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## Business Bad Debts: The Vanishing Deduction

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one cannot assert the interests of another not a party to the litigation, the Court in previous decisions has relaxed its "self-imposed rule against the assertion of third-party rights," thereby allowing a party in certain circumstances to assert the interests and rights of a non-party.<sup>57</sup> Thus, the *Yoder* Court could have determined that the state had standing to represent the rights of the children in the litigation. Such a holding would have provided a fair adjudication with respect to all persons ultimately affected by the holding.

Despite the Court's attempts to narrow the scope of the *Yoder* holding, it is submitted that the holding may prove to be an uncomfortably broad one for courts to implement in resolving future free exercise claims asserted against state compulsory education laws. In expressly stating that its decision in *Yoder* is based only upon the unique circumstances the case presents, yet equating a people's religion with their culture, the Court seems to have plugged up cracks in the wall while leaving the front door open to first amendment claims.

#### IV. CONCLUSION

The significance of *Yoder* lies in the fact that the Supreme Court broadened its first amendment definition of "religion," at least in the instance of the Amish, to include the complete way of life of a separate minority culture. The most laudable aspect of the holding is the Court's recognition of the uniqueness of the Amish plight, in its realization of the distinct threat compulsory education laws presented to the Amish as compared with other religious groups.

However, *Yoder* is suspect for two reasons. First, there is a possibility that the holding in *Yoder* may prove to be an uncomfortably broad one for granting exemptions from attendance laws. The Court's attempts to restrict the scope of its holding to the Amish alone may prove to be futile in the face of like claims of other religious minorities. Secondly, the Court's refusal to recognize that the children's rights were indeed involved in the case raises a possibility that a significant number of children may be denied a high school education, contrary to their wishes. In this respect it might be said that *Yoder* is regressive; for while the rights of Amish parents are broadened, their children may be subjected to a life chosen for them by another.

Marc H. Folladori

### Business Bad Debts: The Vanishing Deduction

The taxpayer, president of a closely-held construction company, had originally invested \$38,900 to establish his business with his son-in-law. The taxpayer received a \$12,000 annual salary for obtaining bank financing and securing bid and performance bonds for the company's construction contracts.

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<sup>57</sup> See *Eisenstadt v. Baird*, 405 U.S. 438, 444 (1972). In *Eisenstadt* the Court found that a lecturer who had given a woman student a contraceptive and thereby violated Massachusetts law had standing to assert the rights of unmarried persons who had no access to contraceptives. See also *Griswold v. Connecticut*, 381 U.S. 479 (1965); *Barrows v. Jackson*, 346 U.S. 249 (1953).

The underwriters of these bonds required the taxpayer and his son-in-law to sign a blanket indemnity agreement which protected the underwriters from any loss sustained as a result of the bonding. Two significant defaults occurred for which a \$162,000 indemnification was paid by the taxpayer. As the construction company was thereafter in bankruptcy receivership, the taxpayer was unable to recoup his losses from the company. The taxpayer then deducted the amount of the loss incurred as a business bad debt under section 166 of the Internal Revenue Code.<sup>1</sup> The Internal Revenue Commissioner, in disallowing the deduction, ruled that the loss did not give rise to a business bad debt.<sup>2</sup> The refund claim was tried in federal district court and the jury returned a verdict for the taxpayer.<sup>3</sup> The Government appealed to the Fifth Circuit Court of Appeals, but the jury verdict for the taxpayer was affirmed on the basis that the debt need only be "significantly motivated by the taxpayer's trade or business."<sup>4</sup> The Supreme Court granted certiorari<sup>5</sup> to resolve a conflict among the circuits.<sup>6</sup> *Held, reversed and remanded, with direction that judgment be entered for the United States*: In determining whether a bad debt has a proximate relationship to the taxpayer's trade or business and thus qualifies as a business bad debt, the proper standard is that of dominant rather than significant motivation. *United States v. Generes*, 405 U.S. 93 (1972).

