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Federal Income Taxation--Section 165 (c) Loss Allowed for Securities Loaned to Brokerage Firm That Subsequently Became Insolvent and Sold the Securities to Meet the Claims of Creditors--*Stahl v. United States*

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RECENT DEVELOPMENTS

FEDERAL INCOME TAXATION—Section 165(c) Loss Allowed for Securities Loaned to Brokerage Firm That Subsequently Became Insolvent and Sold the Securities to Meet the Claims of Creditors—*Stahl v. United States**

It is frequently said that there are only two certainties in life: death and taxes. The Court of Appeals for the District of Columbia Circuit recently upheld a district court decision[1] that considerably eased the latter burden for plaintiff-taxpayer in *Stahl v. United States.*[2] On April 12, 1962, Mrs. Stahl, a widowed musician and music teacher, reached an agreement with Balough & Company (Balough), a Washington securities firm, under which she was to surrender to it control of securities with a market value of approximately $210,000. Balough used the securities to meet the minimum capital requirements for brokerage firms established by the Securities and Exchange Commission (SEC).[3] To comply with these requirements, the agreement was structured to subordinate the rights of Mrs. Stahl to the claims of all the firm's creditors, present and future. As compensation for the use of the securities, Mrs. Stahl was to receive one per cent of the market value of the securities every three months. In addition, she was to receive the dividend and interest income that the securities produced.[4] Consistent with the firm's policy, Mrs. Stahl was made a member of the board of directors of Balough shortly before the subordination agreement was signed. The initial agreement provided that the securities were to be returned on May 12, 1963, but a subsequent amendment extended the termination date. Prior to the extended termination date, the securities were sold to meet the claims of Balough's creditors and in August 1964 the firm filed a voluntary petition in bankruptcy.[5]

In her amended tax return for 1963, Mrs. Stahl claimed an ordi-

* 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970).

1. Stahl v. United States, 294 F. Supp. 243 (D.D.C. 1969).

2. 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970).

3. SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1971).

4. Both Mrs. Stahl and an officer of the securities firm testified that Mrs. Stahl was also entitled to share in the profits of the firm at such time as profits were declared. Brief for Appellee at 13, Stahl v. United States, 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970). This fact was not disclosed in the opinions of either the district court or the court of appeals. For a brief discussion of the significance of profit-sharing in relation to capital participation, see note 67 *infra*.

5. 70-2 U.S. Tax Cas. at 84,825. Mrs. Stahl was authorized at a special meeting of directors to file the bankruptcy petition. She signed the petition as assistant secretary. On October 15, 1964, Mrs. Stahl filed a Proof of Claim as a general creditor for $257, 078.90, representing the market value of the securities at the time of adjudication and all interest and dividends accrued after the 1963 sale of the securities. *In re* Balough & Co., Inc., Bankrupt, No. 69-64 (Bankruptcy Ct. D.D.C., Sept. 20, 1971).

nary loss of $87,146[6] under section 165(c) of the Internal Revenue Code of 1954.[7] The Internal Revenue Service disallowed the deduction on the ground that the loss was not a loss deductible from ordinary income but a loss from a nonbusiness bad debt deductible under section 166(d) of the Code and therefore limited to short-term capital loss treatment.[8] Furthermore, the debt was not deductible in 1963 because it was not wholly worthless within that year.[9] Mrs. Stahl paid the additional assessment and brought suit for a refund.

Both the Government and the taxpayer agreed that the loss was deductible. The dispute centered on the proper characterization of the transaction since substantial differences in tax treatment result from its characterization. Section 165(c)(1) provides for a deduction from ordinary income of losses incurred in a taxpayer's trade or business.[10] A similar deduction is allowed under section 165(c)(2) for losses incurred in any nontrade or business transaction entered into for profit.[11] If the transaction is characterized as a bad debt under section 166,[12] the taxpayer may receive less favorable treatment.

6. This figure was obtained by deducting Mrs. Stahl's expected recovery in bankruptcy, $39,866, from her basis in the securities, $127,012. 70-2 U.S. Tax Cas. at 84,825. Mrs. Stahl ultimately received a $19,516 recovery in bankruptcy. *In re* Balough & Co., Inc., Bankrupt, No. 69-64 (Bankruptcy Ct. D.D.C., Sept. 20, 1971).

7. INT. REV. CODE of 1954, § 165(c). Although taxpayer claimed the loss qualified under § 165(c)(1) as a loss incurred in her trade or business, as opposed to a loss on a transaction entered into for profit under § 165(c)(2) (*see* text accompanying notes 10-11 *infra*), the district court deemed it unnecessary to decide the issue for purposes of the 1963 tax return and inappropriate because the issue was then before the Tax Court for taxpayer's 1961 and 1962 returns. 294 F. Supp. at 246. The court of appeals, however, did resolve the issue; it found that the loss was one incurred in a transaction entered into for profit under § 165(c)(2). 70-2 U.S. Tax Cas. at 84,828-29. This characterization was important because of the net operating loss carryover provisions of § 172 of the Internal Revenue Code. *See* note 15 *infra*.

8. INT. REV. CODE of 1954, § 166(d)(1)(B), set out in note 12 *infra*.

9. INT. REV. CODE of 1954, § 166 (d)(1)(B), set out in note 12 *infra*. Treas. Reg. § 1.166-2(c) (1959), interpreting the requirement of worthlessness with respect to bankruptcy, indicates that it is a question of fact as to what point in time the debt becomes worthless. Therefore, it is possible that Mrs. Stahl could not have deducted the loss until final settlement in bankruptcy, which occurred in 1971. *See* note 6 *supra*.

