade or business.

III. Trade or Business Requirement

"The thorniest type of case before the courts involving the concept of the nonbusiness bad debt has been that of the stockholder-creditor."[16] Although the statutory prerequisite for a full ordinary income bad debt deduction is that the loan have arisen in connection with activities that the law recognizes as constituting a "trade or business," there is no general definition of this phrase in either the Code or the Treasury Regulations. In general, the courts have taken a restrictive view of the scope of activities necessary to constitute a trade or business. The courts have usually applied tests previously developed in interpretations of other sections of the Code,[17] thereby arguably attributing to the term a more restricted area of application in the bad debt context than the 1942 amendment fairly suggests.

One of the first cases to establish a working definition of the term "trade or business" was *Flint v. Stone Tracy Co.*[18] In passing on the deductibility of claimed business expenses, the Supreme Court in *Flint* attributed a liberal meaning to "business," defining it to include "everything about which a person can be employed."[19]

As the concept that deductions are a matter of legislative grace and should therefore be strictly construed gained acceptance, however, the Supreme Court's interpretations of "business" became increasingly restrictive. The suggestion that trade or business status requires holding "one's self out to others as engaged in the selling of goods or services"[20] was substantially adopted by a majority of the Court in *Higgins v. Commissioner*,[21] which denied a business expense deduction to a taxpayer whose sole occupation was the management of his securities. Investment activities alone were thus held insufficient to constitute a "business."[22] Prior decisions holding personal investment activities to be

16. Note, *Bad Debts: Business or Non-Business?*, 5 TAX L. REV. 412, 417 (1950).

17. In the determination of bad debt claims, the courts have applied cases interpreting the term "trade or business" in regard to expenses, net operating loss carryover, and losses without examination of their relevance. *See, e.g.*, Commissioner v. Stokes' Estate, 200 F.2d 637 (3d Cir. 1953). *See* 5 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 28.31, at 126-34 (1969).

18. 220 U.S. 107 (1911).

19. *Id.* at 171.

20. Deputy v. DuPont, 308 U.S. 488, 499 (1939) (concurring opinion).

21. 312 U.S. 212 (1941). The majority opinion concludes: "The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law . . . ." *Id.* at 218.

22. The *Higgins* Court rejected *Flint* as based on corporate "excise" tax law. *Id.* at 217.

trades or businesses were distinguished as founded in each case upon the taxpayer's participation in the management of the corporation in which he had invested—an implied recognition that investment-related activities may nevertheless constitute a business.[23]

The courts have adhered strictly to the principle derived from *Higgins* that losses of a shareholder-creditor do not qualify for a business bad debt deduction on a mere showing that the taxpayer engaged in investing for profit. An early judicial tendency to presume that shareholder loans to related corporations were mere personal investments,[24] however, gradually gave way to a recognition that some shareholders may be entitled to business bad debt deductions. In granting a business bad debt deduction to the taxpayer in *Maytag v. United States*,[25] for example, the Court of Claims followed the *Higgins* requirement of a close examination of the business activities of a taxpayer who would use this category.[26] *Higgins* was factually distinguished, however: while the taxpayer in *Higgins* was a mere passive investor who "had not formed and did not control or work in"[27] the corporations in which he invested, taxpayer's lending activities in *Maytag* constituted a trade or business because "he worked in [the debtor corporations], made the important decisions in them, and put up the money to enable them to operate."[28]

The leading case on the "trade or business" requirement in the shareholder-creditor bad debt context is the 1963 decision of the Supreme Court in *Whipple v. Commissioner*.[29] The taxpayer in that case owned the controlling interest in a company which he had actively developed from a sole proprietorship into a productive corporate enterprise and to which he had made substantial cash advances.[30] When the corporation ultimately failed, the taxpayer deducted from his ordinary income the total face amount of the company's outstanding debt obliga-

23. In response to *Higgins*, Congress enacted what is now § 212 of the Code, which allows expense deductions for nonbusiness income-producing activities. *Hearings on H.R. 7378 Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 166 (1942).

24. *See, e.g.*, Putnam v. Commissioner, 352 U.S. 82, 92 (1956). ("There is no real or economic difference between the loss of an investment . . . and one made indirectly in the form of a guaranteed bank loan").

25. 289 F.2d 647 (Ct. Cl. 1961).

26. Higgins v. Commissioner, 312 U.S. 212, 217 (1941).

27. 289 F.2d at 650.

28. *Id.* at 649.

29. 373 U.S. 193 (1963).

30. Taxpayer owned 79% of the outstanding stock of a soft drink bottling company. He bad advanced substantial amounts of cash to the enterprise and had also purchased land and erected buildings to house a bottling plant that he leased to the corporation. He bad also established and developed numerous other partnerships and corporations, all of whicb were actively engaged in various business pursuits not directly related to the regular business of the bottling company.

tions to him. The Supreme Court upheld the Commissioner's characterization of this economic loss as arising from a nonbusiness bad debt.[31]

The Court's decision was founded upon a determination that lending and management activities do not constitute a trade or business when those activities are directed toward increasing the return on, or the value of, the taxpayer's investments.

> Devoting one's time and energy to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. . . . [T]he return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.[32]

The Court acknowledged that its decision placed upon the shareholder-creditor seeking a business bad debt deduction a heavy burden of providing "substantial evidence" to overcome the presumption that "furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business . . . ."[33] The Court then increased this burden by its summary dismissal of taxpayer's contention that his multicorporate financing activities and management responsibilities[34] comprised a personal business independent of the business operations of any constituent corporation:[35] "If full-time service to one corporation does not alone

31. The Tax Court upheld the Commissioner's deficiency assessment because it found that Whipple was not in the business of organizing, promoting, financing, or managing corporations, of money-lending generally, or of bottling soft drinks. 19 CCH Tax Ct. Mem. 187 (1960). Specific findings by the court denied trade or business status to Whipple's lending activity to fellow shareholders, partners, corporations, and partnerships. *Id.* at 191. The Fifth Circuit affirmed. 301 F.2d 108 (5th Cir. 1962). In the Supreme Court, the taxpayer maintained that the loans had been made in connection with one or more of the following businesses: organizing, financing, and managing corporations, partnerships, and joint ventures; financing corporations and lending money; acquiring, owning, expanding, equipping and leasing bottling plants and other equipment; conducting activities in connection with the bottling and sale of soft drinks. Brief for Petitioner at 13, Whipple v. Commissioner, 373 U.S. 193 (1963); *see* Lewis, *Deductibility of Losses Arising from Business Ventures*, 18 MAJOR TAX PLANNING 625, 634 (1966). The Court remanded the case to the Tax Court for consideration of evidence on the third contention, but sustained the lower court's findings on the others.

32. 373 U.S. at 202.

33. *Id.* at 203.

34. Whipple had produced evidence showing continuous and concerted business activities over a 14-year period. During the 2-year period in issue, he realized $94,478.71 ordinary income from salaries, interest, and rent, and $56,378.28 ordinary income from partnerships and joint ventures. Dividend income for the specified period amounted to only $3,300. Brief for Petitioner at 7-8, Whipple v. Commissioner, 373 U.S. 193 (1963).

35. 373 U.S. at 201-02. Whipple emphasized the required nature of his managerial and money-lending activities and the regularity of transactions resulting in ordinary income in his

amount to a trade or business, which it does not, it is difficult to understand how the same service to many corporations would suffice."[36]

The underlying rationale of *Whipple* is essentially that of *Higgins*: activities which, if successful, will generate capital gains ought not, without express Congressional approval, give rise to ordinary loss if unsuccessful. Like *Higgins*, *Whipple* articulated this rationale in broad, almost philosophical terms, providing later courts with only vaguely defined criteria for determining the narrowed scope of activities that will support a full ordinary income deduction. Consequently, previously established judicial characterizations of specific shareholder-creditor activities as giving rise to business bad debts have been continually, and sometimes inconsistently, modified in the decade following *Whipple*. There remain, however, three generalized exceptions to the *Whipple* presumption of non-business status for shareholder-creditor transactions: loans by promoters; loans by taxpayers in the money-lending business; and loans made to a corporation in order to maintain or further the taxpayer's separate trade or business. Loans in the latter class of cases fall into two groups: loans to preserve an employment relationship; and loans to maintain or support the activities of a separate noncorporate enterprise.

A. The Promoter Doctrine

Since the early 1930's, courts have on occasion found a shareholder-creditor to be engaged in the trade or business of a "promoter,"[37] but only in "the exceptional situations where the taxpayer's

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attempt to demonstrate that he was neither passively investing nor merely engaging in transactions for profit. "[I]n order to organize, arrange for and keep in touch with the financing of, coordinate the various activities of, and make the general policy decisions for a group of enterprises, as in the *Whipple* case varying from a retail lumber yard, to a restaurant, to various phases of a soft drinks enterprise . . . rental properties, promotion of oil deals, subdivision of real estate . . . construction of houses in different locations, managing an equipment rental corporation and other activities, would necessarily take such extensive time, thought and efforts of the taxpayer, completely separate from the actual business operations of each of the enterprises themselves, as to constitute a business in itself, which does not exist in the case of the single corporation. This is the basis of the decisions of the cases of multiple corporations." Reply Brief for Petitioner at 21-22, Whipple v. Commissioner, 373 U.S. 193 (1936).