#### I. TREATMENT OF WORTHLESS DEBTS

The significance of the distinction between a business bad debt and a non-business bad debt is in the treatment of the debt for purposes of income taxation. The losses incurred in a business bad debt are treated as ordinary losses which are subject to practically full deduction from ordinary income.<sup>7</sup> A non-business bad debt is treated as a short-term capital loss with very limited deductions.<sup>8</sup> In section 166 the losses considered are those which are not evidenced by a security. Section 165(g)(1) encompasses losses evidenced by securities which, if held for more than six months, are treated as long-term capital losses.<sup>9</sup>

In 1942, an amendment to the Internal Revenue Code of 1939, section

<sup>1</sup> INT. REV. CODE of 1954, § 166.

<sup>2</sup> This bad debt was ruled to be a loss not attributable to the taxpayer's trade or business, governed by the limitations of *id.* § 166(d)(2). The loss was treated as a loss from the sale or exchange of a capital asset held for not more than 6 months under *id.* §§ 1211, 1212.

<sup>3</sup> Charge to the Jury, *Generes v. United States*, Civil No. 16156 (E.D. La., Aug. 24, 1967), 67-2 U.S. Tax. Cas. ¶ 9754.

<sup>4</sup> *United States v. Generes*, 427 F.2d 279, 283 (5th Cir. 1970), quoting *Weddle v. Commissioner*, 325 F.2d 849, 851 (2d Cir. 1963).

<sup>5</sup> *United States v. Generes*, 401 U.S. 972 (1971).

<sup>6</sup> Compare *Weddle v. Commissioner*, 325 F.2d 849 (2d Cir. 1963), with *Niblock v. Commissioner*, 417 F.2d 1185 (7th Cir. 1969), which adopted the Government's test of dominant motivation.

<sup>7</sup> This is true even when the loss exceeds income for the year, due to the provisions of INT. REV. CODE of 1954, § 172, which establishes procedures for carrybacks and carryovers. Illustrations of manipulations of net operating losses, carrybacks, and carryovers are set forth in Treas. Reg. § 1.172-4 (1965). If a net operating loss is not absorbed in the taxable year in which it is created, then the loss can be carried back to the three immediately preceding taxable years, and, if not absorbed by the income of those years, it is then carried over for as many as five years following the year of the loss.

<sup>8</sup> INT. REV. CODE of 1954, §§ 166(d)(1)(B), 1211, 1212.

<sup>9</sup> B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.09(2) (3d ed. 1971).

23(k), was enacted to establish the bad debts section for those losses not evidenced by a security.<sup>10</sup> This section was introduced as a means of minimizing the revenue losses attributable to the practice of deducting from ordinary income "loans" to friends and relatives which were actually intended as gifts. Such "loans" are given nonbusiness bad debt status.<sup>11</sup> For the more preferential treatment of a business bad debt, there must be a proximate relationship to the taxpayer's trade or business.<sup>12</sup>

The first cases considering the applicability of section 166 were concerned with the distinctions between a section 166 bad debt and a section 165 loss. In *Putnam v. Commissioner* the Court held that the discharge of an obligation as guarantor of notes of a corporation was not a loss "incurred in [a] transaction . . . for profit,"<sup>13</sup> but rather was a nonbusiness bad debt. This case recognized the mutually exclusive features of sections 165 and 166: "The making of the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision."<sup>14</sup>

The distinctions between a business and a nonbusiness bad debt received major consideration in *Whipple v. Commissioner*.<sup>15</sup> The Court, citing *Putnam*, determined that the deductibility of a business bad debt turned upon its proximate connection with activities which were recognized in tax law as a trade or business, "a concept which falls far short of reaching every income or profit making activity."<sup>16</sup> As a consequence of this narrow interpretation of section 166, post-*Whipple* cases allowed only a nonbusiness bad debt deduction in many situations.<sup>17</sup>

## II. MOTIVATION IN THE CREATION OF BAD DEBTS

Although the *Whipple* decision laid down the "proximate relationship" test, there remained the question of what motivation must be shown in the creation of the debt to achieve proximate relationship with the taxpayer's trade or business. A split of authority developed over this question.

One view was built on the concept of proximate cause as developed in tort

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<sup>10</sup> Int. Rev. Code of 1939, ch. 1, § 23(k), 56 Stat. 820 (now INT. REV. CODE of 1954, § 166).

<sup>11</sup> INT. REV. CODE of 1954, § 166(d)(2), defines a nonbusiness bad debt as, "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."

