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Taxation - Federal Income Tax - Stockholder's Contractual Duty to Creditors to Finance Corporation as a Business for Purposes of Bad Debt Deduction

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TAXATION—FEDERAL INCOME TAX—STOCKHOLDER'S CONTRACTUAL DUTY TO CREDITORS TO FINANCE CORPORATION AS A BUSINESS FOR PURPOSES OF BAD DEBT DEDUCTION—In 1946 petitioner organized a wholly-owned corporation for the sole purpose of producing a single motion picture at the estimated cost of \$175,000. He obtained loan commitments from two lending institutions for \$170,000 in exchange for his agreement to increase the paid-in capital to \$25,000 and to guarantee personally the financing of the completion of the picture should the budgeted funds prove inadequate. In addition, petitioner made further commitments to secure the institutions' loans. Eventually, \$53,273.65 was advanced by petitioner to fulfill his obligations under the agreements. In 1948 the debt which the corporation owed him was deemed worthless and petitioner deducted his loss as a business bad debt. The Commissioner claimed that the advances were capital contributions, and that even if they were loans, the loss was not incurred in petitioner's trade or business and, therefore, was a nonbusiness bad debt. *Held*, petitioner's activities, including fulfillment of his commitments and guaranties, were sufficient to constitute a business within the meaning of the statute. Particular stress was placed on the fact that he had no discretion in making the loans but was under a contractual duty to third parties to make them. *George J. Schaeffer*, 24 T.C. 638 (1955).

For a worthless debt to be deductible as a business bad debt under section 23 (k) (4) of the 1939 code¹ the loss incurred must be proximately

¹ Now I.R.C., §166 (d).

related to the taxpayer's trade or business.² Stockholders' loans to corporations have been treated as bad debts incurred in the stockholders' own trade or business where the taxpayer proved one of the following: (1) That he was active in promoting, organizing, managing, and financing several corporations and business enterprises to such an extent that his activities would constitute a business separate and distinct from the business carried on by the debtor corporations;³ (2) that he was regularly engaged in the business of lending money to various business ventures;⁴ (3) that he was personally engaged in the same trade or business in which the debtor corporation was involved;⁵ or (4) that his individual trade or business was furthered by the loan even though the debtor corporation was not in the same trade or business.⁶ However, if a stockholder is promoting, managing, and financing only a single corporation, his activities are generally deemed not to be a trade or business separate from that of the corporate debtor,⁷ and any debt loss he incurs is limited to a nonbusiness bad debt. In the principal case, although the petitioner's activities were limited to a single corporation, the fact that he had personally assumed contractual duties, primarily the duty to finance the corporation further if it became necessary, was considered by the court as making petitioner's activities a business separate from the business of the corporation. It is submitted that the addition of these contractual duties does not change the basic nature of the petitioner's acts and that the court improperly expanded the concept of "trade or business." A contractual duty is also present when a stockholder fulfills his guaranty of the corporate debt to an outside lending institution.⁸ Yet in those cases where the loss to the stockholder on his

² Treas. Reg. 118, §39.23 (k) (6).

³ *Giblin v. Commissioner*, (5th Cir. 1955) 227 F. (2d) 692; Charles H. Scott, T. C. Memo. 1955-258; Vincent C. Campbell, 11 T.C. 510 (1948), acq. 1949-1 Cum. Bul. 1. For a discussion of the "promoter" theory, see Bakst, "Bad Debt Treatment of Stockholders' Loans to Closely-Held Corporations," 25 N.Y. CERT. PUB. ACCT. 51 (1955); Friedman, "Bad Debts: Business or Non-Business?" 5 TAX L. REV. 412 (1950).

⁴ *Smith v. Commissioner*, (2d Cir. 1953) 203 F. (2d) 310; John Wrather, 14 T.C.M. 345 (1955).

⁵ *Commissioner v. Stokes' Estate*, (3d Cir. 1953) 200 F. (2d) 637, where a patent exploiter made loans to corporations he organized to exploit patents.