10. Section 165 provides in part:

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . . .

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business . . . .

. . . .

INT. REV. CODE of 1954, § 165(a), (c)(1)-(2).

11. INT. REV. CODE of 1954, § 165(c)(2), set out in note 10 *supra*.

12. Section 166 provides in part:

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

. . . .

Should the debt be one acquired in connection with the taxpayer's trade or business, it is deductible from ordinary income under section 166(a).[13] If the bad debt is a nonbusiness debt, however, any loss is treated as a short-term capital loss under section 166(d).[14] Thus, it is deductible only to the extent of capital gains plus a maximum of $1,000, with any excess carried over to subsequent years as a short-term capital loss.[15]

Mrs. Stahl was faced with the task of selecting a theory that would both maximize her deduction and provide her with the strongest legal claim. Had she contended that the transaction resulted in a business bad debt, Mrs. Stahl would have confronted a consistently narrow interpretation by the Supreme Court of what constitutes a business bad-debt deduction.[16] Nor did she appear to qualify for any of the limited exceptions approved by that Court, which exceptions have been expanded by the lower courts.[17] Mrs. Stahl therefore chose to argue that the agreement with Balough did not place her in the position of creditor at all, but rather that the agreement provided for delivery of personalty to be used for a particular purpose, after which it was to be returned.[18] In a unique decision, the

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(d) *Nonbusiness Debts.*—

(1) *General Rule.*—In the case of a taxpayer other than a corporation—

. . . .

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) *Nonbusiness debt defined.*—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

INT. REV. CODE of 1954, § 166(a)(1), (d)(1)(B), (d)(2).

13. INT. REV. CODE of 1954, § 166(a), set out in note 12 *supra.*

14. INT. REV. CODE of 1954, § 166(d), set out in note 12 *supra.*

15. INT. REV. CODE of 1954, §§ 1211(b), 1212(b). Another important tax consequence hinges upon characterization. If the deduction is characterized as one incurred in a trade or business, either as a loss under § 165(c)(1) or as a bad debt under § 166(a), then to the extent that the deduction results in a net operating loss, such net operating loss may be carried back three years or carried forward five years. INT. REV. CODE of 1954, § 172(b)(1)(A)(i), (b)(1)(B). There is no carryback or carryover under § 165(c)(2), however, because § 172(d)(4) limits net operating loss deductions to those attributable to a taxpayer's trade or business. INT. REV. CODE of 1954, § 172(d)(4).

16. *See* notes 42-43 *infra* and accompanying text.

17. Two exceptions under which Mrs. Stahl might have argued that the transaction constituted a business loss are the "lender" doctrine and the "lender-employee" doctrine. For a discussion of the restrictive interpretation accorded the lender doctrine, which would exclude the *Stahl* situation, see notes 33-35 *infra* and accompanying text and note 49 *infra.* For a discussion of the lender-employee doctrine with specific reference to *Stahl,* see note 55 *infra.* Two additional exceptions, the "promoter" and the "separate legal entity" doctrines, are discussed in notes 48-49 *infra.*

18. *See* Brief for Appellee at 7-13, Stahl v. United States, 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970).

court of appeals affirmed the district court's holding that the agreement between Mrs. Stahl and the securities firm created a bailment and not a debt. Consequently, the full amount of the loss was deductible from ordinary income under section 165(c)(2) as a loss incurred in a transaction entered into for profit.[19]

By its novel treatment of the transaction as a bailment, the court failed to give effect to the congressional purpose for section 166(d) as well as to recent interpretations of that section by the Supreme Court. The bad debt-loss dichotomy can be placed in proper perspective only by examining the evolution of the relevant statutory provisions. Initially, both bad debts and losses were deductible from ordinary income, although the latter were limited to losses incurred in a taxpayer's trade or business.[20] The more favorable tax treatment for bad debts was reduced when Congress amended the loss provision in 1916 to include the deduction of losses sustained in a transaction entered into for profit.[21] An important distinction remained, however, in that losses were deductible if incurred in transactions entered into for profit, if incurred in a trade or business,[22] or if resulting from a casualty.[23] A bad debt, on the other hand, was deductible even if the loan was made for purposes other than making a profit.[24] Finally, in 1934, the Supreme Court found the two to be mutually exclusive.[25] Bad debts were regarded as a special category to be excluded from the general provisions for losses.

The problem in *Stahl* stems primarily from the confusion surrounding a 1942 amendment to section 23(k) of the Internal Revenue Code of 1939,[26] which section was the predecessor to section 166. The Revenue Act of 1942 added section 23(k)(4) to the Code, which dis-

19. 70-2 U.S. Tax Cas. at 84,827, 84,829.

20. Revenue Act of 1913, ch. 16, § IIB, 38 Stat. 167. Actually, deductions for bad debts and losses date from the Revenue Act of 1894, ch. 349, § 28, 28 Stat. 509, which was promptly declared unconstitutional as a direct tax on income. Pollock v. Farmer's Loan & Trust Co., 157 U.S. 429 (1895).

21. Revenue Act of 1916, ch. 463, § 5(a)(5), 39 Stat. 759.

22. Revenue Act of 1916, ch. 463, § 5(a)(4), 39 Stat. 759, *as amended*, INT. REV. CODE of 1954, § 165(c)(1).

23. Revenue Act of 1916, ch. 463, § 5(a)(4), 39 Stat. 759, *as amended*, INT. REV. CODE of 1954, § 165(c)(1).

24. Revenue Act of 1916, ch. 463, § 5(a)(6), 39 Stat. 759. *See* Waterman, *Aspects of the Bad Debt—Loss Dichotomy*, 18 TAX L. REV. 121, 128 (1962). The importance of this distinction has in part been reduced since the addition of § 166(d) to the bad debt provisions. *See* text accompanying notes 26-27 *infra*.

25. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189 (1934). Lower courts have consistently followed *Spring*. *See, e.g.*, Worthington v. United States, 70-1 U.S. Tax Cas. ¶ 9441 (D. Texas 1970); Stuart M. Sales, 37 T.C. 576 (1961); Langdon L. Skarda, 27 T.C. 137 (1956), *affd.*, 250 F.2d 429 (10th Cir. 1957). A taxpayer may, however, allege 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).

26. Revenue Act of 1942, ch. 619, § 124, 56 Stat. 820, *amending* INT. REV. CODE of 1939, § 23(k).

tinguished for the first time between trade or business bad debts and nonbusiness bad debts and limited the latter to short-term capital loss treatment.[27]

The Revenue Act of 1942 was part of a comprehensive tax program designed "to raise every dollar of additional revenue that can be raised without seriously disturbing or shattering our national economy."[28] Consistent with this policy, Congress said that the issue whether a bad debt was a business or nonbusiness debt should be a question of fact to be determined by interpreting "trade or business" in the same restrictive manner as it had previously been treated under the predecessor to section 165(c)(1).[29]

There was yet another rationale for section 23(k)(4). The provision was aimed at a specific abuse, the "friendly" loan, by which a taxpayer "lends" money with no expectation of repayment as a ruse to qualify what is in effect a gift as a bad debt. This abuse was especially prevalent in the situation where a loan was made to a person for whom the taxpayer was not entitled to a dependency exemption. It was felt that losses resulting from an unrepaid loan to a close personal friend, for example, should be distinguished from bad debts legitimately incurred in the course of a taxpayer's trade or business.[30] It should be apparent that the use of the traditional trade or business test to eliminate friendly loans casts an unduly broad net. One rationalization is that difficulties of proof made ad hoc distinctions between bona fide loans and gifts unworkable; hence, the mechanical, albeit gross, distinction between business and nonbusiness debts was introduced.[31] Nevertheless, if the central purpose for limiting the deductibility of nonbusines bad debts is to end specific abuses, use of the term "trade or business"[32] to distinguish between business and nonbusiness debts produces the side effect of denying full deductions to many taxpayers engaged in legitimate

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27. INT. REV. CODE of 1939, § 23(k)(4), *as amended*, INT. REV. CODE of 1954, § 166, the relevant portions of which are set out in note 12 *supra*.

28. *Hearings on Revenue Revision of 1942 Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 1 (1942) (testimony of Chairman Doughton).

29. The question whether a debt is one, the loss from the worthlessness of which is incurred in the taxpayer's trade or business, is a question of fact in each particular case, and the determination is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by Section 23(e) [the predecessor to section 165(c)(1)] is "incurred in trade or business". . . .

H.R. REP. No. 2333, 77th Cong., 2d Sess. 76 (1942). *See also* S. REP. No. 1631, 77th Cong., 2d Sess. 90 (1942).

30. H.R. REP. No. 2333, 77th Cong., 2d Sess. 45 (1942).

31. *Id.*; B. BITTKER, FEDERAL INCOME ESTATE AND GIFT TAXATION 290 (3d ed. 1964).

32. The term "trade or business" is not precisely defined in the Code or Regulations. It has received its basic interpretation through case law involving INT. REV. CODE of 1954, §§ 162, 165, 166 and 212 and their predecessors. *See* 5 J. MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 28.31, at 126-34 (1969).

commercial activities. This point is amply illustrated in *Stuart M. Sales*.[33] Sales was a member of a partnership engaged primarily in the real estate business. The partnership loaned $120,000 to a corporation that was marketing a new and speculative product. To obtain the funds for the loan, which was to produce a 12 per cent annual return, the partnership borrowed the money at 4¾ per cent interest. If the loan was repaid in accordance with the agreement, the partnership stood to gain about $14,000. It was clear that the loan was made solely to secure profits for the partnership and not for the private purposes of any partner. When the borrower defaulted, Sales sought to deduct his distributive share of the partnership's net operating loss as a business bad debt pursuant to section 166(a).[34] Applying an "extent of the activities" test, the court held that the making of a single loan was not so extensive an activity as to justify a conclusion that the partnership was in the business of lending money.[35] Similar cases illustrate that other commercial ventures have been excluded from the scope of "trade or business."[36]

If the purpose of Congress in adding section 23(k)(4) was merely to prevent specific abuses, it would have been more appropriate simply to amend section 23(k) to allow deductions for bad debt losses incurred in any activity pursued for the production of income.[37] If, instead, the stated purpose of raising additional revenue is considered in conjunction with the congressional mandate that "trade or business" continue to be construed in the traditional narrow manner, there is a more reasonable interpretation: the two statements indicate a desire by Congress to alter the tax treatment of bad debts by limiting the category of bad debts that can be deducted from ordinary income. If the latter interpretation is accepted, the relationship of section 165(c) loss deductions to the bad-debt provisions of section 166 is clear. To allow a taxpayer to deduct what is in effect a nonbusiness bad debt from ordinary income by use of the former provision defeats the congressional purpose of limiting nontrade or business bad debts to short-term capital loss treatment under section 166(d).

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33. 37 T.C. 576 (1961).

