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COMMENTS

THE PLIGHT OF THE TAXPAYER WITH A NONBUSINESS BAD DEBT

INTRODUCTION

The primary objective of the taxpayer holding a bad debt is to claim it as a deduction against ordinary income. In addition to securing a full deduction the taxpayer is concerned also with the timing of the deduction, so that it may be claimed in the proper year. With some minor exceptions, it would appear that under the present Internal Revenue Code the avenues of approach to an ordinary deduction have been blocked and the taxpayer's objective rendered incapable of attainment.

Prior to the Revenue Act of 1942¹ there was no distinction made in the code between business and nonbusiness bad debts. Both business and nonbusiness debts were deductible in full against ordinary income except that a special rule applied to security losses.² By the 1942 amendment³ a drastic change was effected. Thereafter, the loss resulting from a totally worthless nonbusiness debt was to be treated as a loss resulting from the sale or exchange, during the taxable year, of a capital asset held for not more than six months.

It would appear that arguments of inequitable treatment could be advanced against such a result in view of the fact that any income realized on the very same debt would be taxed as ordinary income.⁴ However, the holdings that deductions are matters of legislative grace,⁵ and the Ways and Means Committee Report⁶ on the 1942 amendment provide ample rejoinder.

¹ 56 Stat. 798 (1942).

² Int. Rev. Code of 1939.

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

(k) Bad Debts

(1) General rule.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection."

³ Revenue Act of 1942, 56 Stat. 820, §124(a).

⁴ Int. Rev. Code of 1954.

"SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(4) Interest;"

(Subsequent code section citations refer to the Int. Rev. Code of 1954, unless otherwise noted.)

⁵ *Meltzer v. Comm.*, 154 F. 2d 776 (2d Cir. 1946), *cert. denied*, 329 U.S. 723 (1946).

⁶ Report—Ways and Means Committee (77th Cong., 2d Sess., H. Rept. 2333),

Under the presently applicable code section,⁷ the loss resulting from a worthless nonbusiness debt must be treated as a short-term capital loss and, of course, is subject to the restrictions imposed on that type of loss.⁸

1942-2 Cum. Bull. 408.

"The present law gives the same tax treatment to bad debts incurred in nonbusiness transactions as it allows to business bad debts. An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for nonbusiness bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. This practice is particularly prevalent in the case of loans to persons with respect to whom the taxpayer is not entitled to a credit for dependents. This situation has presented serious administrative difficulties because of the requirement of proof.

"The provisions of section 23(k) (1), as amended by this section, Revenue Act of 1942, sec. 124(a), with respect to a debt which has become partially worthless, do not apply in the case of a nonbusiness debt; and a loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless."

⁷ "SEC. 166. BAD DEBTS.

(d) Nonbusiness Debts.

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

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(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' 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."

⁸ "SEC. 1211. LIMITATIONS ON CAPITAL LOSSES.

(b) Other Taxpayers.—In the case of a taxpayer other than a corporation, losses from the sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or \$1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, 'taxable income' as used in this subsection shall be read as 'adjusted gross income'."

"SEC. 1212. CAPITAL LOSS CARRYOVER.

If for any taxable year the taxpayer has a net capital loss, the amount thereof shall be a short-term capital loss in each of the 5 succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this section, a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years, and a net capital loss for a taxable year beginning before October 20, 1951, shall be determined under the applicable law relating to the computation of capital gains and losses in effect before such date."

Bad debts arising from certain securities are specifically excepted from section 166 by subsection (e) thereof, and are treated as losses arising from the sale or exchange, on the last day of the taxable year, of a capital asset. Thus, a long-term capital loss is possible if the security has been held the prescribed length of time. A security is defined as (A) a share of stock in a corporation; (B) a right to subscribe for, or to receive, a share of stock in a corporation; or (C) a bond, debenture, note or certificate, or other evi-

WHOLLY WORTHLESS DEBT

As noted above, the code makes express provision for a loss resulting from a wholly worthless nonbusiness debt. To obtain the limited relief allowed for this loss it would appear incumbent upon the taxpayer to prove (1) the existence of the debt and (2) the fact of worthlessness. Either of these elements can be troublesome depending on the facts of the particular case.