<sup>12</sup> H.R. REP. NO. 2333, 77th Cong., 2d Sess. 76-78 (1942), sets forth a proximate relationship test with the taxpayer's trade or business as the determining criterion for a business bad debt. The language of that report was substantially incorporated into Treas. Reg. § 1.166-5(b)(2) (1959).

<sup>13</sup> 352 U.S. 82 (1956).

<sup>14</sup> *Id.* at 87.

<sup>15</sup> 373 U.S. 193 (1963). The taxpayer's investment activities in several corporations did not satisfy the burden of demonstrating that he was engaged in a trade or business. The Court found that investing is not a trade or business and the taxpayer's return on those investments, though substantially the product of his services, legally arises not from his own trade or business, but from that of the corporation.

<sup>16</sup> *Id.* at 201.

<sup>17</sup> See, e.g., *United States v. Byck*, 325 F.2d 551 (5th Cir. 1963); *Eugene H. Rietzke*, 40 T.C. 433 (1963).

law.<sup>18</sup> The Second Circuit, in *Weddle v. Commissioner*,<sup>19</sup> determined that proximate causation as developed in tort law meant that a cause contributing to a harm may be found proximate despite the fact that it might have been secondary to another contributing cause.<sup>20</sup> The proximate relationship standard established by *Whipple*, with the analogy to tort law, meant that where the creation of a debt was sufficiently motivated by the taxpayer's trade or business, even though a non-qualifying motivation also existed, the deduction as a business debt was allowed. The *Weddle* court was not unanimous in its reasoning. Although concurring with the result, Chief Judge Lumbard recognized that when a taxpayer has the dual status of corporate employee and stockholder, the significant motivation test would always allow a business bad debt deduction. The court in *Whipple* had specifically warned the courts to take great care to "distinguish bad debt losses arising from [the taxpayer's] own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business."<sup>21</sup>

Although not citing the concurring opinion of Chief Judge Lumbard, the Seventh Circuit in *Niblock v. Commissioner*<sup>22</sup> followed his reasoning. The *Niblock* court disagreed with the majority in *Weddle* and upheld the dominant and primary motivation test<sup>23</sup> as the only test which would inject sufficient certainty into the interpretation of section 166 to comply with the admonition of *Whipple*.<sup>24</sup> Unfortunately, the Seventh Circuit did not elucidate their argument in favor of the dominant and primary motivation test as the Second Circuit had with the significant motivation test in *Weddle*. As a consequence the Fifth Circuit in *Generes* was impressed with the *Weddle* majority opinion. The split of the circuits forced the Supreme Court to resolve the motivation issue.

### III. UNITED STATES V. GENERES

In a six-to-one decision, the Supreme Court, in an opinion by Mr. Justice Blackmun, adopted the dominant and primary motivation test established by the Seventh Circuit in *Niblock*. The overriding factual consideration for the Court was whether the debt centered on the taxpayer's business interest in the

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<sup>18</sup> See *Millsap v. Commissioner*, 387 F.2d 420 (8th Cir. 1968); *Odee Smith*, 55 T.C. 260 (1970). The tax court in *Smith* preferred the primary motivation test of the Seventh Circuit, but, following the law of the circuit in which this particular case arose, applied the significant motivation test approved by the Fifth Circuit in *Generes*. Most courts avoided a specific standard determining proximity as the taxpayer's motivation either met or failed under both standards. See, e.g., *Stratmore v. United States*, 420 F.2d 461 (3d Cir. 1970), cert. denied, 398 U.S. 951 (1971); *Lundgren v. Commissioner*, 376 F.2d 623 (9th Cir. 1967); *United States v. Clark*, 358 F.2d 892 (1st Cir. 1966); *Kelly v. Patterson*, 331 F.2d 753 (5th Cir. 1964).

<sup>19</sup> 325 F.2d 849 (2d Cir. 1963).

<sup>20</sup> *Id.* at 851.

<sup>21</sup> 373 U.S. at 202.

<sup>22</sup> 417 F.2d 1185 (7th Cir. 1969).

<sup>23</sup> The dominant and primary motivation test allows the taxpayer only one status in each situation. The test considers what overriding reason the taxpayer had for incurring the obligation. Non-qualifying motivations, nonbusiness in nature, are permissible, but only to the extent that they played a secondary role in the creation of the debt. In *Malat v. Riddell*, 383 U.S. 569, 572 (1966), the Supreme Court had previously defined primarily to mean "principally" or "of first importance."

