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Taxation-Federal Income Tax-Worthless Debt of Corporation Deductible Only as a Nonbusiness Bad Debt by Creditor-Partnership

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TAXATION—FEDERAL INCOME TAX—WORTHLESS DEBT OF CORPORATION DEDUCTIBLE ONLY AS A NONBUSINESS BAD DEBT BY CREDITOR-PARTNERSHIP—A partnership formed for the purpose of holding and renting real estate and "such other business and enterprises" as might be agreed upon by the partners loaned 120,000 dollars to a corporation which manufactured liquid hair spray for women. This was the only loan the partnership had made. The controlling shareholder in the debtor-corporation was another corporation of which every shareholder was either a parent or grandparent of the partners.[1] The debtor-corporation was to repay the loan in monthly in-

[1] A family relation between the creditor and the debtor does not preclude a deduction for a bad debt under INT. REV. CODE OF 1954, § 166, but does bring sharply into focus the issue whether the advance created a bona fide debt. *Compare* John E. Walsh, Jr., 30 P-H Tax Ct. Mem. 1603 (1961), *with* William Hauser, 29 P-H Tax Ct. Mem. 944 (1960).

stallments of 3,000 dollars plus interest at the rate of twelve percent on the unpaid balance. When the debt became worthless, the partnership deducted the full amount of the loss from ordinary income, which resulted in a net operating loss for that year. Petitioner, one of the partners, then deducted her proportionate share of this loss on her individual return. In a deficiency notice, the Commissioner increased petitioner's taxable income, explaining that the deduction taken by the partnership was limited to 1,000 dollars as a nonbusiness bad debt because of section 166(d) of the Internal Revenue Code.[2] On petition to the Tax Court, *held,* for the Commissioner, four judges dissenting. The loan was not proximately related to the partnership's real estate business nor was the partnership engaged in the business of lending money. *Stuart M. Sales,* 37 T.C. 576 (1961).

If a taxpayer advances money in the form of a loan, and the debt is not repaid, section 166(a)[3] provides that the full amount of the loss may be deducted from ordinary income in the year that the debt becomes worthless.[4] When the taxpayer, as in the principal case, is not a corporation, section 166(d) qualifies section 166(a) by providing that, if the debt is a "nonbusiness" debt,[5] the loss is a short-term capital loss. It may be used to diminish gross income only to the extent that the capital loss provisions of the Code permit.[6] Although the legislative history of the nonbusiness bad debt subsection indicates that it was enacted to prevent individual taxpayers from deducting the full amount of "loans" made to friends or relatives often without any expectation of repayment,[7] the cases have not so restricted its application.[8] To gain a full deduction, the non-corporate

[2] INT. REV. CODE OF 1954, § 166(d).

[3] INT. REV. CODE OF 1954, § 166(a).

[4] Bad debt losses are not deductible under INT. REV. CODE OF 1954, § 165; if they are to be deducted, it must be under § 166. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189 (1934). However, debts evidenced by "securities," defined in § 165(g)(2)(C) as including any "bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form," are deductible, if worthless, under § 165(g)(1).

[5] INT. REV. CODE OF 1954, § 166(d)(2), defines a nonbusiness debt as "(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

[6] In the tax year that the debt becomes worthless, INT. REV. CODE OF 1954, § 1211(b), provides that nonbusiness debts are deductible only to the extent of capital gains plus $1,000 of ordinary income. However, INT. REV. CODE OF 1954, § 1212 permits the taxpayer to carry over as a short-term capital loss into the five succeeding tax years any portion of the nonbusiness debt not deductible under § 1211.

[7] H.R. REP. No. 2333, 77th Cong., 2d Sess. 77 (1942). Only one case, Robert Cluett, 3rd, 8 T.C. 1178 (1947), the first to construe the nonbusiness debt subsection, adopted this view of the legislative history. In Putnam v. Commissioner, 352 U.S. 82, 90-93 (1956), the Court found a more restrictive purpose in the legislative history. One argument against limiting § 166(d) to family "loans" is simply that the plain meaning of the language has a broader scope. See Campbell v. Walker, 208 F.2d 457, 460 (5th Cir. 1953).

[8] Probably the most frequent application of § 166(d) is to loans by a shareholder to

taxpayer must prove that the debt was not a nonbusiness debt,[9] which can be accomplished only by showing that the debt (or the loss from its worthlessness) was proximately related to a trade or business of the taxpayer.[10]

In the principal case, the petitioner did not contend that the loan was proximately related to the partnership's real estate business,[11] but rather that making the single loan established the partnership in the business of lending money. Whether a taxpayer is or is not engaged in a certain business for tax purposes is a question of fact.[12] The finding in each particular case, however, depends upon the tests which a court employs in resolving this factual issue. The majority in the principal case relied solely on the "extent-of-activities test," which focuses on only one factual circumstance—the frequency with which the taxpayer makes loans.[13] This test was originally recognized as determinative in situations in which a shareholder, whose loan to a corporation that he helped organize and manage had become worthless, contended that he was in the business of promoting business enterprises.[14] There the decisions are clear that the taxpayer, to qualify

his corporation. See generally 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, 48-61 (1957); Bakst, *Bad Debt Treatment of Stockholders' Loans to Closely-Held Corporations*, 25 NEW YORK CERTIFIED PUBLIC ACCOUNTANT 51 (1955); Comment, 75 HARV. L. REV. 589 (1962).