Obviously, a taxpayer cannot take a deduction for a worthless debt unless there is a valid debt arising out of an actual debtor-creditor relationship.⁹ The underlying principle is that no valid debt exists unless there is an unconditional obligation of another to pay the taxpayer.¹⁰ It is the *sine qua non* of the existence of the debt and accordingly of the right to deduct worthless debts.¹¹

Even if a valid unconditional debt is created, a bad debt deduction will be denied where the money was advanced with no reasonable belief at the time that it would be repaid.¹² It is not necessary, however, that there be an unqualified expectation of repayment.¹³ Loans to relatives and close friends would seem to be an area in which the burden of proof of these factors would be an extremely difficult one to sustain.¹⁴ This burden of proof is also difficult in cases of shareholder loans to corporations which are susceptible to being interpreted as contributions to capital.¹⁵

dence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

⁹ George J. Schaefer, 24 T.C. 638 (1955); Est. of Alexander J. Tutiendgy, ¶58,057 P-H Memo TC.

¹⁰ Bercaw v. Comm., 165 F. 2d 521 (4th Cir. 1948) and William Francis Mercil, 24 T.C. 1150 (1955) (advancements by father to son to finance college and medical education; *held*, under these facts, not to be indebtedness within meaning of the code).

¹¹ Allen-Bradley Co. v. Comm., 112 F. 2d 335 (7th Cir. 1940).

¹² W. F. Young, Inc. v. Comm., 120 F. 2d 159 (1st Cir. 1941); Clark v. Comm., 205 F. 2d 353 (2d Cir. 1953); Woodward v. United States, 208 F. 2d 893 (8th Cir. 1953); United States v. Herbert W. Virgin, Jr., 230 F. 2d 880 (5th Cir. 1956), and Harry K. Oliphint, 24 T.C. 744 (1955) (evidence of advances to corporation operating a ranch and which greatly benefited taxpayer's sister left strong inference inconsistent with the existence of a worthless debt for tax purposes and failed to overcome presumption of correctness attached to commissioner's determination.)

¹³ Richard M. Drachman, 23 T.C. 558 (1954).

¹⁴ See Committee Report, *supra* note 6.

¹⁵ American Cigar Co. v. Comm., 66 F. 2d 425 (2d Cir. 1933); *cert. denied*, 290 U.S. 699 (1933); Lewis L. Culley, 29 T.C. 1076 (1958); Hoguet Real Estate Corporation, 30 T.C. 580 (1958, and Estate of Olson; U.S. Treasury Dept. v. LaCrosse Trust Co., 271 Wis. 199, 72 N.W. 2d 717 (1955). For examples of advances classified as gifts see Fred A. Bihlmaier, 17 T.C. 620 (1951) and Frederick C. Moser, ¶59,025 P-H Memo TC. In the area of tax planning, for what not to do as regards bad debts see Byerlyte Corporation v. Williams, 170 F. Supp. 48 (E.D. Ohio, 1958) (advancements made by corporate taxpayer to its wholly-owned subsidiary were not deductible as bad debts, for income and excess profits tax purposes, but were contributions to capital, so that no deductions by taxpayer were permitted, where there was no fixed maturity date for payment of the advances; no notes evidencing advancements; no agreement was made for payment of

A taxpayer claiming a bad debt deduction must prove that worthlessness occurred during the taxable year for which the deduction is claimed.¹⁶ Where the taxpayer can point to a clearly identifiable event causing worthlessness, no serious problem arises. However, many debts become worthless gradually and it is often extremely difficult to prove that worthlessness occurred during a particular year. For that reason, a special seven-year period of limitations applies to refund claims relating to bad debts and worthless securities.¹⁷

PARTIALLY WORTHLESS DEBT

The regulations clearly indicate that there is no allowable deduction for a nonbusiness debt which is recoverable in part during the taxable year.¹⁸ Is there any possibility of relief for a taxpayer in this situation? The cases of *Maurice Levy*¹⁹ and *Ralph Perkins*²⁰ suggest a method of obtaining, at least, the limited capital loss deduction.