36. 373 U.S. at 202.

37. In Washburn v. Commissioner, 51 F.2d 949 (8th Cir. 1931), taxpayer owned and managed a number of corporations. He claimed that a loss incurred on the sale of stock of one of several corporations under his control and management was eligible for net operating loss carry forward because it resulted from the regular operation of a business carried on in accordance with § 214 of the Revenue Act of 1921. The court held that the exclusive devotion of one's time to the management of corporate ventures could constitute a trade or business separate and distinct from the activities of any of the particular managed corporations, stating that "[the taxpayer's] income was the result, not alone of his investments, but also of his labor expended in connection with the

activities in promoting, financing, managing, and making loans to a number of corporations have been regarded as so extensive as to constitute a business separate and distinct from the business carried on by the corporations themselves."[38] Prior to *Whipple*, most determinations of promoter status appear to have turned on the multicorporate extent of the taxpayer's activities. Some courts, however, eschewed the superficial inquiry "whether the occupation of the party involved so consists of time, money, and effort as to constitute his business life,"[39] and instead based their decisions on the character of the taxpayer's activities.

These incompatible approaches led to conflicting decisions on business bad debt claims founded on alleged promoter status. In *Vincent C. Campbell*,[40] taxpayers, who for sixteen years had owned and operated twelve related corporations, sought business bad debt deductions for losses sustained on loans to one of their enterprises. The Tax Court allowed the deductions on the theory that the losses resulted from the business of owning and operating corporations. In *Commissioner v. Smith*,[41] however, the Second Circuit denied a similar claim for business bad debt treatment on the authority of *Burnet v. Clark*,[42] which had held that business conducted in the taxpayer's capacity as a corporate officer did not constitute a separate, independent trade or business. The *Smith* court stated:

> Respondent's activities in the case at bar were essentially similar to those of the taxpayer in the *Clark* case, except that respondent here was interested as an investor, manager, and creditor in a number of business enterprises. But since each of these activities separately does not constitute a business, we cannot see how a combination of them spread over various businesses can alter the result."[43]

In *Whipple*, the Supreme Court wholly redefined the promoter doctrine. In language quite similar to that of the *Smith* decision,[44] the *Whipple* opinion clearly rejected prior cases holding that a mere showing of multicorporate organization and management would suffice to establish an independent business of the taxpayer.[45] The Court not only

management. . . . The combination of the two is his vocation." *Id.* at 954. *See also* Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935) (sustaining taxpayer's deduction of attorney's fees as a business expense under § 214(a) of the Revenue Act of 1918).

38. Charles G. Berwind, 20 T.C. 808, 815 (1953), *aff'd per curiam*, 211 F.2d 575 (3d Cir. 1954). Financing, organizing, and operating a single business enterprise will not qualify a shareholder-creditor for promoter status. *See, e.g.*, Nicholson v. Commissioner, 218 F.2d 240 (10th Cir. 1954); William Bernstein, 11 CCH Tax Ct. Mem. 118 (1952).

39. A. Kingsley Ferguson, 16 T.C. 1248, 1257 (1951).

40. 11 T.C. 510 (1948).

41. 203 F.2d 310 (2d Cir.), *cert. denied*, 346 U.S. 816 (1953).

42. 287 U.S. 410 (1932).

43. 203 F.2d at 312.

44. *See* text accompanying note 43 *supra*.

45. *See* note 36 *supra* and accompanying text.

narrowed the class of promotional activities that may constitute a trade or business; it effectively bifurcated the remainder into categories of "pure promoter" and "dealer in enterprises" business activities.

The "pure promoter" is one who, for a fee or commission, organizes a corporation and supplies its operating capital. To qualify for business bad debt treatment, however, a pure promoter's loan need not be made in the initial capitalization of the corporation if it is a reasonably necessary incident of other promotional activities. In *Ralph Biernbaum*,[46] for example, taxpayer had advanced cash to a controlled department store corporation so that it could maintain a program of business expansion. The corporation used the funds to finance leases for lots in shopping centers that taxpayer promoted, thereby enhancing taxpayer's bargaining position with other prospective tenants. The Tax Court allowed the deduction, holding that the loans were a direct incident of taxpayer's separate and distinct promoting business.

The "dealer in enterprises" concept acknowledged by *Whipple*[47] had been formulated previously in *Giblin v. Commissioner*.[48] Like the pure promoter, the dealer in enterprises organizes, finances, and promotes corporations, but he does so with the sole objective of selling the developed corporations at a profit. In passing upon taxpayer claims of "dealer in enterprises" status, courts have rigorously applied *Whipple*'s substantial evidence standard to forestall unwarranted business bad debt deductions. In *Townshend v. United States*,[49] for example, taxpayer's claim that he had developed several small businesses with the primary intent of subsequently selling the enterprises at a profit was defeated by a finding that taxpayer had neither sold a corporation in which he had an interest nor made any effort to sell one. Taxpayer's evidence that he had influenced the corporations to sell some of their assets in the form of product lines was adjudged insufficient proof of a separate trade or business.

> In pointing to this transaction as a typical instance of his engagement in the business of selling product lines, plaintiff betrays a common lay misconception, i.e., that of the major stockholder in a closely held corporation confusing the corporate business with his own. It was not plaintiff who sold the power tool line . . . . [I]f anyone can be said to be engaged in the business of selling product lines, it was the corporation which was so engaged, not plaintiff. And the business of a corporation is not the business of its stockholders or officers.[50]

46. 32 P-H Tax Ct. Mem. 1188 (1963).

47. 373 U.S. at 202-03.

48. 227 F.2d 692 (5th Cir. 1955) (during the course of 20 years, taxpayer provided money and much of his time to the organization and sale of numerous business enterprises).

49. 384 F.2d 1008 (Ct. Cl. 1967).

50. *Id.* at 1013. *See also* United States v. Byck, 325 F.2d 551 (5th Cir. 1963).

Although the emphasis of the *Whipple* decision was on the character of the financial return ultimately to be derived by the taxpayer, subsequent courts have tended to focus on the taxpayer's activities themselves in defining the parameters of "pure promoter" and "dealer in enterprises" status. Nevertheless, the courts have not lost sight of *Whipple*'s underlying rationale. As stated by the court in *Townshend*:

> If [the taxpayer] promotes corporate enterprises for fees and commissions or with a view to an early and profitable sale thereof after the business has become established, then the expected income would be "received directly for his own services rather than indirectly through the corporate enterprise," and he may properly be said to have a business of his own separate and apart from the businesses of the corporations.[51]

Thus a finding of prolonged taxpayer investment or of withdrawal from promotional activities for personal or family reasons, for example, will vitiate a contention that the taxpayer is engaged in separate business activities and will provide potent evidence from which to infer the predominance of affirmative investment interests.[52]

B. *The Money-Lending Business Doctrine*

The courts have readily accepted the proposition that a taxpayer who is actively and regularly engaged in the business of lending money is entitled to a business bad debt deduction for worthless loans made in the course of this business. Taxpayers seeking to justify full ordinary income deductions for losses on loans to related corporations by resort to the money-lending business doctrine, however, have met with only slight success.[53] Few taxpayers other than full-time finance-business operators make loans in sufficient amounts to qualify their money-lending activities as a trade or business. A taxpayer who demonstrates sufficient lending activity, moreover, may still be denied a full ordinary deduction for a loan to a closely held corporation in which he has an interest if, as is frequently the case, the loan was made on terms lenient enough to indicate that the loan was not made in the course of the

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51. 384 F.2d at 1012.

52. Syer v. United States, 380 F.2d 1009, 1010 (4th Cir. 1967). For a general discussion of the promoter doctrine see Brink, *How Business Promoters Can Meet the Trade or Business Test for Bad Debts*, 23 J. TAXATION 170 (1965).

53. *See, e.g.*, Max Barish, 31 T.C. 1280 (1959). Taxpayer in *Barish* had made 9 loans, totaling $29,860.32, to 4 borrowers. Taxpayer owned 50% of the stock of a new car dealership, which constituted his principal business activity, and had numerous other business interests that he had promoted and organized. The worthless debt obligations were held against his new car dealership. The Tax Court determined that taxpayer had demonstrated insufficient lending activity to constitute a trade or business.

lending business.[54]

Because it is usually urged in the alternative to "promoter" or "furtherance of separate business" claims, the money-lending business doctrine rarely has been given a thorough analysis; even cases that find a valid money-lending business offer little guidance beyond the general observation that "the question of whether the [lending] activities of a taxpayer constitute the carrying on of a trade or business is largely one of fact . . . ."[55] Moreover, the vast majority of bad debt claims arising from a taxpayer's alleged separate lending business presumably have not been challenged by the Commissioner. It is thus diffieult to determine what general criteria the courts will deem relevant in deciding whether the lending activity of a taxpayer is significant enough to constitute a separate trade or business.