[9] The decision whether a worthless debt falls within the business or nonbusiness category is a question of fact in each particular case. Treas. Reg. § 1.166-5(b) (1962). The burden of persuasion is on the taxpayer. *E.g.*, Noonan v. Fahs, 59-1 U.S. Tax Cas. 71355 (N.D. Fla. 1958); Edgar W. Waybright, Sr., 20 P-H Tax Ct. Mem. 557 (1951).

[10] Under the Internal Revenue Code of 1939, § 23(k), as amended, ch. 619, § 124, 56 Stat. 820 (1942), a debt was considered nonbusiness unless the loss from its worthlessness was incurred in the taxpayer's trade or business. The definition was expanded in the 1954 Code to include a debt that is created or acquired (as the case may be) in connection with a trade or business of the taxpayer. The proximate-relation test is set forth in Treas. Reg. § 1.166-5(b) (1962).

[11] The majority opinion says that even if this had been argued, the evidence would not support the contention. The decisions are in accord with this view. If the taxpayer is actively engaged in a business other than lending money, a loan must have been made for the purpose of increasing or preventing the loss of sales or profit if it is to be considered related proximately to that business. *E.g.*, Wilfred J. Funk, 35 T.C. 42 (1960) (loan by writer to publishing corporation organized to promote his literary reputation and assure him of a publisher, held business debt); Stuart Bart, 21 T.C. 880 (1954).

[12] Higgins v. Commissioner, 312 U.S. 212 (1941), interpreting § 23(a) of the Revenue Act of 1932, ch. 209, § 23(a), 47 Stat. 179, which is the forerunner of INT. REV. CODE OF 1954, § 162(a).

[13] To meet this test, the frequency must be high. See, *e.g.*, Cushman v. United States, 148 F. Supp. 880 (D. Ariz. 1956) (twenty-one loans during seven-year period sufficient); Hyman R. Minkoff, 25 P-H Tax. Ct. Mem. 1146 (1956) (forty loans during five-year period sufficient).

[14] The business of promoting business enterprises is established only in the "exceptional situations where the taxpayer's 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." Charles G. Berwind, 20 T.C. 808, 815 (1953), *aff'd per curiam*, 211 F.2d 575

as being in the "promotion" business, must have invested time, effort, and money in substantially more than one corporation.[15] Although it is similarly true that no case has yet found that a taxpayer, by making a single loan, became engaged for tax purposes in the business of lending money, several recent decisions, wherein business bad debt deductions were disallowed, suggest that factors in addition to the frequency with which loans were made by the taxpayer may be important. One of these additional circumstances seems to be the taxpayer's motives in making loans. In *Lloyd E. Mangrum*,[16] the Tax Court relied on the taxpayer-creditor's purpose of assisting members of his family in deciding that the loans he made did not constitute a business. It may be that what troubled the court in *Mangrum* was essentially the absence of a profit motive. This analysis is supported by a comparison of the principal case; quite possibly, the family relationship was not a ground for the decision in the principal case since the underlying profit motive was put beyond question because of the high rate of interest charged on the loan. Another of these additional factors seems to be the quantitative substantiality of the loans outstanding, both separately and totally, in the year the debt becomes worthless.[17] This consideration would tend to accord the same treatment to situations in which a taxpayer makes one 100,000 dollar loan or four 25,000 dollar loans as well as a situation in which the taxpayer makes fifty 2,000 dollar loans. An additional factor sometimes considered is the relationship of the taxpayer's income from his other business endeavors to his income from interest on the loans. The opinion which made this comparison, however, neglected to consider as interest income the interest that the particular loan for which the full deduction was claimed would have earned had it not become worthless.[18] Since the failure to receive this interest was not the fault of the taxpayer-creditor, it is probable that if brought to the court's attention, this interest would be included along with interest actually re-

(3d Cir. 1954). The business of the corporation probably will not be attributed to the shareholder-creditor in any situation. See Burnet v. Clark, 287 U.S. 410, 415 (1932).