The taxpayer, Maurice Levy, was engaged in the business of importing and manufacturing perfumery and toilet articles in New York City. In 1926 he organized a Canadian corporation to conduct a business in Montreal, Canada, similar to that conducted by him in the United States. At the time of organization, Levy advanced cash to it and sold it merchandise, and continued to do so from time to time thereafter. The amount representing the advance and sales was carried on the taxpayer's books as an account receivable. Thereafter, taxpayer sold all of his stock in the corporation and also sold his claim against the corporation to the purchaser for less than the face value of the debt. The debt was charged off on taxpayer's books and in his return at the end of the taxable year an ordinary deduction was claimed in the amount of the difference between the face value of the debt and what he received on its sale. The Commissioner assessed a deficiency holding that the transaction involved the sale of a capital asset and was limited by the provisions of the capital loss section.

In sustaining the assessment made by the Commissioner, the Board

interest; advances were treated by taxpayer as deferred assets; no outsider would have loaned money to the subsidiary, and no attempt was made by taxpayer to enforce collection of advances.)

¹⁶ §166 (d).

¹⁷ §6511 (d).

¹⁸ Treas. Reg. §1.166-5 Nonbusiness bad debts—

“(a) Allowance of deduction as a capital loss.

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Such loss is subject to the limitations on capital losses, and section 1212 relating to the capital loss carryover, and in the regulations under these sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.”

¹⁹ 46 B.T.A. 423 (1942), *aff'd*, 131 F. 2d 544 (2d Cir. 1942).

²⁰ 41 B.T.A. 1225 (1940), *aff'd*, 125 F. 2d 150 (6th Cir. 1942).

of Tax Appeals stated that there was no doubt that the claim was partially worthless. But in fact the debt was sold and at the time the charge-off was made the taxpayer was not the owner of the obligation. The case was squarely within the provisions of the loss section,²¹ and being a capital asset was so limited.

The *Ralph Perkins* case involved a different type of debt. Here, the taxpayer had deposits in two closed or liquidating banks of \$2,317.24 and \$296.18, which, at the beginning of the taxable year, had been held some three and five years, respectively. During the year, the larger claim was sold for \$407.90 and the smaller claim for \$2.96. In taxpayers' return the aggregate loss incurred, \$2,202.56, was claimed as a bad debt. The Commissioner held the loss to be a capital loss and limited as such. The opinion of the Board of Tax Appeals, affirming the Commissioner, states:

Debts partially or totally worthless may, of course, be written off, Revenue Act of 1936, §23(k). But there seems little doubt that in the alternative they may be sold or exchanged. . . . There is no reason to assume that a chose in action such as a bank deposit may not be disposed of by sale in the same manner as any other debt, and the evidence is clear that that is in fact what was done with the claims in this proceeding. Debts must be considered property, see *Twin Ports Bridge Co.*, 27 B.T.A. 346, 355, and these obligations do not fall within any of the exceptions to the definition of capital assets contained in section 117. It seems to us to follow that petitioner is limited by the capital loss provisions. It is, in fact, only the sale that entitles her to take a deduction for any loss whatever, for no other evidence of the uncollectibility of the indebtedness has been produced.²²

It is true that these cases arose prior to the 1942 amendment²³ and that the taxpayers were seeking full deductions under the bad debt section. Nevertheless, the method they indicate for obtaining a deduction can be utilized under the 1954 Code.²⁴ Where a debt is represented

²¹ Revenue Act of 1936, §117.

²² 41 B.T.A. at 1231.