An exception to the pattern of superficial treatment that courts have given the money-lending business doctrine is the opinion in *Williams v. United States*,[56] in which a district court upheld taxpayer's claim that his personal guarantees of the notes of a citrus machinery corporation in which he held stock, as well as his direct loans to the corporation, were made in the course of his separate business of lending money. The court declared that a taxpayer must show continuous and repeated lending activity together with a reasonable expectation of profit in order to succeed in his money-lending business claim. The court then enumerated the criteria by which it would determine whether the activities of a taxpayer meet the required business standard. These criteria included: (1) the frequency with which the taxpayer aetually made loans with the expectation of profit; (2) his primary source of income during the years involved; (3) the profession that he would deem his own; (4) the effort and care devoted by him to money-lending activities; (5) the number of times that he engaged in such activity; (6) whether he considered and treated his lending transactions as closer to an investment activity than an active business.[57]

The *Williams* court's effort to articulate the factors that indicate separate business activity is commendable, but it is of limited assistance to the taxpayer planning lending activity or to the attorney preparing

54. *See, e.g.*, United States v. Henderson, 375 F.2d 36 (5th Cir.), *cert. denied*, 389 U.S. 844 (1967).

55. Yeager v. United States, 1 Am. Fed. Tax R.2d 523, 528 (W.D. Ky. 1958). Decedent had personally interviewed potential borrowers almost daily, and kept detailed records of the loans he made. He took mortgages and notes as security and was diligent in enforcing collection. "The extent of his activity . . . warrants the conclusion that he was more than a passive investor." *Id.*

56. 12 Am. Fed. Tax R.2d 6157 (M.D. Fla. 1963).

57. *Id.* at 6160.

to litigate his claim. The thrust of the court's analysis, as revealed by the third and sixth of the listed criteria, is to determine the state of mind with which the taxpayer engaged in lending activity. Although this approach appears consistent with the Supreme Court's unstated emphasis on the taxpayer's subjective investment intent in the *Higgins* and *Whipple* cases, the *Williams* state-of-mind standard is unsuitable for purposes of both judicial administration and business planning. Although the first five of the *Williams* criteria are—with the possible exception of the third—satisfactorily objective, they are of value only as factors from which inferences may be drawn in determining the ultimate question of the taxpayer's subjective expectations. Business bad debt litigation may thus be expected to turn largely upon the sixth criterion, which will place undue emphasis on the taxpayer's self-serving statements before the court. The absence of a clearly established objective standard will thus continue to breed considerable uncertainty and to cause business bad debt claims based on regular lending activity to be determined on a case-by-case basis. Nevertheless, some limits on the money-lending business doctrine are clear. It seems certain, for example, that lending money solely to one's own corporations will not support a finding of a separate money-lending business. Further, loans to corporations in which one has a substantial investment or family interest are patently suspect and will seldom be useful for purposes of showing regular money-lending activity.[58] Finally, informal personal lending activity has always been viewed with suspicion; unless the taxpayer forms and operates a business enterprise exclusively for lending activity, it is unlikely that he will be able to establish his financing activities as a trade or business.

C. *Shareholder's Separate Trade or Business Related to Corporation*

A shareholder who is engaged in a separate trade or business related to that of his corporation may obtain a business bad debt deduction for uncollectible loans to the corporation made in connection with his individual business. The taxpayer's separate trade or business may be either that of being an officer or other employee of the debtor corporation or of operating a sole proprietorship which is either a customer or supplier of the debtor corporation. Of the three exceptions to the *Whipple* presumption of nonbusiness status, claims based upon a related individual trade or business have met with the highest degree of success in recent years.[59]

58. Gross v. Commissioner, 401 F.2d 600 (9th Cir. 1968).

59. Because these cases have frequently turned upon a showing of proximate relationship

1. *Preserving the Employment Relationship.*—Bad debts arising from loans to a corporation made by an employee in order to retain his employment may qualify for business bad debt treatment. This judicial doctrine of relatively recent origin is predicated on the idea that an employee may be engaged in a "trade or business of rendering services for pay"[60] and may thus be motivated to lend money to his corporation by considerations other than expected investment return.

That a taxpayer's service as an officer of a corporation in which he is a stockholder or creditor would not constitute a separate individual trade or business was generally assumed prior to 1961.[61] In *Trent v. Commissioner*,[62] however, the Second Circuit rejected this narrow view of the trade or business requirement. In *Trent*, taxpayer had been required to purchase one-third of the employing corporation's stock as a condition of his employment and had been instructed that it would be necessary for him to make loans to the corporation from time to time until the corporation's financial condition improved. Taxpayer dutifully lent the corporation 9,000 dollars during the first year of his employment. Because he refused to continue making loans, however, he was ultimately discharged. When the corporation defaulted on the loans, taxpayer sought a business bad debt deduction. The Second Circuit unanimously reversed the Tax Court's disallowance of the deduction, stating that the lower court's holding was founded upon the erroneous belief "that, as a matter of law, loans made to a corporation by an employee for the purpose of protecting his employment cannot be" a business debt.[63] The *Trent* opinion stated in dictum that only if taxpayer had not devoted a major part of his working time to serving the debtor corporation[64] or had not been compensated for his services[65] would his claim that he was engaged in a full-time business for pay be denied.[66]

between the individual business and the worthless debt, however, this exception will presumably be the one most severely affected by the Supreme Court's decision in United States v. Generes, 405 U.S. 93 (1972). *See* text accompanying notes 106-28 *infra.*

60. Folker v. Johnson, 230 F.2d 906 (2d Cir. 1956).

61. *See, e.g.*, Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957).

62. 291 F.2d 669 (2d Cir. 1961).

63. 291 F.2d at 670.

64. *See, e.g.*, Hickerson v. Commissioner, 229 F.2d 631 (2d Cir. 1956) (taxpayer owned and operated another business).

65. *See, e.g.*, Commissioner v. Shaefer, 240 F.2d 381 (2d Cir. 1957) (taxpayer served as corporate president without pay). In the *Whipple* case, the Court made no determination of the weight to be accorded compensation for services to a debtor corporation, since taxpayer had received no compensation from the debtor corporation.

66. The decision tacitly recognized that active participation in the activities of a corporation might constitute a trade or business of the shareholder. *Contra*, United States v. Worrell, 398 F.2d

Trent's sweeping approval of business bad debt status for worthless corporate obligations in the hands of shareholder-employees was soon narrowed by the Second Circuit in *Weddle v. Commissioner*.[67] Although it quoted *Trent* with approval, the *Weddle* court affirmed a Tax Court decision denying business bad debt treatment to the loss stemming from repayment of a guaranteed corporate loan by a majority stockholder who was employed by her corporation as president and general manager. The Tax Court had accepted taxpayer's contention that she was engaged in the separate trade or business of being an employee of her corporation, but nevertheless sustained the Commissioner's deficiency assessment on the ground that her "endorsement of the company's notes was not proximately related to such trade or business"[68] as opposed to her status as an investor in the corporation.[69] The Second Circuit affirmed, on the single ground that taxpayer had failed to show that protection of her trade or business of employment had been a significant motivation for guaranteeing the obligations.[70]

The stigma thus attached to a controlling shareholder is apparent in many later cases. In *Kelley v. Patterson*,[71] the Fifth Circuit held that loans by a salaried sole shareholder to his employer corporation were made only to protect the shareholder's investment. Applying the "significant motivation" test advanced in *Weddle*, the Fifth Circuit concluded that preservation of a controlling shareholder's employment by his corporation is but an incident of the protection of his investment interest and is thus inadequate to support a claim of independent business motivation for a loan to his enterprise. In *Niblock v. Commissioner*,[72] the Seventh Circuit similarly denied business bad debt treatment to losses sustained by the taxpayer on his satisfaction of personal guaranties of his corporation's debt obligations to a bank. In rejecting taxpayer's

427 (5th Cir. 1968) (mere voluntary service as personal indemnitor of a corporation's surety creditor is not job protection and business bad debt deduction is therefore unavailable).

67. 325 F.2d 849 (2d Cir. 1963), *aff'g* 39 T.C. 493 (1962).

68. 39 T.C. 493, 495 (1962).

69. *Id.* at 496. Taxpayer's testimony revealed that she had presumed that her position as "owner" of the business compelled her to assume the responsibility of guaranteeing loans obtained for carrying on the activities of the business enterprise. *Id.* at 497. The court declared this belief insufficient to establish the required proximate relationship of the guaranty to the preservation of her separate business as a corporate employee.