34. Determination of income or loss to partners is governed by INT. REV. CODE of 1954, §§ 701-08.

35. 37 T.C. at 580. On the basis of *Sales*, one might conclude that if Mrs. Stahl had claimed a § 166 deduction, she would have been relegated to a § 166(d) nonbusiness bad-debt deduction.

36. *See, e.g.*, Higgins v. Commissioner, 312 U.S. 212 (1941) (expenses incurred in connection with individual's investment portfolio not a trade or business, regardless of how large or how continuous the portfolio is); Berner v. United States, 282 F.2d 720 (Ct. Cl. 1960) (loss on sale of stock to key employees under incentive program denied to corporate officer and controlling shareholder because it is not a general business practice).

37. Waterman, *supra* note 24, at 128.

A period of confusion followed the 1942 amendment, with the lower courts applying "trade or business" to a broader spectrum of situations.[38] Much of the confusion was a result of a failure on the part of the legislature to isolate the dominant purpose of the amendment.[39] In the 1954 Internal Revenue Act,[40] Congress again addressed the distinction between business and nonbusiness bad debts, but this time it spoke in terms of "trade or business," without further reference to the specific abuse of "friendly" loans.[41] Omission of such a reference might suggest a congressional intent to narrow the category of business bad debts. Although the congressional omission is indecisive at best, the Supreme Court amply clarified the matter in *Putnam v. Commissioner*.[42] The taxpayer in *Putnam* had personally guaranteed a loan to a corporation in which he was a shareholder. Shortly thereafter, the corporation liquidated its assets and ceased doing business. Putnam was obligated to repay the loan and sought to deduct it as a loss. In holding that taxpayer was limited to a nonbusiness bad-debt deduction, the Court noted that "friendly" loans were *merely an example* of the kind of deduction that the amendment was intended to disallow. It was equally designed to put "nonbusiness investments in the form of loans on a footing with other nonbusiness investments."[43] The thrust of *Putnam* was clearly to limit the types of loans that qualify for deduction from ordinary income.

Several years later, in *Whipple v. Commissioner*,[44] the Supreme Court extended the rationale of *Putnam* by further restricting the categories of bad debts that would qualify for deduction from ordinary income. The taxpayer in *Whipple* was the majority stockholder and principal officer of a bottling corporation as well as an incorporator and investor in other corporations. As the corporation began to experience financial problems, Whipple made sizable cash

38. *See, e.g.*, Commissioner v. Stokes Estate, 200 F.2d 637 (3d Cir. 1953), *overruled by* Whipple v. Commissioner, 373 U.S. 193 (1963); Campbell v. Commissioner, 11 T.C. 510 (1948), *overruled by* Whipple v. Commissioner, 373 U.S. 193 (1963); Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949).

39. *See* Putnam v. Commissioner, 352 U.S. 82, 97-99 (1956) (Harlan, J., dissenting).

40. Internal Revenue Act of Aug. 16, 1954, ch. 736, 68A Stat. 3.

41. Nonbusiness bad debts continue to be treated as short-term capital losses. Two types of indebtedness are specifically excluded from the definition of nonbusiness bad debts. First, debts which become worthless in the course of the trade or business of the taxpayer. . . . [and] [s]econd, any debt which is either created in the course of the trade or business of the taxpayer or is acquired by him in the course thereof without regard to the relationship of the debt to the trade or business of the taxpayer at the time the debt became worthless, shall not be treated as a nonbusiness bad debt.

S. REP. No. 1622, 83d Cong., 2d Sess. 199 (1954).

42. 352 U.S. 82 (1956), *discussed in* Recent Development, 57 COLUM. L. REV. 577 (1957), *and* Recent Development, 34 TEXAS L. REV. 779 (1956).

43. 352 U.S. at 91-92.

44. 373 U.S. 193 (1963), *discussed in* Recent Decision, 13 BUFFALO L. REV. 635 (1963), *and* Recent Development, 51 CALIF. L. REV. 1015 (1963).

advances to it over a period of several years. When the debts became worthless, he sought to deduct them from his ordinary income as business bad debts pursuant to section 23(k).

To the extent that taxpayer was a stockholder, creditor, and officer of the corporation, *Whipple* represents one of the classic characterization problems in the area of the bad-debt deduction when small, closely held corporations are involved. During the period of indebtedness, the corporation paid no interest or salary to the taxpayer, and presumably no dividends.[45] The taxpayer thus received no return in the form of ordinary income from his investments of time and money. Yet the substantial loans and activities of the taxpayer may have had a significant impact upon the value of the capital stock of the corporation. If this were so and the value of his stock increased, a taxpayer such as Whipple would realize preferentially treated capital gains upon selling some or all of his stock in the corporation. On the other hand, if taxpayer's theory were followed, any losses incurred on the same loans that might at one time have enhanced the value of his stock would be deductible from ordinary income.[46] The Court held that when the only return to a taxpayer is that of an investor, he has not satisfied his burden of demonstrating that he is engaged in a trade or business. Merely devoting one's time and energies to the affairs of a corporation is not a trade or business of the person so engaged, but is the business of the corporation. Moreover, if full-time service to one corporation could not amount to a trade or business, the Court reasoned, it was difficult to understand how the same service to many corporations would suffice.[47] The opinion therefore had a clearly negative impact on the promoter doctrine, *i.e.*, that a taxpayer could be in the business of promoting business ventures outside certain narrowly defined circumstances.[48]

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45. 373 U.S. at 196.