²³ Revenue Act of 1942, 56 Stat. 820, §124 (a).

²⁴ See *Von Hoffmann Corporation*, ¶57,127 P-H Memo T.C. (Taxpayer sold all of the outstanding stock of a corporation to one Smith. The corporation was indebted to taxpayer in the amount of \$65,000. Later taxpayer assigned the \$65,000. note to Smith for \$500. and on the same day charged off \$64,500. as a bad debt. *Held*: Taxpayer entitled only to a capital loss deduction. Sale of the note to a third person for less than face held not to result in bad debt deduction where transaction was sale of a capital asset. Taxpayer as sole corporation stock holder held demand note from the corporation. Sale was negotiated prior to the time the debt was charged off. As such, it was sale of a capital asset, since, in effect, a debt was charged off when no longer owned.) *Accord A. T. Mathews*, ¶55,330 P-H Memo T.C. (Taxpayer held the note of Anchor Fixture Co. in the face amount of \$62,500. On Oct. 16, 1950, the company was insolvent and the note was sold to a third party for \$25,000. Taxpayer contended that he was engaged in the business of lending money and that the loss was deductible in full as a business loss. Facts showed he was president and manager of a hotel corporation. Commissioner determined

by a chose in action, the taxpayer can obtain a deduction for a partially worthless nonbusiness debt through a sale. In such case the deduction is, of course, classified as a loss,²⁵ rather than a bad debt, and is subject to the limitation on capital losses.²⁶

While it is true that this legal method is available to the taxpayer to diminish the amount of his tax liability, in every instance he must prove that the required test for the allowance of a loss deduction has been met. A sale of the debt may be legal and complete and result in a transfer of ownership but it may still not justify the allowance of a loss deduction.

If a loss is to be deductible, it must be established by a *bona fide* transaction whether of sale or otherwise.²⁷ Realities will control and the event in connection with which the loss was incurred must not be

that taxpayer had sustained a long-term capital loss or in the alternative a nonbusiness bad debt. *Held*: Long-term capital loss. Court held it was unnecessary to decide whether petitioner was engaged in the business of making loans. Even assuming he was, the record clearly indicated that the note evidencing such loan was sold, and that the note was a capital asset. Taxpayer elected to sell the note rather than exercise his legal rights as a creditor.) ; Eugene Reynal, ¶55,078 P-H Memo TC. (Petitioner was organizer and officer of a publishing company to which he had advanced sums receiving interest bearing notes issued by the company. Subsequently, all of the stock in the company and the notes in question were sold to a large publisher. At the time of this transaction the stock was worthless and the notes, face value \$145,000., were worth \$85,000. Petitioner argued that the loss was deductible as a business bad debt. *Held*: Capital loss. Even in the event that he had shown that he was engaged in a business of his own to which the indebtedness was proximately related, the argument could not be sustained. On the record presented, the sale of the notes was the first and only event during the taxable year which gave rise to a recognizable loss.) ; Estate of Lawrence Harrison, ¶53,069 P-H Memo TC. (Taxpayer, who had advanced sums totalling \$23,000. to a corporation, was financially over-extended, but the corporation was not in a position to repay the loan. However, the corporation was not insolvent and it was not shown that the debt was worthless in whole or in part. The claim was transferred to a third party for \$18,000. Although a promoter of numerous enterprises, taxpayer was not in the business of buying and selling accounts and loans receivable. *Held*: Capital loss. The debtor corporation was not insolvent and the debt was not shown to be worthless to the extent of \$5000. The taxpayer being a stockholder of the debtor apparently did not see fit to exercise fully his legal rights as creditor. Therefore, he had not met the requirement for a deduction under the bad debt section.) ; The Pancoast Hotel Company, ¶40,503 P-H Memo B.T.A. (Petitioner held a certificate of deposit issued by the liquidator of the Trust Company of Florida, in the amount of \$9,486.52. This was sold for \$5,691.01 and the difference was claimed in full as a loss. *Held*: Case controlled by case of Ralph Perkins, 41 B.T.A. 1225. No basis for distinguishing the facts. The fact that the certificate had been sold was stipulated.)