70. Rejecting the lower court's reference to a primary motivation standard for determining the sufficiency of the proximate relationship, the majority opinion stated: "[i]t 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." 325 F.2d at 851 (emphasis added).

71. 331 F.2d 753 (5th Cir. 1964).

72. 417 F.2d 1185 (7th Cir. 1969).

contention that the guaranties were necessarily related to the preservation of his employee trade or business, the court relied on a factual determination that the taxpayer certainly would be able to obtain equivalent employment elsewhere.

Although controlling shareholders who seek to justify business bad debt deductions on "preservation of the employment relationship" grounds have been generally unsuccessful, the Tax Court has shown a willingness to grant deductions to controlling shareholders who are unable to find or to accept employment elsewhere. In *Isidor Jaffe*,[73] taxpayer's claim that he had made loans and personal guaranties to insure the liquidity of his closely held corporation and thereby to preserve his employment relationship was upheld on the grounds that taxpayer's age—70 years—made him virtually unemployable in the open market. A similar rationale supported the decision in *Estate of Kent Avery*,[74] in which the Tax Court relied on the following unusual facts:

> Here . . . the $50,000 advance was not made merely to protect an existing job, but was made in order to *create* the very job that [taxpayer] sought for himself. His personality difficulties in working under others or with others of equal status were amply described by his psychiatrist . . . . His trade or business was that of a stylist and the corporation was organized to enable him to carry on that trade or business. . . . [T]his loan was primarily related to his trade or business as a stylist and only secondarily may it be considered a mere investment in the corporation.[75]

In a recent Revenue Ruling,[76] the Commissioner has accepted the judicial doctrine that a taxpayer's job may constitute a trade or business, and that losses on loans made to protect that job may therefore qualify as business bad debts. The recurrent problem in shareholder-creditor claims relying on this theory, however, will continue to be the proof of a proximate relationship between loans or guaranties and employment preservation. Apart from a few recent cases finding an insufficient causal relationship between the loans and employment protection,[77] the major obstacle faced by shareholder-employees has been proving that loans to their corporations were not in fact motivated by investment considerations. For the controlling shareholder this obstacle has been virtually insurmountable,[78] especially when his salary has been modest in comparison with his investment return.[79] Indeed, the shareholder-employee cases indicate that, in the absence of unusual

73. 26 CCH Tax Ct. Mem. 1063 (1967).
74. 28 CCH Tax Ct. Mem. 364 (1969).
75. *Id.* at 370-71.
76. Rev. Rul. 71-561, 1971 INT. REV. BULL. No. 50, at 13.
77. *See, e.g.*, Stratmore v. United States, 420 F.2d 461 (3d Cir. 1970).
78. *Cf.* Whipple v. Commissioner, 373 U.S. 193, 204 (1963) (dictum).
79. Millsap v. Commissioner, 387 F.2d 420 (8th Cir. 1968).

factual circumstances, it is essential that a taxpayer hold less than a controlling interest in the employing corporation if he is to establish the necessary proximate relation of loan to employment protection. Moreover, the smaller the taxpayer's interest in the corporation, the more probable it is that he will overcome the imputation of disqualifying investment motivation.[80]

2. *Separate Noncorporate Business Enterprise.*—The rationale upholding "business" treatment for loans to related corporations made in order to support a separate enterprise in which the taxpayer has a business interest is essentially identical to that underlying the employment preservation doctrine. Just as loans to a corporate employer may be required to protect one's employee status, lending to a corporate supplier or major customer of one's separate enterprise may be necessary to preserve one's separate business interests. To bring his transactions within this rationale, the taxpayer must show that the trade or business is separate and distinct from that of the debtor corporation[81] and is one in which the taxpayer actively participates as a sole proprietor or partner.[82]

The two leading cases interpreting the separate business enterprise doctrine were decided under section 23(k)(4) of the Internal Revenue Code of 1939, the immediate predecessor of present section 166. In *J. T. Dorminey*,[83] taxpayer had made loans to a banana import corporation of which he was vice president and a major stockholder. Taxpayer had formed the corporation to assure a constant supply of bananas for a wholesale produce dealership of which he was the sole proprietor. Finding that the loans were incidental and proximately related to the needs of taxpayer's produce business, the Tax Court held that the loss resulting from the corporation's default was fully deductible as a business bad debt. A different conclusion was reached by the Fourth Circuit in *Gulledge v. Commissioner*.[84] Taxpayer in that case was a peanut farmer who had advanced funds to a peanut processing corporation that he and other peanut farmers had formed to assure a better market for their produce. The corporation purchased not only taxpayer's peanut crop but also the crops of all farmers in the area. Although the court found the farming and processing businesses to be separate and distinct, it

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80. Philip W. Fitzpatrick, 26 CCH Tax Ct. Mem. 1 (1967).

81. *See* Burnet v. Clark, 287 U.S. 410 (1932); Dalton v. Bowers, 287 U.S. 404 (1932).

82. *See, e.g.*, S. E. Maitland Brenhouse, 37 T.C. 326 (1961), *acquiesced in*, 1962-2 CUM. BULL. 4.

83. 26 T.C. 940 (1956).

84. 249 F.2d 225 (4th Cir. 1957), *cert. denied*, 356 U.S. 959 (1958); *cf.* Spillers v. Commissioner, 407 F.2d 530, 534-35 (5th Cir. 1969).

found that taxpayer's loans had been made with the objective, not of supporting his farming operations, but rather of generating investment returns through dividends and an enhancement in the processing corporation's capital value.

The Tax Court generally has given the independent business doctrine a liberal application. Thus, when taxpayer's building contractor partnership executed a guaranty, customary in the trade, in connection with the financing arrangements of taxpayer's partially owned housing development corporation, the court held that taxpayer's payment upon the corporation's default was properly deductible under section 166 or section 162(a).[85] Similarly, when a professional has been able to establish a direct relationship between a loan to a client corporation and the preservation or enhancement of his professional income, the court has sustained a business bad debt deduction for resultant losses.[86] Defaulted loans to corporations that are not yet clients, however, are subjected to close scrutiny when claimed as business bad debts,[87] especially when the professional is a majority shareholder of the borrowing corporation.[88]

The decision of the Ninth Circuit in *Lundgren v. Commissioner*[89] contains an important application of the separate business enterprise and preservation of employment doctrines. In *Lundgren*, taxpayer had organized and actively managed several interrelated timber and lumber businesses. One of these enterprises, a lumber marketing corporation of which taxpayer was both an officer and the majority stockholder, had been organized to purchase timber that taxpayer acquired in an individual capacity. The marketing corporation had been unable to obtain loans from banks and had sought a loan from the United States Small Business Administration (SBA). The SBA agreed to advance funds to the corporation upon condition that taxpayer, among other things, act as guarantor, advance an additional 145,000 dollars of his own money, and make timber available to the corporation at cost until the obligation was satisfied. Taxpayer complied with this request, and when the corporation's facilities were ultimately destroyed by fire, he sustained a loss of 129,000 dollars on his advance.

The Ninth Circuit reversed the Tax Court's disallowance of taxpayer's business bad debt deduction and held that he had satisfied the requirements of section 166 on both employment protection and sepa-

85. A. L. Stanchfield, 24 CCH Tax Ct. Mem. 1681 (1965).
86. Frank A. Garlove, 34 P-H Tax Ct. Mem. 1147 (1965).
87. Robert B. Milgroom, 31 P-H Tax Ct. Mem. 533 (1962).
88. Estate of Dominick F. Pachella, 37 T.C. 347 (1961), *aff'd per curiam*, 310 F.2d 815 (3d Cir. 1962).
89. 376 F.2d 623 (9th Cir. 1967).

rate business enterprise grounds. The conditions imposed by the SBA financing agreement were central to each holding. Although taxpayer had never profited from his sales of timber to the corporation, the court reasoned that the SBA requirement that taxpayer sell to the corporation at cost justified his separate business enterprise claim, which was based upon anticipated sales to the corporation at a profit upon retirement of the debt. The court also rejected the lower court's finding that taxpayer was not in the business of providing services to the corporation because he never received a salary. The court held that, because the SBA prohibited payment of any salary to officers of the corporation without SBA permission, and because taxpayer fully anticipated receipt of salary as soon as the restrictions were withdrawn, the postponed realization of economic gain would not vitiate taxpayer's claim that his rendition of services to the corporation constituted a trade or business. The court reasoned:

> Rushmore's [the corporation's] existence depended upon its ability to obtain the financing necessary to put its . . . operations under way. If the SBA loan had not gone through, the corporation—and petitioner's job with it—would have been finished. In a direct sense, therefore, the advances were related to petitioner's trade or business activities in connection with Rushmore.[90]

The *Lundgren* holding was the product of somewhat unusual factual circumstances. Nevertheless, the decision introduces significant flexibility into the trade or business requirement. Although proof of a separate trade or business based upon anticipated salary income or projected independent business profits on transactions with a related corporation may pose a difficult evidentiary problem, *Lundgren* clearly shows that reasonable expectations of this nature are not insufficient as a matter of law to support business bad debt claims.