<sup>24</sup> 417 F.2d at 1187.

corporation as an employee, or on his nonbusiness interest in his corporate investment as a shareholder.<sup>25</sup> By phrasing the question in this manner, the Court exposed one of the crucial weaknesses of the significant motivation test. When a taxpayer has the status of both employee and investor, the significant motivation test will always allow the business debt deduction, unless the business interest is inconsequential. Therefore, the distinction between the different types of debt is blurred by the use of significant motivation. Although neither was considered controlling, both *Putnam* and *Whipple* were examined by the Court to determine previous Court views of section 166. The cases were said to "indicate . . . a cautious and not a free-wheeling approach to the business bad debt."<sup>26</sup>

The Court's opinion specifically sets out the reasons for the application of the dominant motivation test as the proper measure for business bad debt qualifications. It is important to give each reason some consideration as this decision marks the first time the dominant motivation test was fully examined under section 166.

First, the Court noted that a careful distinction has been made in the Code between business and nonbusiness items.<sup>27</sup> The significant motivation test clearly obliterated that distinction when a taxpayer had a dual status. It allowed the preferred business deduction even when nonbusiness motivations predominated, if the business motivation was also significant. Thus, the significant motivation test had allowed secondary considerations to govern the tax consequences.

Second, the Court had previously encouraged the enforcement of the business-nonbusiness distinction in *Whipple*. The significant motivation test circumscribed the *Whipple* concept that a shareholder's role did not constitute a trade or business and was not to be given business status.

Third, the attributes of the dominant motivation standard were considered. Unlike significant motivation, this standard injected the elements of workability and certainty. In distinguishing between investment and business, the trier of fact "may compare the risk against the potential reward and give proper emphasis to the objective rather than to the subjective."<sup>28</sup> The scales may be so balanced between the competing interests of dual status that to obtain the preferential tax treatment the business interest must be of first importance.

Fourth, under section 262 of the Code, no deduction is to be allowed for personal, living, or family expenses.<sup>29</sup> The significant motivation test circumscribed this provision by allowing personal nonbusiness debts to be deducted.

Fifth, the Court observed the similarities between section 166 and section 165. Losses deductible under section 165(c)(1) must be incurred in a trade or business.<sup>30</sup> Previous circuit court decisions had clearly indicated that in de-

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<sup>25</sup> 405 U.S. at 100 (1972). As both a shareholder and an employee, the taxpayer had both business and nonbusiness interests. The business interest arose out of the taxpayer's status as an employee. The shareholder status could only result in a nonbusiness interest due to the doctrine announced in *Whipple*. See notes 15-16 *supra*, and accompanying text.

<sup>26</sup> *Id.* at 103.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 104.

<sup>29</sup> INT. REV. CODE of 1954, § 262.

<sup>30</sup> *Id.* § 165(c)(1).

termining the deductibility of a section 165 loss, the primary motive must be ascertained and given effect.<sup>31</sup> Although the Government had urged only significant motivation in other areas, such as liability for the accumulated earnings tax<sup>32</sup> and includability of a transfer made in contemplation of death in the gross estate,<sup>33</sup> there was no inconsistency in urging the use of the dominant motivation test for business bad debts in view of the use of the dominant motivation standard under section 165. This application indicates that tax tests are to be applied independently, but relative to the specific problems involved in a similar section or series of sections.

As a final reason for establishing the dominant motivation test, the Court attacked the tort law analogy which some courts had used in applying the significant motivation test. Tort law deals with different factors. Duty and foreseeability are clearly distinct from the tax problems encountered in ascertaining deduction status. As Chief Judge Lumbard had noted in his concurrence in *Weddle*, "[t]o import notions of proximate causation distilled from the great body of tort law into consideration of §166 is of little value, because factors such as time, space, and foreseeability . . . are by their nature incapable of application to a problem which requires dissection of different motivations toward a similar objective."<sup>34</sup>

The *Generes* case does leave one question unanswered: What evidence will be needed to allow the fact-finder to approve the business debt status? The majority of the Court simply ruled that the evidence did not support a verdict for the taxpayer under a dominant motivation standard. Therefore, a judgment n.o.v. was ordered for the United States.