46. *See* Allen & Orechkoff, *Toward a More Systematic Drafting and Interpreting of the Internal Revenue Code: Expenses, Losses and Bad Debts*, 25 U. CHI. L. REV. 1, 56-58 (1957).

47. 373 U.S. at 202.

48. After voicing general disapproval of the promoter doctrine, the Court summarily overruled eight earlier decisions in the area, to the extent they were contrary to *Whipple*. 373 U.S. at 203 n.10. It then proceeded to delineate two narrow situations in which the doctrine might still be utilized: (1) where a taxpayer is engaged in a regular course of promoting corporations for a commission or fee; and (2) where promotion of the enterprises is for the purpose of a profit on their sale. 373 U.S. at 202-03. As an example of the latter situation, the Court cited with approval Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955). *Giblin* involved a situation in which a lawyer, during the course of twenty years, provided money and about half his time to the organization and sale of numerous business enterprises.

Few taxpayers have qualified under the promoter doctrine since *Whipple*. *Compare* United States v. Clark, 358 F.2d 892 (1st Cir.), *cert. denied*, 385 U.S. 817 (1966) (taxpayer held to be mere investor), *with* Elliott v. United States, 268 F. Supp. 521 (D. Ore. 1967) (taxpayer in business of promoting ventures). For a general discussion of the promoter

The Court went on to cite with approval several other limited inroads to the trade or business test;[49] but it reiterated its interpretation of the amendment that first distinguished between business and nonbusiness debts:

> The 1942 amendment of section 23K, 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 far short of reaching every income or profit making activity.[50]

By its highly technical characterization of the arrangement in *Stahl* as a bailment, the court ignored the thrust of these recent Supreme Court decisions as well as the legislative intent underlying section 166(d). Rather than restricting itself to the few narrow exceptions to the definition of trade or business sanctioned by the Supreme Court, the *Stahl* court has opened an entirely new and substantial loophole through which a taxpayer can more easily qualify for a deduction from ordinary income under the provision for nonbusiness losses, section 165(c)(2).

Although *Stahl* is the only decision since *Whipple* in which the taxpayer has escaped the limited deductibility provided in section 166(d) by applying section 165(c),[51] other courts have sought to

doctrine, see Brink, *How Business Promoters Can Meet the Trade or Business Test for Bad Debts*, 23 J. TAX. 170 (1965).

49. The Court specifically sanctioned the business of "lending money." 373 U.S. at 204. *See, e.g.*, Noonan v. Fahs, 59-1 U.S. Tax Cas. ¶ 9199 (D. Fla. 1958); Yeager v. United States, 58-1 U.S. Tax Cas. ¶ 9174 (D. Ky. 1957). However, it is only under very narrowly defined circumstances that the courts permit such a contention. *See* notes 35-36 *supra* and accompanying text. The Court also cited cases involving the "separate legal entity doctrine," in which a taxpayer's loans to an enterprise are given business status if they are essential to the operation of another separate business of the taxpayer. 373 U.S. at 203 n.11. *See* Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949); J.T. Dorminey, 26 T.C. 940 (1956). The Court was less explicit in its treatment of the "lender-employee doctrine." 373 U.S. at 204. *See* notes 53-59 *infra* and accompanying text.

50. 373 U.S. at 201. Since taxpayer was the owner and lessor of the real estate and plant in which the bottling corporation did business, the Court remanded the case for a determination whether the loan to the corporation was incurred in his business capacity as a landlord. 373 U.S. at 205.

51. Prior to *Whipple*, several cases had accepted taxpayer's theory that the Code's loss provisions rather than the bad debt provisions should be applied to his loss, although their validity as support for the present case should be negligible. In Ansley v. Commissioner, 217 F.2d 252 (3d Cir. 1954), the president and majority stockholder of a corporation deposited $30,000 worth of bonds with a bank as collateral for the loan of a similar amount to the corporation. Unable to collect the loan, the bank sold the securities and taxpayer successfully deducted the loss as a loss on "a transaction entered for profit" pursuant to § 165(c)(2). Although similar to the fact situation in *Stahl*, the viability of *Ansley* is questionable. *See* J. Meredith Siple, 54 T.C. 1, 10 (1970). *Ansley* preceded *Putnam* (*see* notes 42-43 *supra* and accompanying text), and *Putnam* has been interpreted as limiting stockholders to nonbusiness bad debt treatment when they pro-

accomplish a similar result by broadening the narrow exceptions to the "trade or business" test prescribed by the Supreme Court.[52] The most prominent example—prominent not only because it involves the most obtrusive extension of the Court's rationale, but also because the attack is upon legal theory and not merely a liberal application of facts—is the so-called "lender-employee" theory. Under this doctrine, a corporate executive's duties have been considered a trade or business when certain conditions are met. The Court in *Whipple* left this area untouched,[53] although it expressly referred to *Trent v. Commissioner*[54] as an example of the narrow circumstances under which such a characterization would be permitted. In *Trent*, taxpayer accepted employment in several capacities with two closely held corporations. As a condition of his employment he was required to pay $5,000 for one third of the stock in one of the corporations, and he was informed that, from time to time, he would be required to make loans to the corporations. In return, he was to receive a salary. Over a period of several years, taxpayer made eleven loans to the corporations in amounts that greatly exceeded his investment. Several times he was advised that failure to make the loans would result in his termination as an employee. The discrepancy between the large value of the loans and taxpayer's small investment in the corporation, as well as the fact that his annual salary was well in excess of his capital contribution, made it apparent that taxpayer's primary motivation for the loans was to retain his status as an employee. The Second Circuit held that when loans are made in connection with the taxpayer's trade or business of rendering

vide debt financing to the corporation in order to protect or enhance their proprietary interest. This is true whether or not there is a technical subrogation as existed in *Putnam*. Stratmore v. United States, 420 F.2d 461 (3d Cir.), *cert. denied*, 398 U.S. 951 (1970); United States v. Hoffman, 423 F.2d 1217 (9th Cir. 1970). Although the district court in *Stahl* relied heavily upon *Ansley* in reaching a verdict for taxpayer, 294 F. Supp. at 245, the court of appeals noted its doubtful validity and affirmed on other grounds. 70-2 U.S. Tax Cas. at 84,828-29.