²⁵ "SEC. 165. LOSSES.

(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:

(f) Capital Losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212."

²⁶ §§1211 and 1212.

²⁷ *Higgins v. Smith*, 308 U.S. 473 (1940).

unreal or a sham.²⁸ In this connection it is also important to note that the requirement that a transaction be entered into for profit²⁹ includes the taxpayer's entire relation to the subject matter of the sale, including the acquisition thereof, and not merely the sale.³⁰

Investigation of many factors is required in making a determination that the sale is *bona fide* or merely a sham, a pretense, unreal or lacking substance. The factors include, for example, the relationship of the taxpayer to the other party to the transaction, the terms and form of payment, the character of the interest or title conveyed and the right retained, if any, to recover the property.

It appears that the most successful basis relied on by the Commissioner in challenging transactions resulting in alleged losses has been the charge that the person to whom the sale was made bears such a close relationship to the vendor as to justify the conclusion that no real loss was sustained. Reference is again made to the 1942 Committee Report cited previously.³¹ Deductions for losses sustained in transactions between certain related taxpayers are specifically denied under section 267.³² Even where the required degree of relationship to bring the transaction within the code section does not exist, a sale made to a related taxpayer is likely to be subjected to close scrutiny. The taxpayer would be well advised if he refrained from sales to controlled or sympathetic vendees where the transfer might permit the allegation that the taxpayer was manipulating his property in an attempt to establish a deductible loss.

POSSIBLE ADVANTAGE INVOLVED IN SALE OF DEBT

It may be more advantageous where a sale of the debt is made, depending on the particular circumstances of the taxpayer, since the deduction can be timed by making the sale in the desired taxable year.

This advantage of a sale is well illustrated in *Helvering v. Ames*.³³ In 1927 the taxpayer, Ames, sold for \$500.00 one-half (\$221,788.33)

²⁸ Treas. Reg. §1.165-1.

"(b) Nature of loss allowable.—To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss."

²⁹ §165(c)(2).

³⁰ *Terry v. U.S.*, 10 F. Supp. 183 (D. Conn. 1934).

³¹ See note 6.

³² "SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS.

(a) Deduction Disallowed.—No deduction shall be allowed—

(1) Losses.—In respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of subsection (b).

(b) Relationships.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c) (4); . . ."

³³ 71 F. 2d 939 (8th Cir. 1934), *aff'd* 27 B.T.A. 624 (1933).

of an indebtedness and claimed a loss of \$221,288.33 on his 1927 return which the Commissioner allowed. In 1928 he sold the remaining one-half of the indebtedness for \$100.00 and deducted a loss of \$221,688.33 in his 1928 return. The Commissioner disallowed the 1928 deduction on the ground that the entire indebtedness became worthless in 1927, relying on the fact that the sale of one-half of the debt for \$500.00 in 1927 conclusively showed such worthlessness in 1928. In sustaining the determination of the Board of Tax Appeals that the disallowance of the deduction was erroneous, the Court of Appeals indicated that under the facts the sale was not solely to be attributed to such cause:

Mr. Ames had made large capital gains on his investments in 1927 and 1928. Offsetting these gains by a *bona fide* sale of his indebtedness was not forbidden by law. Even though the transaction is a device to avoid the burden of taxation, it is not for that reason alone illegal. . . . He may have preferred the certainty of a present sale of a claim doubtful in the time of payment, if not in the ultimate amount of the amount to be collected, carrying with it the certainty of an offset to his capital gains and a minimization of income tax for 1927.³⁴

Important to the decision, of course, is the fact that the genuineness of both sales was not questioned.