⁶ Tony Martin, 25 T.C. 94 (1955) (loans to a corporation created to revive petitioner's prestige as an actor); Stuart Bart, 21 T.C. 880 (1954) (loan by advertising agent to a client, a publishing corporation of which he was a minority stockholder, for the purpose of retaining the client on a profitable basis, and also maintaining taxpayer's credit standing and reputation as an advertising agent). But see Jacob Heilweil, T.C. Memo. 1956-13, where an accountant who previously had made numerous loans to clients was denied a business bad debt deduction on a loan to close relative's enterprise since the loan was not for the purpose of acquiring a client or creating professional goodwill.

⁷ *Burnett v. Clark*, 287 U.S. 410, 53 S.Ct. 207 (1932); *Omaha Nat. Bank v. Commissioner*, (8th Cir. 1950) 183 F. (2d) 899; *Nicholson v. Commissioner*, (10th Cir. 1954) 218 F. (2d) 240.

⁸ For a full discussion of the guaranty loss problem, see 63 YALE L. J. 862 (1954).

guaranty has been treated under the bad debt section, 23 (k),⁹ rather than the loss section, 23 (e) (2),¹⁰ the question of the stockholder's contractual duty to pay has never been raised in connection with treating the debt as a business bad debt. While a duty element was present in *Maloney v. Spencer*,¹¹ where the stockholder-lessor was under contract to assist in the financing of his corporate lessees, a business bad debt deduction was proper there because the loss incurred on the stockholder's loans was related to his active business as landlord of several corporations.

The fact that funds are advanced under an obligation to a third party does have significance in determining whether the money advanced to the corporation is truly a loan or is just disguised equity.¹² Because of the limited scope of business bad debt deductions, this issue is often moot, since the treatment of nonbusiness bad debts¹³ and capital stock losses¹⁴ yield the same tax results.¹⁵ But if Congress should ever extend a full deduction to worthless debts resulting from "transactions entered into for profit,"¹⁶ the issue of whether the advance is truly a debt will become more crucial. In such a case the fact that there is a duty to make the loan under a contract with an outside lending institution will likely have considerable weight in finding the existence of a valid debt.¹⁷ However, absent such a change by Congress, the fact that the stockholder did assume a contractual obligation to a third party should not qualify him for business bad debt treatment.

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⁹ Peter Stamos, 22 T.C. 885 (1954), acq. Int. Rev. Bul. No. 50, p. 6 (1954); Putnam v. Commissioner, (8th Cir. 1955) 224 F. (2d) 947.

¹⁰ Now I.R.C., §165. See Pollak v. Commissioner, (3d Cir. 1954) 209 F. (2d) 57; Edwards v. Allen, (5th Cir. 1954) 216 F. (2d) 794; Cudlip v. Commissioner, (6th Cir. 1955) 220 F. (2d) 565.

¹¹ (9th Cir. 1949) 172 F. (2d) 638.

¹² See Hemenway-Johnson Furniture Co., P-H T.C. Mem. Dec. ¶48,113 (1948), affd. (5th Cir. 1949) 174 F. (2d) 793, where a third party creditor's requirements were material to the financial situation of the corporation and the stockholder's loans were considered as debts rather than equity. For an excellent recent comment on when a stockholder's loan will be treated as an equity investment, see 55 Col. L. Rev. 1054 (1955).

¹³ I.R.C. (1939), §23 (k) (4), now I.R.C., §166 (d) (1) (B).

¹⁴ I.R.C., §1211 (b).

¹⁵ Unless there are capital gains against which the losses may be applied, both are deductible from ordinary income only to the extent of \$1,000. See I.R.C., §1211 (b). For a concise explanation of the difference when capital gains are present, see 63 YALE L. J. 862 at 863, n. 13 (1954).

¹⁶ Such terminology is found in I.R.C., §165 (c) (2). For a discussion of this proposal, see Bakst, "Bad Debt Treatment of Stockholders' Loans to Closely-Held Corporations," 25 N.Y. CERT. PUB. ACCT. 51 (1955).

¹⁷ See note 11 supra and adjacent text.