[15] *E.g.*, Nicholson v. Commissioner, 218 F.2d 240 (10th Cir. 1954); Jan G. J. Boissevain, 17 T.C. 325 (1951). It is impossible at the present time to predict the lowest frequency that will meet the test. *Compare* J. Terry Huffstutler, 23 P-H Tax Ct. Mem. 1 (1953) (four corporations in five years, held insufficient), *with* Vincent C. Campbell, 11 T.C. 510 (1948) (twelve corporations in fifteen years, held sufficient).

[16] 29 P-H Tax Ct. Mem. 778 (1960).

[17] See John W. Beeman, 30 P-H Tax Ct. Mem. 432 (1961); Lloyd E. Mangrum, 29 P-H Tax Ct. Mem. 778 (1960); Max M. Barish, 31 T.C. 1280 (1959). In Cushman v. United States, 148 F. Supp. 880 (D. Ariz. 1956), the total amount of the twenty-one loans was $288,352, and in Hyman R. Minkoff, 25 P-H Tax Ct. Mem. 1146 (1956) the forty loans totalled over $30,000.

[18] See Max M. Barish, 31 T.C. 1280 (1959). The taxpayer received a salary of $19,000 from his automobile dealership, which had total sales of $2,500,000 and to which he devoted 90% of his time, as compared with interest income of only $830.29 from loans outstanding of $29,860 (plus the worthless debt of $16,750).

ceived when comparing interest income with the taxpayer's other income.

The view that the frequency with which the taxpayer makes loans is the controlling factor, adhered to by the majority in the principal case, is an extremely narrow analysis of the issue of whether or not a taxpayer is in the business of lending money. The more factors the court takes into consideration when deciding this abstract issue, the more accurate the finding in each particular case should be. It is proposed, therefore, that a court, rather than give controlling significance to only one factor, should also take into consideration at least the factors previously mentioned—motive for making the loan, quantitative substantiality of the loans outstanding, and relation of interest income to other income—as well as frequency. A possible explanation of the narrow, "frequency-only" analysis is the historical inclination of the courts toward limiting the availability of full deductions under the business bad debt subsection.[19] The broader analysis here suggested, if used instead of the frequency-only approach, would not necessarily result in liberalizing the availability of business bad debt deductions. For example, if a taxpayer should make thirty 50-dollar, interest-free, loans during the tax year, the narrow analysis probably would lead a court to find that the taxpayer was in the business of lending money. But, if a court also considers that the total amount of the loans made was only 1,500 dollars, and that the motive for making the loans was not to earn income (thus the relation-of-loan-income-to-other-income test would not be satisfied either), a business bad debt deduction would then be denied. Even if a taxpayer charged a low interest rate on the loans, a business bad debt deduction still would not be justified in a typical case because the weight accorded the taxpayer's profit motive in making the loan would be offset by the low ratio of the taxpayer's interest income to his other income. On the other hand, there are situations that would qualify for a full deduction that could not possibly so qualify if frequency alone is considered. The facts of the principal case provide an example. The court assumed that profit was the sole motive for making the loan, and it cannot be disputed that the dollar amount of the loan outstanding was substantial. Although no accurate analysis can be made on the basis of the reported facts, it would appear that the partnership's interest income from the loan in the tax year was higher than the partnership's profit from its real estate business.[20]

[19] 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, 42 (1957).

[20] The loan was made in November 1953, and became worthless in the tax year of 1955. At the rate of payment of principal ($3,000 per month), $42,000 should have been paid off at the beginning of 1955, leaving an unpaid balance of $78,000. If the debtor-corporation had continued to repay the debt as prescribed, $36,000 of principal would have been repaid during 1955, and the interest thereon at the rate of 12% per year on the unpaid balance would have been $7,380. On its 1955 return, the partnership reported a net operating loss of $67,059.70, which was due to the bad debt deduction of $71,400 (which was disallowed). This perhaps would indicate that the partnership's profit from

None of the above facts is discussed in the majority opinion; the four dissenters, however, thought that frequency should not be the controlling fact in every case, and two of the dissenting judges would apply the "frequency-only" approach only to individuals, and never to partnerships. Lamentably, however, the only additional factor discussed by the dissenters was the profit motive.

Use of a broader approach in each case should result in more accurate determinations than if frequency alone is considered. Additionally, there is no reason to believe that tax revenues will diminish by replacing the "frequency-only" analysis with a more accurate appraisal of each taxpayer's position. Yet it appears that thus far a majority of the Tax Court judges have been willing to look at factors other than frequency only when they line up *against* allowing a business bad debt deduction. One-sided application, however, ought not to continue because of its obvious injustice, and a prejudicial analysis certainly cannot be justified by any inclination to restrict the availability of full deductions under the business bad debt subsection.

Larry W. Waggoner

its real estate business was $4,340.30. But, during 1955, the partnership sued the debtor-corporation for the sum due, and at a judicial sale of the corporate assets, purchased certain trademarks of the debtor-corporation for $35,000, receiving a deficiency judgment of $84,325.46.