SETTLEMENT WITH THE DEBTOR

While the courts are thus willing to make the transition from a bad debt to a loss where there is a sale of the obligation to a third party, they have not seen fit to do so where the taxpayer elects to make a settlement with the debtor himself.³⁵ Assuming that a valid debt exists and there has been a *bona fide* settlement, under the doctrine of mutual exclusiveness set forth in *Spring City Foundry Co. v. Commissioner*,³⁶ the loss attributable to the partial worthlessness of the debt must be regarded as a bad debt, deductible as such or not at all.³⁷ The full deduction available under the loss provision³⁸ is simply not available. A taxpayer may not deduct as a bad debt what in truth is a loss, and *vice versa*.³⁹

As was noted earlier, worthlessness, as a prerequisite to deductibility, presents problems of proof. The possible difficulties to be encountered where a settlement with the debtor is effected should be obvious. An early ruling⁴⁰ allows a deduction if the debtor lacks assets from

³⁴ *Id.* at 943.

³⁵ The possibility of such transition might be argued from the language of section 1001 which speaks of "the sale or other disposition" of an asset in the computation of gain or loss.

³⁶ 292 U.S. 182 (1934).

³⁷ *Putnam v. Comm.*, 352 U.S. 82 (1956); *Maurice Levy*, 46 B.T.A. 423 (1942), *aff'd*, 131 F. 2d 544 (2d Cir. 1942); *Edmund Thomas Gullledge*, ¶57,029 P-H Memo TC, and *Ben Sonz*, ¶58,030 P-H Memo TC.

³⁸ Sec. 165.

³⁹ *Katherine J. Hanes*, 2 T.C. 213 (1943).

⁴⁰ O.D. 297, 1919 Cum. Bull. 126.

which the entire amount could be collected. However, a valid debt is not ascertained to be worthless where the creditor, for consideration satisfactory, to himself, voluntarily releases a solvent debtor from liability.⁴¹

An interesting result seems possible where the cancelled part of the debt is not actually worthless. In theory, an ordinary loss deduction is allowable. Not being actually worthless, there is no bad debt and the mutual exclusiveness doctrine of the *Spring City* case⁴² is not operative. The capital loss restrictions⁴³ are not imposed because the compromise does not constitute a sale or exchange of a capital asset⁴⁴ which would bring the case under the provisions of section 165(f).

In *Johnson, Drake & Piper, Inc.*⁴⁵ it was said that the voluntary cancellation or forgiveness of indebtedness does not give rise to a deductible loss. Obviously this is too broad a statement of the rule for a recent ruling⁴⁶ held that the discount given upon the settlement of a purchase-money mortgage before maturity was deductible as an ordinary loss, even though the debtor was fully able to pay the entire debt and there was no decrease in the value of the mortgaged property.

An ordinary loss was allowed in *Alexander County National Bank*⁴⁷ where notes of a financially embarrassed debtor were cancelled in the hope that by so doing the debtor corporation, under a new management that was agreed upon, would be able to pay the remainder of the indebtedness in full. The Board of Tax Appeals reached a similar result in *First National Bank of Durant, Okla.*,⁴⁸ holding that a cancelled debt was allowable as a loss where it appeared that the cancellation was made in consideration of the giving of security for other debts previously unsecured.

Nevertheless, in practice, it is many times difficult to justify the loss deduction. A creditor who claims a loss deduction for the amount by which he reduces the debt is frequently met with the contention that the forgiveness was a gift or capital contribution; and a taxpayer who compromised the amount rightfully due him on an interest bearing

⁴¹ *American Felt Co. v. Burnet*, 58 F. 2d 530 (D.C. Cir. 1932) and *Estate of Nathaniel King*, ¶41,216 P-H Memo B.T.A., *aff'd*, 122 F. 2d 934 (3rd Cir. 1941). For cases allowing a bad debt deduction for the difference between the face amount of the loan and the amount received in compromise where the debtor was unable to make payment in full, see: *Arthur W. Harrison*, ¶41,584 P-H Memo B.T.A.; *George A. Adam*, ¶44,220 P-H Memo TC, and *Annie B. Smith*, ¶53,046 P-H Memo TC.