IV. Proximate Relationship Requirement

A successful showing that the activities of a shareholder-creditor constitute a trade or business separate from that of the corporate debtor is alone not enough to qualify a worthless obligation for full deductibility from ordinary income. Section 166(d)(2)(A), defining business bad debts as debts acquired "in connection with a trade or business of the taxpayer,"[91] requires a further showing that the loan in issue was related to taxpayer's trade or business rather than to other profit-seeking activity. Treasury Regulation section 1.166-5(b) explains this definition as limiting business bad debt status to those debts that are *proximately*

90. *Id.* at 628 (citations omitted).
91. Int. Rev. Code of 1954, § 166(d)(2)(A).

related to the taxpayer's separate trade or business.[92] Neither the Code nor the Regulations, however, provide a general definition of "proximate," the crucial term in Regulation section 1.166-5(b).[93] This definitional void became the focus of much of the bad debt litigation of the last decade.

A. Development of Conflicting Judicial Standards

The judicial development of criteria for determining the existence of a proximate relationship between bad debt losses and a shareholder-creditor's separate trade or business may be traced to a joint origin in *Trent v. Commissioner*[94] and *Whipple v. Commissioner*.[95] *Trent* held that a proximate relationship was established when advances to a related corporation were shown to be a necessary condition of taxpayer's continuation of his separate trade or business.[96] In *Whipple*, the Supreme Court apparently accepted the *Trent* situation as the exemplar of a proximate relationship, and indicated approval of the proximate relation test itself, by rejecting taxpayer's employment protection claim on the grounds that "no proof [had been offered] . . . that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee."[97] By its central emphasis on the distinction between bad debts arising from business activities and those arising from activities peculiar to investors, moreover, *Whipple* added to the proximate relation parameters a consideration of the relative weights attributable to a shareholder-creditor's underlying investment and separate business interests.

92. Treas. Reg. § 1.166-5(b) (1959) provides: "(b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than— . . . (2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The question whether a debt is a nonbusiness debt is a question of fact in each particular case. . . . For purpose of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph." For a general discussion of the problems posed by the Regulation see Comment, *Bad Debt Deduction for Shareholder-Creditor Under Proximate Relation Test*, 28 WASH. & LEE L. REV. 161 (1971).

93. Although the term occurs several times in the Report of the Committee on Ways and Means on the Revenue Act of 1942, HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1942, H.R. REP. No. 2333, 77th Cong., 2d Sess. 74-76 (1942), no specific meaning is ascribed to it therein.

94. 291 F.2d 669 (2d Cir. 1961).

95. 373 U.S. 193 (1963).

96. *Cf.* J.T. Dorminey, 26 T.C. 940 (1956); Tony Martin, 25 T.C. 94 (1955).

97. 373 U.S. at 204 (1963).

A synthesis of these various elements was attempted by the Second Circuit in *Weddle v. Commissioner*.[98] The court first applied the "necessary condition" test of *Trent*, and found that loan obligations of a related corporation in the hands of a majority shareholder-officer could be proximately related to the preservation of employment on the ground that the failure of the corporation for lack of funds would effectively result in employee discharge. The court then interpreted *Whipple* as requiring some minimum amount of separate business motivation for the loan in order to qualify it for business bad debt status. Existence of the necessary degree of noninvestment motivation was found to turn on the meaning of "proximate." The majority concluded that a showing of a *significant* business motive would be sufficient to offset such considerations as a desire to enhance the value of capital stock or to increase dividend returns. Writing for the majority, Judge Friendly buttressed this position with two arguments: the majority's interpretation was wholly consistent with the legislative history of the Revenue Act of 1942; and, more importantly, the purposeful selection of the word "proximate" indicated an acceptance of the meaning of that word in its area of greatest use—the law of torts. Judge Friendly reasoned: "[A] cause contributing to a harm may be found 'proximate' despite the fact that it may have been 'secondary' to another contributing cause. [Thus] 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."[99] Finding that taxpayer had failed to prove even a significant business motivation for the loan in question, however, the majority disallowed the business bad debt deduction.

Judge Lumbard concurred in the result in *Weddle*, but he insisted that "proximately related" to a creditor's business should be held to mean "primarily" related thereto. Judge Lumbard emphasized the patent incongruity of considerations peculiarly relevant to tort law—time, space, foreseeability, and the basic notion of causation in fact—to a tax problem requiring the isolation and evaluation of the various motivations that may simultaneously trigger a given loan or guaranty. The significant motivation standard, he predicted, would invariably result in judgment for the taxpayer; more importantly, that standard would not easily be understood or applied.[100]

Although most courts continued to avoid setting out a specific

98. 325 F.2d 849 (2d Cir. 1963).
99. *Id.* at 851.
100. *Id.*

standard of "proximate relationship,"[101] each of the competing interpretations in *Weddle* attracted adherents. The "significant motivation" standard was adopted by the Fifth Circuit in *Kelley v. Patterson*[102] and by the Eighth Circuit in *Millsap v. Commissioner*.[103] Several courts, however, viewed the liberal interpretation of the *Weddle* majority as inconsistent with *Whipple* and as contrary to the congressional policy of encouraging active business endeavours by making available tax benefits not accorded mere passive investments. In *Niblock v. Commissioner*,[104] the Seventh Circuit challenged the relevance of tort concepts to the federal income tax law because of the very different social policy considerations underlying each body of law. *Niblock* adopted a "dominant and primary" motivation standard as the only test that would assure consistency in the application of section 166. No court, however, departed from the *Weddle* pattern to suggest a possible third test of proximate relationship, and the issue was thus fixed as a conflict between the two motivational standards. In *United States v. Generes*,[105] the Supreme Court resolved this conflict.

B. *United States v. Generes*

The taxpayer in *Generes* was president of a family construction corporation in which he and a son-in-law each owned 44 percent of the capital stock.[106] Although taxpayer was paid an annual salary of 12,000 dollars, he received neither dividends nor any other return on his original investment during the entire history of the enterprise. In addition to formulating cost estimates and feasibility projections and receiving job bids for the corporation, taxpayer had helped obtain necessary financing by arranging loans and providing personal guarantees. When the construction company went into receivership, taxpayer was forced to satisfy a personal indemnity obligation arising from his agreement to reimburse a bonding company in the event of the construction company's default on payment and performance bonds. Taxpayer deducted this payment from his current ordinary income pro tanto, and applied the remainder as a net operating loss carry back under section 172.[107]

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101. *See, e.g.*, Stratmore v. United States, 420 F.2d 461 (3d Cir. 1970); Maurice Arstein, 29 CCH Tax Ct. Mem. 961 (1970).

102. 331 F.2d 753 (5th Cir. 1964).

103. 387 F.2d 420 (8th Cir. 1968). *See* Comment, *Income Tax—Significant Motivation Test for Determining Business Bad Debt Deductions*, 2 TEXAS TECH. L. REV. 318 (1971).

104. 417 F.2d 1185 (7th Cir. 1969).

105. 405 U.S. 93 (1972).

106. The remaining 12% of the stock in the corporation was owned by a son of the taxpayer and by another son-in-law.

107. INT. REV. CODE OF 1954, § 172. Section 172 provides generally that the excess of

The Commissioner disallowed the claimed business bad debt deduction, and taxpayer instituted suit for a refund. After an instruction by the district court that taxpayer need prove only "a significant business motivation" for executing the guaranty agreement in order to satisfy the "proximate relation" requirement, the jury handed down a verdict for taxpayer and the Government appealed.[108] When the Fifth Circuit affirmed the district court judgment,[109] the Supreme Court granted certiorari to resolve the conflict in the circuits over the meaning of "proximate relation" in Regulation section 1.166-5.[110] The Court reversed, holding that a taxpayer who seeks business bad debt treatment must prove that his *primary* motive in consummating the loan transaction was to protect his separate business activity.[111]

Taxpayer had contended that Congress, in enacting the 1954 Code, intended to extend the availability of ordinary deductions to losses from debts not directly related to the taxpayer's trade or business. Under section 23(k)(4) of the Internal Revenue Code of 1939, the immediate predecessor of section 166(d)(2), the definition of a business debt had included only "a debt the worthlessness of which is incurred in the taxpayer's trade or business."[112] Taxpayer argued that the 1954 addition of section 166(d)(2)(A)—including in the business debt definition debts "created or acquired (as the case may be) in connection with a trade or business of the taxpayer"—would have been meaningless unless motivated by a desire to place both directly and indirectly related debts on an equal footing.[113] The majority opinion skirted the thrust of this argument by declaring that the significant motivation test would tend to obliterate or blunt[114] the distinction drawn throughout the Code between the "particular tax benefits [given] to business losses, business bad debts, and business expenses, and . . . [the] lesser benefits, or none at all, [accorded] to non-business losses, non-business bad debts and non-business expenses."[115]

Taxpayer also argued that the Supreme Court had already indi-

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allowable deductions from ordinary income over the taxpayer's actual income in a given year may be applied (carried "back" or "forward") against his taxable income in other years.