In Starr v. Commissioner, 267 F.2d 148 (7th Cir. 1959), taxpayers advanced money to a partnership in return for one sixth of the partnership profits at the end of three years with the principal to be repaid at the same time, regardless of losses. Without citing any authority, the court found this to be a profit-sharing arrangement and granted a deduction pursuant to § 165(c)(2). The brevity of the opinion and the fact that it preceded *Whipple* cast doubt upon the validity of *Starr* as meaningful precedent for the *Stahl* decision. *See also* First Natl. Bank v. Smith, 141 F. Supp. 722 (D. Pa. 1956); Larry E. Webb, 23 T.C. 1035 (1955); Charles S. Guggenheimer, 8 T.C. 789 (1947); Waterman, *supra* note 24.

52. There is seldom any need for a lower court to confront directly the legal framework established by the Supreme Court. The test prescribed in Treas. Reg. § 1.166-5(b) (2) (1959) ("The question whether a debt is a nonbusiness debt is a question of fact in each particular case."), based on the rule of Higgins v. Commissioner, 312 U.S. 212, 217 (1941), affords a lower court sufficient latitude so that it can make a liberal application of existing law in any context.

53. 373 U.S. at 204.

54. 291 F.2d 669 (2d Cir. 1961).

services for pay, the resulting losses are bad debts deductible from ordinary income under section 166(a).[55] Following *Trent,* two circuits held, in similar situations, that when the taxpayer's *primary or dominant* motivation for making the loan was to ensure his status as a corporate employee, he might deduct resulting losses as business bad debts.[56] However, other courts, including the Second Circuit, have held that to qualify as a business bad debt retention of employment need be merely a *significant* motivation for the loan, a ruling that expands the narrow limits of *Trent* and *Whipple.*[57] The same controversy has arisen in the Tax Court.[58] The Supreme Court apparently deems the discrepancy to be significant since it has recently accepted the issue on certiorari.[59] Thus, while the *Stahl* court is not alone in its attempt to expand the kind of losses that are deductible from ordinary income, it appears to have deviated further from the express policy of the Supreme Court than have other courts by creating an entirely new category.

With the dominant policy implications of *Stahl* thus outlined, it remains only to examine the court's rationale in holding that the relationship between Mrs. Stahl and the securities firm was not in

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55. 291 F.2d at 676. It is interesting to note that *Trent* might be construed as authority for the proposition that Mrs. Stahl *was* engaged in a trade or business. The crucial issue would be whether her activities as a director of Balough were significant enough, and her remuneration rewarding enough, to support a conclusion that her dominant motivation for making the loan was to acquire or protect her directorship. It is unlikely that this was the case, and perhaps for that reason the taxpayer chose not to raise the point.

56. Stratmore v. United States, 420 F.2d 461 (3d Cir.), *cert. denied,* 398 U.S. 951 (1970); Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969).

57. *See, e.g.,* United States v. Generes, 427 F.2d 279 (5th Cir. 1970), *cert. granted,* 401 U.S. 972 (1971); Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963).

58. *Compare* Isidore Jaffe, 26 T.C.M. 1063 (1967) (significant motivation), *with* Ida Rosati, 29 T.C.M. 1661 (1970) (primary motivation).

59. United States v. Generes, 427 F.2d 279 (5th Cir. 1970), *cert. granted,* 401 U.S. 972 (1971). The taxpayer was a 44% stockholder and the chief officer of a close corporation engaged in the construction business. To obtain the requisite performance and payment bonds for the corporation, taxpayer executed a blanket indemnity agreement with the guarantor. The corporation defaulted on two contracts, and the taxpayer was forced to pay approximately $162,000 to the guarantor. He sought to deduct the loss as a business bad debt pursuant to § 166(a)(1), but the Service disagreed. The issue ultimately presented on appeal was whether the judge had correctly charged the jury:

> A debt is proximately related to the taxpayer's trade or business when its creation was *significantly* motivated by the taxpayer's trade or business, and it is not rendered a non-business debt merely because there was a non-qualifying motivation as well, even though the non-qualifying motivation was the primary one.

427 F.2d at 289 (emphasis added). The test to be applied was quite important since taxpayer received less than one third of his annual income as salary from the corporation and he spent only six to eight hours per week pursuing corporate business. Indeed, he had another full-time job. 427 F.2d at 280. Affirming the jury verdict in favor of taxpayer, the court of appeals accepted the "significant motivation" test.