⁴² *Supra* note 36.

⁴³ §§1211 and 1212.

⁴⁴ *Hale v. Helvering*, 85 F. 2d 819 (D.C. Cir. 1936); but settlement with a corporate debtor is subject to §1232(a)(1). See *McClain v. Comm.*, 311 U.S. 527 (1941).

⁴⁵ 27 B.T.A. 585 (1933), *aff'd*, 69 F. 2d 151 (8th Cir. 1934).

⁴⁶ I.T. 4018, 1950-2 Cum. Bull. 20.

⁴⁷ 12 B.T.A. 1238 (1928).

⁴⁸ 6 B.T.A. 545 (1927).

note in order to save the time and expense of litigation was denied a loss deduction in *Nicholas D'Alonzo*.⁴⁹

One other question in this area requires consideration. Is the obligation which is the subject of the settlement with the debtor a worthless bad debt within the meaning of section 166(d) or only partially worthless and therefore not deductible? Conceivably it could be argued that, the debtor having paid a portion of the amount owing, the debt is now only partially worthless. There appears to be no discussion of this point in the cases. In the light of the *Annie B. Smith* case⁵⁰ which allowed the deduction in these circumstances it seems that the code must refer to the situation where the debt is still in existence and the taxpayer seeks a deduction for partial worthlessness, and not where the obligation has been extinguished by a settlement.

GUARANTORS, ENDORSERS, AND INDEMNITORS

Whatever confusion may have existed following the decisions in cases such as *Pollak v. Commissioner*,⁵¹ it is now settled that an endorser or guarantor who is required to pay the debt of his principal under a contract of suretyship may take a bad debt deduction but will not be allowed a loss from the transaction.⁵² Prior to *Putnam v. Commissioner*,⁵³ a number of circuit courts of appeal had allowed taxpayers full deductions for payments made as guarantors on the basis that they were losses incurred in transactions entered into for profit though not connected with trade or business.⁵⁴ In the *Putnam* case, the petitioner, a lawyer, in a business venture not connected with his law practice, organized a corporation, supplied its capital, and financed its operations through advances and guarantees of its debts. Later he wound up the corporation's affairs and liquidated its assets but did not terminate its corporate existence. Its assets were insufficient to pay its debts and petitioner paid \$9,005.00 of its debts in discharge of his obligation as guarantor. In holding that the loss was a nonbusiness bad debt loss to be given short-term capital loss treatment, the Supreme Court clearly set forth the nature of a guaranty obligation:

The familiar rule is that, *instantly* upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes. Thus, the loss sustained by the guarantor unable to recover

⁴⁹ ¶51,251, P-H Memo TC.

⁵⁰ *Supra* note 41.

⁵¹ 209 F. 2d 57 (3rd Cir. 1953).

⁵² *Putnam v. Comm.*, 352 U.S. 82 (1956).

⁵³ *Ibid.*

⁵⁴ *Pollak v. Comm.*, *supra* note 53; *Fox v. Comm.*, 190 F. 2d 101 (2d Cir. 1951); *Edwards v. Allen*, 216 F. 2d 794 (5th Cir. 1954); *Ansley v. Comm.*, 217 F. 2d 252 (3rd Cir. 1954); *Cudlip v. Comm.*, 220 F. 2d 565 (6th Cir. 1955).

from the debtor is by its very nature a loss from the worthlessness of a debt.⁵⁵

Thus, the deduction is allowed, not because of the payment, but because the payment gives rise to a claim which, if it is worthless, constitutes a bad debt. The status of this obligation between debtor and guarantor, as regards existence and collectability, determines when and if a deduction is allowable.

As also pointed out in the *Putnam* case, if the debt is a nonbusiness debt as defined in section 166(d),⁵⁶ the loss is treated as a short-term capital loss rather than an ordinary deduction from gross income. The additional provisions of that section and the regulations covering partial worthlessness are also applicable.