108. 67-2 U.S. Tax Cas. ¶ 9754 (E.D. La. 1967).

109. 427 F.2d 279 (5th Cir. 1970).

110. 401 U.S. 972 (1971).

111. 405 U.S. 93 (1972); *see* Cohen, *Supreme Court Restricts Business Bad Debt Treatment of Stockholder-Corporate Loans*, 36 J. TAXATION 194 (1972).

112. Revenue Act of 1942, ch. 619, § 124, 56 Stat. 821, *amending* INT. REV. CODE OF 1939, ch. 2, § 23(k), 53 Stat. 12.

113. Brief for Respondent at 11, United States v. Generes, 405 U.S. 93 (1972).

114. 405 U.S. at 104.

115. *Id.* at 103.

cated its approval of the significant motivation test in *Whipple*,[116] basing his contention on the Court's ultimate disposition of the earlier case. Taxpayer reasoned that, by remanding *Whipple* to the Tax Court for a determination whether the loan had been made in taxpayer's business of being a landlord, the Court had implicitly required proof of only a single qualifying motivation, rather than proof that only qualifying motivations were present. The majority again avoided a direct rebuttal, instead rejecting taxpayer's thesis on the ground that the significant movitation standard would vitiate the distinction between a shareholder-creditor's investment and business interests upon which *Whipple* was founded. In support of this conclusion, the majority opinion cited Judge Lumbard's concurrence in *Weddle*, which had stated that the significant motivation test would inevitably favor the taxpayer by discounting entirely the effect of investment motivations.[117]

In reply to taxpayer's contention that *Lundgren v. Commissioner*[118] had demonstrated the "workability" of a significant motivation standard,[119] the Court announced that the "dominant and primary" test provides maximum certainty and is thus the only standard suitable for resolving, by reference to objective criteria, the basic incongruity of the dual motivation of a shareholder-creditor. "The trier then may compare the risk against the potential reward and give proper emphasis to the objective rather than the subjective."[120] Taxpayer's alternative demand that the Court not sacrifice fairness to the taxpayer in order to achieve certainty[121] was dismissed with the observation that the strict requirement of a dominant motivation standard would better insure a fair allocation of tax benefits consistent with the Code's rigid separation of business from other activities.[122]

The majority conceded that the use in the Regulations of the term "proximate" was indeed unfortunate, but rejected out of hand taxpayer's suggestion that the word be given the meaning ascribed to it in tort law. Considerations of unquestionable validity in the law of torts were ruled quite inappropriate in federal income tax law.[123] Finally, the Court refused to remand the case, on the ground that taxpayer had offered no evidence that could satisfy the dominant motivation stan-

116. Brief for Respondent at 12.

117. 405 U.S. at 104; *see* Weddle v. Commissioner, 325 F.2d 849, 852 (2d Cir. 1963) (Lumbard, J., concurring in part, dissenting in part).

118. 376 F.2d 623 (9th Cir. 1967). *See* text accompanying notes 89-90 *supra*.

119. Brief for Respondent at 15.

120. 405 U.S. at 104.

121. Brief for Respondent at 17.

122. 405 U.S. at 105.

123. *Id.*

dard; taxpayer's only evidence of a qualifying employment protection motive was characterized by the majority as "self-serving statements" that would not "withstand the light of analysis" on the facts of the case.[124]

In a concurring opinion, Mr. Justice Marshall expressed reservations about the majority's purposive conclusion that "proximate" necessarily meant dominant and primary, reasoning that the ambiguity in the statute and the regulations required a more penetrating inquiry into the legislative history of section 166(d) and related loss provisions. This inquiry led him to conclude that the primary motivation standard was appropriate for two specific reasons. The first was the overall congressional approach to bad debt and loss deductions:

> Congress wanted to permit deductions against ordinary income for bad-debt losses only when the losses bore the same relation to the taxpayer's trade or business as did other losses that the Code permits to be deducted against ordinary income. Under § 165(c)(1) of the Code, 26 U.S.C. § 165(c)(1), the primary-motivation test has always been used to determine whether these other losses are incurred in a trade or business or in some other capacity, see e.g. *Imbesi v. Commissioner*, 361 F.2d 640 (CA3 1966), *United States v. Gilmore*, 372 U.S. 39 (1963).[125]

The second justification found by Justice Marshall in the legislative history for the application of a primary motivation standard was the express objective of the 1942 amendments—discouraging the use of intrafamily loans to obtain unwarranted tax benefits, an especially relevant consideration in *Generes*, since the *Generes* facts could easily be characterized as the use of a corporation as a mere conduit for intrafamilial transactions.[126]

In a separate opinion, Justices White and Brennan approved the dominant motivation test, but challenged the majority's outright reversal, asserting that the Court should have remanded the case for a hearing on the sufficiency of the evidence under the approved standard.[127] Implicit in this recommendation was a recognition that an outright reversal without an elaboration of the objective criteria sufficient to establish a dominant motivation would confuse future courts seeking to

124. *Id.* at 106.

125. *Id.* at 111-12.

126. "If this taxpayer had simply lent his son-in-law $162,000 and then sought to deduct that amount as a business bad debt when the latter's business collapsed, he plainly could not have prevailed. This was just the sort of intra-family loan that Congress intended to bar from treatment as a business bad debt. The fact that a corporation served as a conduit for the loan should make no difference . . . . [I]f instead of guaranteeing the construction bonds, the taxpayer had invested $162,000 in the corporation to strengthen its economic position . . . any loss [from that investment] would not be deductible against ordinary income. The fact that the intra-family contribution was made in the form of a guarantee should be irrelevant for income tax purposes." *Id.* at 111.

127. 405 U.S. at 112.

apply the standard in varying factual situations.

Mr. Justice Douglas voiced a lone, but vigorous, dissent. He felt that the ambiguity inherent in the statute and regulations should be referred to the Treasury or Congress for clarification, rather than tested by individual taxpayers proceeding in case-by-case litigation. In his judgment, moreover, the Court's decision on the merits effectively upheld affirmative executive deprivation of taxpayers' property without express legislative authority.[128]

C. *The Impact of Generes*

That four separate opinions were filed in *Generes* indicates the difficulty that the Supreme Court encountered in applying the "proximate relation" test. It is not unlikely that this difficulty provided a major impetus for the Court's decision to adopt the dominant motivation standard. Certainty in the law of taxation is indisputably a virtue; the *Generes* standard will no doubt further this ideal in the administration of bad debt litigation. Guided by the primary motivation standard, the fact finder need determine only the controlling motive of the taxpayer for extending a loan to his corporation. The Court's assumption that this narrower inquiry will lead to more consistent adjudications of bad debt claims than will independent evaluations of multiple motivations against a protean standard of "significance" seems well warranted. Nevertheless, *Generes* has effectively promoted certainty of administration by sacrifing the equally desirable objective of certainty in business and tax planning. Because the *Generes* decision leaves both the fact finder and the shareholder-creditor with no clear statement of the criteria that reveal a taxpayer's primary motivation, even the rare businessman who thinks he has identified his dominant motive cannot be sure that the fact finder will find it so. The *Generes* standard thus injects substantial uncertainty into the planning of debt financing for a related corporation.