In light of *Whipple* (*see* notes 44-50 *supra* and accompanying text), it is likely that the Supreme Court will reject the "significant motivation" test in favor of the narrower "primary motivation" test.

fact one of debtor and creditor. Perhaps the simplest, and yet the most convincing, argument relied upon by the Government was that ancient terms derived from Roman and common law should not be determinative of tax consequences.[60] For purposes of determining whether a loss is deductible under section 165 or section 166, the term "bailment" serves no useful purpose. The principle that common-law distinctions are not determinative for tax purposes has been uniformly recognized since the Supreme Court first confronted such distinctions in *Burnet v. Harmel*.[61] The issue presented in that case was whether Texas law should control the classification of a bonus payment on an oil and gas lease as a gain from the sale or exchange of a capital asset. Taxpayer contended that such treatment was appropriate since Texas law characterized the initial bonus payment as a sale of oil and gas in place. The Court stated, *inter alia:*

> For the purpose of applying this section [of the Internal Revenue Act] to the particular payments now under consideration, the Act of Congress has its own criteria, irrespective of any particular characterization of the payments in the local law. . . . The fact that title to the oil and gas is said to pass before severance, rather than after, is not [determinative]. The economic consequences to the lessor of the two types of lease are the same.[62]

The same result has been reached by the Court with respect to principles of conveyancing; the intention of Congress as manifested in the Code has been held to override such common-law distinctions, which were originated under a feudal economy and which "are peculiarly irrelevant in the application of tax measures."[63]

The economic significance of the transaction in *Stahl* supports characterization as a loan rather than a bailment. The agreement was framed to allow Balough to meet the net capital requirements of the SEC. The relevant provision explicitly permits only cash and liquid assets (excluding all fixed assets) to be used in computing net capital.[64] It is inconsistent to argue for tax purposes that the transaction was a bailment rather than a loan because personalty and not cash was involved, while contending for SEC purposes that the securities fulfilled the requisite net capital requirements since they were liquid assets closely approximating cash. But more significant than

60. Brief for Appellant at 10-12, Stahl v. United States, 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970).

61. 287 U.S. 103 (1932). *See also* Watson v. Commissioner, 345 U.S. 544 (1953); Estate of Putnam v. Commissioner, 324 U.S. 393 (1945); Morgan v. Commissioner, 309 U.S. 78 (1940); Heiner v. Mellon, 304 U.S. 271 (1938).

62. 287 U.S. at 110-11.

63. Helvering v. Hallock, 309 U.S. 106, 118 (1940).

64. SEC Rule 15c3-1(c)(2), 17 C.F.R. § 240.15c3-1(c)(2) (1971).

consistency is the mere fact that the very substance and purpose of the transaction was a loan.

Rather than directly addressing the bailment argument, the court of appeals chose to deal with it only by negative implication and addressed itself to the alleged flaws in characterizing the transaction as a bad debt. The court first considered Treasury Regulation 1.166-1(c),[65] which states that only a bona fide debt qualifies for deduction under section 166. The same section goes on to state that a gift or contribution to capital shall not be considered a bona fide debt. This qualification reveals the purpose for requiring a bona fide debt. Congress meant only to exclude two categories of transactions from section 166, and its intent was summarized by the Senate Finance Committee: "The applicability of subsection (d) of section 166 still depends upon the existence of a bona fide debt *as distinguished* from a gift or a contribution to the capital of the corporation."[66] The bona fide requirement should be of little consequence in *Stahl*, since the court did not suggest that Mrs. Stahl's action constituted either a gift or a contribution to capital.[67]

Apparently, the court seized upon the regulation instead because of its language that a debt must be based on a "valid and enforceable obligation to pay a fixed or determinable sum of money."[68] The court felt the conditional nature of the obligation of Balough to pay a fixed sum of money necessarily disqualified the transaction from any deduction under section 166(d).[69] The obligation to pay a fixed sum was conditional because it could not be assumed that Mrs. Stahl had given Balough the option to return either the securities or the cash equivalent. The return of a cash equivalent would necessitate that Balough have discretion to choose the timing of the sale and this, the court reasoned, was too important a decision to be

65. Treas. Reg. § 1.166-1(c) (1959), *as amended*, T.D. 6996 (Jan. 17, 1969).

66. S. REP. No. 1622, 83d Cong., 2d Sess. 199 (1954) (emphasis added).

67. Mrs. Stahl did argue that she and Balough were engaged in a joint venture and her status was that of a limited or silent partner. She argued that sharing in the profits of the corporation was a characteristic of a partner and not a lender. Thus, her loss was one incurred in a trade or business. Brief for Appellee at 13-14, Stahl v. United States, 70-2 U.S. Tax Cas. ¶ 9714 (D.C. Cir. 1970). Irrespective of the merits of the joint venture argument, the Government could have used this argument to its advantage. Since taxpayer's contribution was admittedly subordinated to the claims of creditors, and since it entitled her to share in the profits of the corporation, it conceivably was a contribution to capital. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 4-10 to 4-15 (3d ed. 1971). If the Government had made and been upheld on such an argument, any loss sustained by Mrs. Stahl would have eventually resulted in long-term capital loss treatment. *See* INT. REV. CODE of 1954, §§ 165, 1211(b), 1212(b). The Government's position would also have been strengthened by the fact that Mrs. Stahl and other subordinated creditors took over the operation of the firm approximately a year before bankruptcy when the principal officer and stockholder suffered a heart attack. Interview with Referee of Bankruptcy Court, Nov. 10, 1971, District of Columbia.

68. Treas. Reg. § 1.166-1(c) (1959), *as amended*, T.D. 6996 (Jan. 17, 1969).

69. 70-2 U.S. Tax Cas. at 84,826-27.

implicitly delegated.[70] The actual agreement between Mrs. Stahl and the securities firm could, however, just as easily be interpreted to mean that while the firm did possess the power to sell, it was obligated to return the securities or their equivalent in cash or comparable securities on the date of termination of the agreement.[71] Under such an interpretation, Balough was obligated to repay Mrs. Stahl on a specific date at a value to be determined by market forces. The spectre of unbridled discretion in timing and hence in cash recovery should be disregarded.