Ordinarily the simple finding that there was no evidence to support a verdict would not be controversial. However, in *Generes* the taxpayer testified that he was solely motivated by the protection of his employee status. Although two Justices dissented from the judgment n.o.v.,<sup>35</sup> the majority found that the taxpayer's statements were self-serving and to be given no evidentiary weight while standing alone. However, in this case, the taxpayer's statements did not stand alone, but rather were submitted along with the monetary data of the taxpayer's salary, investment, and loss. Although these figures did not totally support the taxpayer's statements that he never once thought of his corporate investment when incurring the debt, there was enough evidence to allow a new trial under the standard of dominant motivation. Although this is a stricter standard than the significant motivation standard, by rendering a verdict for the Government, the Court has moved beyond the bounds of their own definition of dominant and primary. By imposing strict evidentiary requirements on

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<sup>31</sup> See, e.g., *United States v. Gilmore*, 372 U.S. 39 (1963); *Imbesi v. Commissioner*, 361 F.2d 640 (3d Cir. 1966); *Austin v. Commissioner*, 298 F.2d 583 (2d Cir. 1962); *Arata v. Commissioner*, 277 F.2d 576 (2d Cir. 1960); cf. *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

<sup>32</sup> INT. REV. CODE OF 1954, § 531.

<sup>33</sup> *Id.* § 2035.

<sup>34</sup> 325 F.2d at 852.

<sup>35</sup> 405 U.S. at 112-13. (White & Brennan, JJ., concurring in part, dissenting in part). These two Justices agreed with the dominant and primary motivation standard established by the majority decision, but disagreed with the judgment n.o.v., instead maintaining that the case should have been remanded for a new trial. Mr. Justice Douglas dissented with the majority opinion in its entirety. *Id.* at 113-16.

the dominant motivation test, the Court has in effect moved to a sole motivation test; *i.e.*, if a non-qualifying motivation is present, the business deduction is lost. At least two Justices felt that the taxpayer "has never had an opportunity to be heard, after it is determined that his verdict cannot stand, as to whether factual issues remain on which he is entitled to a new trial."<sup>36</sup> The taxpayer carried his burden of proof according to the significant motivation test. With the imposition of a new test, he should again be allowed to present further evidence which would be measured by the new standard.

In a subtle area such as motivation, mere figures of a taxpayer's salary, investment, and loss do not give the clearest picture. A taxpayer's own testimony may be necessary as an interpreting measure. It would then be left to the Government to rebut such testimony. Simply to say that a taxpayer's statements are self-serving, and to be given little or no evidentiary weight, robs the taxpayer of a most important consideration; the opportunity to establish his own priorities in his financial affairs. The circumstances surrounding the creation of the debt may belie the taxpayer's statements, but this is a question for the fact-finder to evaluate in light of the dominant motivation test.

Undoubtedly the *Generes* decision imposes a greater weight on the taxpayer to show that his employment status dominantly prevailed in his debt considerations. The judgment n.o.v. section is an indication to such taxpayers and their attorneys that greater corroborating testimony will be necessary for the dual status employee-shareholder to achieve a business bad debt deduction. In view of these considerations, it is evident that the possibility of a business bad debt deduction for many dual status taxpayers is vanishing by judicial interpretation.

#### IV. CONCLUSION

Each time the Supreme Court has had an opportunity to consider the business bad debts section, the taxpayer has found it increasingly difficult to obtain this ordinary loss deduction. *Whipple* attempted to establish a strict division between business and nonbusiness roles. The dominant and primary motivation test applied by *Generes* is the only standard which is consistent with the *Whipple* decision because it imposes greater objectivity in determining the division between these roles, and consequently the status of the debt arising from the roles. It should be recognized that, in addition to the dominant motivation test, the Court is expecting greater corroboration of the business motivation. Much greater attention is placed on the circumstances surrounding the creation of the debt.

In accepting the greater burden on the taxpayer, the courts should also recognize that the dual status employee-shareholder is caught in the middle. *Whipple* and *Generes* only establish a division between business and non-business bad debts; this is not to say that business bad debt status is eliminated simply because a nonbusiness interest also exists. When a dual status exists, there is still clearly a business interest in the corporation through the employment, which should be recognized if it is dominant in the taxpayer's debt considerations. Investment status by its nature covers a period of years, while

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<sup>36</sup> *Id.* at 112.