The *Generes* majority was primarily concerned with an inherent problem in a system of voluntary taxation—taxpayer attempts to cast their transactions in forms giving rise to more favorable tax treatment than the legislature deemed merited by the substance of what is done. The Commissioner had warned that the significant motivation test would intensify this problem because its more liberal approach "permits the business considerations to control the tax result where the nonbusiness consideration is the predominant motivating factor."[129] *Generes*

128. *Id.* at 113.
129. Brief for Petitioner at 16.

thus represents a basic policy decision to value considerations of substance over those of form in the bad debt context. This central policy orientation may explain the majority's casual attitude toward both the specific terms of the statute and its legislative history. Although an abandonment of strict statutory construction in furtherance of a clear statutory policy may be laudable, it is arguable that the *Generes* Court's emphasis on substance over form led it to contravene the explicit congressional policy of using tax incentives to encourage small business investment and development. Congressional concern for small business development, even at the expense of disparate treatment of individual taxpayer investment activities, is most clearly embodied in section 1244[130] and the Subchapter S provisions[131] of the Code. Adoption of the significant motivation standard would have furthered this policy by providing an incentive to entrepreneurial activities in the form of tax relief for losses sustained by individuals on cash advances to small business enterprises. The primary motivation standard, however, magnifies the threat of capital loss treatment inherent in loans to related corporations,[132] and may thus be expected to inhibit significantly high-risk advances to close corporations. The planning uncertainty and increased probability of capital loss treatment occasioned by *Generes*, moreover, may pose a direct threat to future small business formation and development. Because close corporations often possess negligible credit leverage, debt financing to survive business reverses or to capitalize upon risk opportunities is usually available only through direct loans by interested shareholders or by third-party lenders, such as banks and other lending institutions, who require personal guarantees from controlling shareholders. The budding entrepreneur who is unwilling to risk capital treatment of his entire economic loss in the event his business fails will thus be forced to abandon his corporate ambitions unless he can structure his advances to avoid possible confrontations with *Generes* and the dominant motivation standard. One method of avoid-

130. INT. REV. CODE OF 1954, § 1244 (added by the Business Tax Revision Act of 1958, § 202(b), 72 Stat. 1676). "This provision is designed to encourage the flow of new funds into small business. The encouragement in this case takes the form of reducing the risk of a loss for these new funds. The ordinary loss treatment which the bill accords shareholders in small corporations in effect is already available to proprietors and partners. They report directly the earnings of business ventures and thus ordinary losses realized by a proprietorship or partnership constitute ordinary loss to the proprietor or partner. As a result, from the standpoint of risk taking, the bill places shareholders in small corporations on a more nearly equal basis with these proprietors and partners." H.R. REP. NO. 2198, 85th Cong., 2d Sess. 4 (1958).

131. INT. REV. CODE OF 1954, §§ 1371-79 (added by the Technical Amendments Act of 1958, § 64, 72 Stat. 1650).

132. *See* INT. REV. CODE OF 1954, § 385(b).

ing the effects of *Generes* that may be available to the taxpayer is designing the transaction to avoid section 166 entirely.

1. Third-Party Creditors.—A much-litigated device by which taxpayers have sought to avoid section 166 has been the claim of a full ordinary loss deduction under section 165(c)(2) for shareholder losses on personal indemnity or guaranty agreements given to secure corporate borrowings from unrelated third-party lenders. In *Putnam v. Commissioner*,[133] the Supreme Court rejected such a claim by a taxpayer who had been required by the terms of a personal guaranty to satisfy a corporate debt obligation. The Court's holding that taxpayer was entitled only to a nonbusiness bad debt deduction was based upon a precise analysis of the legal relationship between a guarantor and the principal obligor, which the Court found to be that of creditor and debtor. "The familiar rule is that, *instanter* upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes."[134] By a parity of reasoning, a shareholder-surety who manages to avoid subrogee status should not automatically be viewed as the corporation's creditor; consequently, the surety's loss does not technically arise from the worthlessness of a debt in his hands.[135] This reasoning led several courts to uphold ordinary deductions under section 165(c)(2) for losses sustained on transactions so structured that the taxpayer had no right of subrogation against the corporate obligor.[136] Similarly, guarantors occasionally were able to avoid the effect of *Putnam* when they had forestalled automatic subrogation through such devices as partial payment of the principal obligation in settlement of the guaranty.[137]

The emphasis in *Putnam* on the technical effect of subrogation in the guaranty context left undetermined the proper tax treatment of a shareholder who agrees to indemnify the third-party surety of his corporation's obligation. It is settled law that an indemnitor does not enjoy the absolute right of subrogation that accrues to a guarantor automatically upon his payment of the obligation. Thus no debtor-creditor rela-

133. 352 U.S. 82 (1956).

134. *Id.* at 85.

135. *See* 3 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION ¶ 35.06, at 3552-53 (rev. supp. 1972). *See also* Note, *Nonbusiness Guaranty Loss: Ordinary or Capital Deduction?*, 10 WM. & MARY L. REV. 705, 709 (1969).

136. *See, e.g.*, Commissioner v. Condit, 333 F.2d 585 (10th Cir. 1964); J.J. Shea, 36 T.C. 577 (1961), *aff'd per curiam*, 327 F.2d 1002 (5th Cir. 1964); *cf.* Peter Stamos, 22 T.C. 885 (1954).

137. *See, e.g.*, Santa Anita Consol., Inc., 50 T.C. 536, 555, 560-61 (1968).

tionship is created between an obligor corporation and a shareholder surety *instanter* upon the latter's payment under the indemnity agreement, and the shareholder's losses would seem to fall outside the restrictive provisions of section 166. Not all courts allowed such fine common-law distinctions to create different tax consequences for transactions identical in economic substance.[138] In *United States v. Hoffman*,[139] for example, the Ninth Circuit denied 165(c)(2) status to an indemnitor's losses in a factual situation virtually indistinguishable from that in *Generes*.[140] The court held that evaluation of the claimed deduction under section 166 was necessary "to protect the statutory scheme for a common tax treatment of all losses suffered by a corporate stockholder in providing his corporation with financing."[141] *Hoffman* cited with approval an earlier decision of the Third Circuit, which had stated that

> [i]t is not meaningful to emphasize unduly the common law principle of subrogation in analyzing the substantial realities upon which federal taxation is based. . . . To allow the tax result to turn on the presence or absence of this technical right of subrogation under state law would be to undermine the *Putnam* doctrine—taxpayers could change capital losses to ordinary losses almost at will.[142]

In *Generes*, because taxpayer made no 165(c)(2) claim for an ordinary loss deduction, the Supreme Court did not rule on the significance of subrogation rights in that context. Moreover, it would be inaccurate to conclude that the Supreme Court necessarily rejected the materiality of subrogation rights by its disposition of *Generes* merely because taxpayer there, like the taxpayer in *Hoffman*, stood in the position of indemnitor to the surety bonding company; under the technical rules of the common law, an indemnitor who is compelled to satisfy a surety's liability is not entitled to subrogation.[143] Nevertheless, the emphasis in *Generes* on the economic substance of loan transactions is clearly inconsistent with a hypertechnical reading of the Code by which a two-step capital contribution by a shareholder-surety would produce ordinary income deductions for investment activity. Reliance upon the peculiari-

138. *Cf., e.g.*, Burnet v. Harmel, 287 U.S. 103 (1933) (common-law distinctions are not determinative for tax purposes).

139. 423 F.2d 1217 (9th Cir. 1970).

140. Taxpayer in *Hoffman* was the president, director, and sole owner of a corporation engaged in construction work. He received an annual salary for his services as an officer. In addition to his responsibilities of receiving job bids, he obtained financing for the corporation's performance bonds by agreeing to indemnify the bonding company. As a result of his corporation's operational difficulties the bonding company was forced to make payments, for which taxpayer made full indemnification.

141. 423 F.2d at 1218.

142. Stratmore v. United States, 420 F.2d 461, 465 (3d Cir. 1970).

143. Howell v. Commissioner, 69 F.2d 447, 451 (8tb Cir. 1934).

ties of the common law of subrogation will henceforth surely be misplaced.

2. *Other Escapes from Section 166.*—By eschewing direct or guaranteed third-party loans the individual shareholder may still maximize his prospective tax benefits by supplying his corporate enterprise with liquid assets in transactions that fall within section 165(c)(2). A shareholder can, for example, easily convert cash into securities that may be delivered to the use of his corporation for a stated periodic fee. If the taxpayer takes care to avoid any arrangement for a right of return by the corporation of a cash equivalent for the securities, the transaction will retain the legal character of a bailment. If the corporation is later forced to sell the securities because of business collapse, the shareholder-bailor will be entitled to a full ordinary loss deduction under section 165(c)(2).[144]

A few taxpayers will find it convenient to protect potential ordinary loss deductions by placing risk capital in partnerships, corporations issuing "small business stock" pursuant to section 1244, or Subchapter S corporations. Both section 1244 and Subchapter S were designed to encourage high-risk loans to developing corporations by providing ordinary deduction tax relief upon failure of the corporate enterprise. Each, however, has rigid eligibility requirements and limitations on deductions. Section 1244 is perhaps better suited for investment in a new corporation; because the limitations on total shareholder investment apply only at the time a plan to offer section 1244 stock is adopted, the taxpayer's potential deduction from ordinary income is preserved as long as he holds the stock. Nevertheless, the ordinary deduction limit of 25,000 dollars in any one year[145] offers inadequate protection in many situations.

Causing an eligible debtor corporation to file an election under Subchapter S is a method of salvaging a full loss deduction when expected corporate reverses threaten outstanding shareholder-creditor advances. After the election becomes effective, current net operating losses of the corporation are passed through to the shareholders. These losses are immediately deductible from ordinary income, and there is no requirement that deductions be postponed until disposition of the stock or ultimate worthlessness of the investment. The amount of loss available to the shareholder as a deduction is limited to the basis of his stock in the corporation and to any debt the corporation owes him. Discharge of guaranty obligations incurred by a stockholder, however,

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144. Stahl v. United States, 441 F.2d 999 (D.C. Cir. 1970).