The court of appeals next focused on the fact that even the obligation of the brokerage firm to return the securities was subject to a condition because

> Mrs. Stahl expressly agreed to subordinate her right to return of the securities to the claims of all creditors of Balogh, agreed that they would be "subject to the risks of Balogh's business," and . . . agreed that ". . . [the] agreement may not be terminated, rescinded or modified by mutual consent or otherwise [if the result would be inconsistent with the rules of the Securities and Exchange Commission]."[72]

Although the court cited several cases which hold that the bad-debt provisions are applicable only in the case of an unconditional obligation, each of those cases was concerned with the bad debt-capital contribution or gift conflict, and not the bad debt-loss dichotomy.[73] In the capital contribution cases courts are concerned not only with that limited problem but also with a variety of additional factors in determining whether the substance of the transaction is really an equity investment by the taxpayer.[74] In any event, it was particularly inapposite for the court to cite *United States v. Henderson*,[75] for in that case the court had distinguished a conditional obligation to repay from a debt for the purpose of invoking capital-loss treatment for the transaction. The *Stahl* court mistakenly applied the reasoning of the capital-contribution cases to justify a deduction from ordinary income. Moreover, it is likely that the "subject to the claims of creditors" provision in the loan agreement was intended merely to subordinate Mrs. Stahl's loan to the lowest priority rather than to

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70. 70-2 U.S. Tax Cas. at 84,826.

71. 70-2 U.S. Tax Cas. at 84,826.

72. 70-2 U.S. Tax Cas. at 84,827.

73. United States v. Henderson, 375 F.2d 36 (5th Cir.), *cert. denied*, 389 U.S. 953 (1967) (debt v. contribution to capital); Zimmerman v. United States, 318 F.2d 611 (9th Cir. 1963) (debt v. contribution to capital of nonprofit organization); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957) (debt v. contribution to capital); Milton Bradley Co. v. United States, 146 F.2d 541 (1st Cir. 1944) (question of bad debt moot as taxpayer failed to file timely claim for refund).

74. These considerations were codified in the Tax Reform Act of 1969. *See* INT. REV. CODE of 1954, § 385. *See also* S. REP. No. 91-552, 91st Cong., 1st Sess. 137 (1969).

75. 375 F.2d 36, 40 (5th Cir.), *cert. denied*, 389 U.S. 953 (1967).

eliminate the need for repayment.[76] If, on the other hand, the court was correct in assuming that Balough was under no duty to repay, then the transaction may, indeed, have been a contribution to capital and should have been treated as such.[77]

Despite earlier confusion over its purpose, section 166 has been consistently defined by Congress and interpreted by the Supreme Court. Both have felt that the deduction from ordinary income provided for business bad debts should be limited to only those debts incurred in the taxpayer's trade or business. All other bad debts, except for certain narrow exceptions sanctioned by the Court, should receive short-term capital loss treatment. Although several lower courts have expanded the limited exceptions established by the Supreme Court, none has gone so far as *Stahl.* For many purposes the liquidity of securities makes them a ready substitute for cash. Thus, for many taxpayers it would be advisable merely to change the form of the loan agreement by lending securities rather than cash and thereby receive the preferential tax treatment of section 165 should a loss result from the transaction. Such a device would be particularly attractive to the shareholder-creditor, who receives the best of both worlds: if his loan adds to the prosperity of the corporation, he receives the bulk of his gain through enhancement of stock value that will eventually be taxed at low capital gain rates; if, on the other hand, the corporation fails, he can deduct his loss from ordinary income under the *Stahl* rationale. Although the equities of Mrs. Stahl's situation may heavily favor her case,[78] the decision ignores Congress' intent as interpreted by the Supreme Court and provides an ominous precedent for abuse of the tax laws.

76. A strong argument can be made that the loan by Mrs. Stahl was not, in fact, conditional in the traditional sense. Under the discernible provisions of the loan agreement, Mrs. Stahl was not to be repaid only if two conditions occurred: (1) the firm became insolvent; and (2) after all other creditors were paid, no funds remained. Thus, her status was merely one of a low priority creditor who, like any other creditor, subjected her money to the ultimate risk of insolvency, The fact that Mrs. Stahl claimed full recovery in bankruptcy as a general creditor supports the contention that she expected to recover the full amount of the securities. *See* note 5 *supra.*

For examples of conditional obligations, see Zimmerman v. United States, 318 F.2d 611 (9th Cir. 1963) (repayment only when recipient could carry itself financially); Lowei & Co. v. Commissioner, 232 F.2d 621 (7th Cir. 1956) (customer not legally obligated to pay difference between contract price and market value until stock was actually issued when taxpayer-stockbroker bought "when, as and if issued" contracts to buy stock); S.S. Bercaw, 165 F.2d 521 (4th Cir. 1948) (repayment only if recipient realized proceeds from a lawsuit). *But cf.* Alexander & Baldwin, Ltd. v. Kanne, 190 F.2d 153 (9th Cir. 1951).

77. *See* note 67 *supra.*

78. Although the court of appeals did not discuss the point, the district court appeared to be influenced by the equities in favor of Mrs. Stahl. The lower court noted that the elderly widow had been the victim of "reprehensible" overreaching by Balough. United States v. Stahl, 294 F. Supp. 243, 246 (1969).