145. The limitation is $50,000 for married shareholders filing a joint return.

will occasion indebtedness on the part of the corporation, thereby increasing pro tanto the amount of deductible loss. The limits to which a net operating loss can be charged off cannot be increased by an increase of investment or by corporate debt to the stockholder in a year subsequent to the taxable year in which the net operating loss occurs.

3. Business Bad Debts After Generes.—Although *Generes* has clearly narrowed the concept of the business bad debt, the decision does not appear to have altered substantially the factors one must consider when preparing a claim for a full ordinary deduction. Unquestionably, the burden of proof necessary to sustain a business bad debt claim has been markedly increased. Indeed, it may now be unrealistic for a taxpayer to expect to overcome a challenge by the Commissioner to business debt status. Nevertheless, the shareholder-creditor who is pressed into conference or litigation should resort to established judicial doctrines in order to support his claim. For example, business bad debt deductions remain available to the true promoter, and to the dealer in enterprises,[146] if the underlying loan is proximately related to such activity.[147] An individual who organizes one or many corporations does not necessarily qualify as a promoter. If he neither earns fees for promotions nor profits on *quick* sales, but seeks only investment gains from long-term operations and ultimate disposition, he will be denied promoter status.[148] One who is in the business of lending money for profit may obtain the tax benefits accruing to business bad debts; nevertheless, loans to corporations in which the taxpayer has a substantial investment or family interest will rarely qualify.[149] Loans made to preserve one's employment may qualify for business bad debt treatment,[150] but this result does not follow from the mere showing of an employment relationship.[151] The controlling shareholder who relies on the employment protection doctrine has small chance of success, particularly when his salary is modest in comparison with his investment interests,[152] or when he could readily obtain equivalent employment elsewhere.[153] Loans to

146. A dealer in enterprises is a person in the business of organizing and financing corporations and selling them at a profit. Giblin v. Commissioner, 227 F.2d 692, 695-96 (5th Cir. 1955); *see* Ralph Biernbaum, 32 P-H Tax Ct. Mem. 1188, 1196 (1963); text accompanying notes 44-52 *supra*.

147. United States v. Clark, 358 F.2d 892 (1st Cir. 1966).

148. Townshend v. United States, 384 F.2d 1008 (Ct. Cl. 1967); Syer v. United States, 380 F.2d 1009 (4th Cir. 1967); United States v. Byck, 325 F.2d 551 (5th Cir. 1963).

149. Gross v. Commissioner, 401 F.2d 600 (9th Cir. 1968); United States v. Henderson, 375 F.2d 36, 41 (5th Cir.), *cert. denied*, 389 U.S. 844 (1967).

150. Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).

151. United States v. Worrell, 398 F.2d 427 (5th Cir. 1968).

152. Millsap v. Commissioner, 387 F.2d 420, 422 (8th Cir. 1968).

153. Niblock v. Commissioner, 417 F.2d 1185, 1187 (7th Cir. 1969).

a related corporation made to assure a source of supply or demand for one's individual business may result in business bad debts.[154] If there is no shortage of supply, however, an ordinary deduction may be denied on the assumption that the real motivation of the loan was the lender's investment interests.[155] Finally, even a pure equity investment may be so proximately related to the shareholder's separate business that the loss may qualify as an ordinary business deduction.[156]

The types of evidence isolated as most significant in determining a shareholder-creditor's motivation have been: the taxpayer's testimony; the proportional relationship of the taxpayer's salary to the value of his investment; the possibility of the corporation's failure without the lending assistance procured by the taxpayer; and the extent of authority the taxpayer could exercise over the hiring and firing of corporate employees.[157] These criteria appear to remain valid. Other factors, such as the frequency of taxpayer's lending activity and the demands of the corporation's creditors, that bear upon the shareholder's motivation may also be considered by the trier of fact. Additional indicia of business motivation will presumably be enumerated on a case-by-case basis.

The *Generes* holding attempts to remove from individual cases arising under section 166—the provisions of which are perhaps as vaguely drawn and as susceptible to varying interpretation as any in the Code—the necessity of balancing the competing taxpayer and revenue interests by adopting a uniform standard that will serve both interests in all bad debt litigation. The inquiry required by *Generes* is designed not only to encourage the production of evidence that will "bear the light of analysis" and thus relieve litigants of inaccurate and inconsistent decisions, but also to restrict the availability of preferential tax treatment, thereby ensuring both a more equitable allocation of the tax burden and an increase in tax revenues. The resulting strong presumption in favor of the Commissioner will theoretically be acceptable to the individual taxpayer when he realizes that a demanding, objective standard for allocating tax benefits will foster certainty in tax administration.[158]

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154. J.T. Dorminey, 26 T.C. 940, 945 (1956).

155. Spillers v. Commissioner, 407 F.2d 530, 534-35 (5th Cir. 1969).

156. *See* Steadman v. Commissioner, 424 F.2d 1, 5-6 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970).

157. Note, *Individual's Deduction for Business Bad Debts Under the Internal Revenue Code*, 12 B.C. IND. & COM. L. REV. 478, 488 (1971).

158. Controversy over the dominant motivation standard as a useful device for revealing taxpayer intent had earlier surfaced in United States v. Donruss Co., 393 U.S. 297 (1969), in which the Court sought to determine the quantum of tax avoidance purpose necessary to incur liability

The question remains, however, whether the substantial contribution of *Generes* to sound tax administration is sufficient to negate the decision's adverse practical impact upon taxpayers in a congressionally favored sector of the economy. The Court's "primary motivation" test of proximate relationship will invariably discriminate against the shareholder-creditor who had several motives for his advance, even when he would not have made the loan but for his independent business interests. As a result, all but the most obvious business bad debt claims will be placed in jeopardy. Absent a reasonable availability of full deductions from ordinary income to partially offset the risk of loss, small businessmen will hesitate to supply, through loans or guaranties, the financing necessary to stabilize a floundering corporation. Third-party lending institutions, understandably reluctant to assume the great risk of small business financing without the assurance of a personal guaranty executed by a shareholder or employee of substantial personal net worth, offer no residual relief. Thus, the increased probability of capital loss treatment following *Generes* may largely vitiate investment incentive.

V. Conclusion

The federal income tax system has fostered a constant struggle between the taxpayer, who tries to alleviate what he feels to be a weighty tax burden by structuring transactional forms to meet the letter of the Code, and the Commissioner, who seeks to cut through these forms to expose the underlying economic reality by a purposive reading of the levying enactments. In justification of his position, the taxpayer urges that he is legally right, and perhaps morally obligated, to save every tax dollar that the letter of the law allows, while the Commissioner insists that the always escalating revenue needs of responsible government require each taxpayer to contribute his fair share. It is axiomatic that

for the accumulated earnings tax imposed by section 531. The Court held that, unless a corporate taxpayer can establish that shareholder tax avoidance was not *one* of the purposes for accumulation, the fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business shall be determinative of surtax liability. Taxpayer's contention that the tax avoidance purpose need be dominant, compelling, and controlling was rejected as contrary to the true legislative purpose behind the accumulated earnings tax, because the suggested standard would allow the taxpayer to escape the surtax by a purposive marshalling of subjective evidence showing at least one qualifying business motive equal to that of tax avoidance. In refusing to require a difficult and dubious separate evaluation and comparison of subjectively evidenced multiple corporate motives, the Court articulated a preference for the more objective inquiry into the reasonableness of the retention of earnings and profits for purported business needs. Thus, these seemingly inconsistent decisions are easily reconciled as products of the same judicial desire to accomodate the conflicting interests of the government and the taxpayer.

tax liability should reflect the substance of a taxpayer's economic status. Similarly, a self-assessment system requires that taxpayers retain confidence that each bears only his fair share of the tax burden.

The conflict between these essentially dissimilar objectives comes to sharpest focus in the context of vaguely drawn legislation. In resolving this conflict, the judiciary must try to accommodate both interests as it applies the statutory language to particular cases. A judicial effort to grant relief in an individual case may open the door to flagrant abuse, and an attempt to rectify abuse may result in an unjustified reversal of the taxpayer's expectations.

The *Generes* case represents an attempt by the Court to fashion a clear standard that will lead to decisions based upon considerations of economic substance underlying the form of particular transactions. In one sense, the Court unquestionably has succeeded; the stringent requirements of the primary motivation test appear to leave little likelihood that a transaction consummated in anticipation of investment rewards will escape capital loss treatment. The almost insuperable difficulty of proving dominant business motivation, however, seems likely to make the result in many cases depend more upon forensic considerations than upon economic substance. To the extent that the economic realities of taxpayer activity are thus discounted, the *Generes* Court is guilty of judicial overkill.

BLAND W. CANNON, JR.