A recent example of the treatment accorded losses arising from the guarantee of corporate obligations is found in the case of *Aubrey Campbell*.⁵⁷ There, the taxpayer-petitioner was long associated with his father in a construction business, first as a sole proprietorship owned by the father, later as a corporation, of which petitioner held 90 shares of stock and was secretary-treasurer. In 1953, petitioner promoted a second construction enterprise, held 240 shares of the corporate stock and was president from 1953 through 1956. He guaranteed the payment of notes and open account of this corporation, and in 1956 paid a total of \$33,207.39 on these obligations. In July of 1955, petitioner purchased one-third of the capital stock of a coal mining company and became secretary of that company. These were the only companies in whose affairs petitioner actively participated during the year 1956. In his return for that year the amount paid as guarantor of the corporate obligations was claimed as a business bad debt. The Commissioner assessed a deficiency allowing only a nonbusiness bad debt. Petitioner contended (1) he was engaged in the business of promoting enterprises and therefore was entitled to a deduction as a business bad debt; and (2) that the loss was incurred in a "transaction entered into for profit" and was deductible under section 165(c)(2).

In striking down both of these contentions, the Tax Court held that petitioner's activities with respect to these enterprises was not "so extensive as to qualify as the exceptional situation of being in the trade or business of promoting, managing, and financing corporations," and there has been no showing of any proximate relationship between the claimed bad debt and any trade or business in which he was engaged; and that petitioner was squarely foreclosed from claiming a deduction under the loss section by the doctrine of *Putnam v. Commissioner*.⁵⁸

⁵⁵ *Supra*, note 52 at 85.

⁵⁶ The *Putnam* case actually involved section 23(k)(4) of the 1939 code and the definition of a nonbusiness bad debt has since been changed somewhat.

⁵⁷ ¶60,039 P-H Memo TC.

⁵⁸ *Supra* note 52.

It is important in this area to distinguish between a contract of guaranty and one of indemnity. While the object of both may be the same, to save the promisee from loss, the legal effect is different. One guarantees the performance of an obligation according to its terms. A nonperformance of the obligation constitutes a breach of the guaranty agreement giving rise to the liability of the guarantor. The other indemnifies against loss in case of nonperformance, the failure to perform does not create the liability, and there is no liability until the ascertainment of a loss therefrom. It appears that the indemnitor, in order to obtain a deduction, usually must show a loss under section 165(a).⁵⁹

GUARANTY OF CERTAIN NONCORPORATE OBLIGATIONS

The 1954 Code carved out an exception to the general rules applicable to guarantors by section 166(f).⁶⁰ Under this provision, a taxpayer, other than a corporation, is entitled to a full deduction for a loss through payment of all or part of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation if he can show (1) that the proceeds of the loan were used in the trade or business of the borrower; and (2) that the obligation was worthless at the time payment was made. In determining whether the obligation of the borrower was worthless at that time, the taxpayer's guaranty, endorsement, or indemnity is, of course, disregarded.

This rule applies not only to persons having collateral obligations as guarantors or endorsers, but also to the persons having direct obligations as indemnitors, and also whether the debt, as between borrower and guarantor, endorser, or indemnitor, is business or nonbusiness.

Of importance is the factor that the code section is concerned only with the worthlessness of the original debt, and does not touch on the worthlessness of the claim that the guarantor, endorser, or indemnitor has against the principal debtor. The taxpayer need not show that his "right over" is worthless.

In the great majority of the cases it is no doubt true that the subrogee stands in no better position than the original creditor. Nevertheless, situations could exist where a guarantor's claim has value although the original creditor's claim against the principal debtor is

⁵⁹ *Supra* note 25.

⁶⁰ "SEC. 166. BAD DEBTS.

"(f) Guarantor of Certain Noncorporate Obligations.—A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment."

worthless. As, for example, where the debtor has indicated that he will rely on the statute of limitations as a defense if sued by the creditor, but not if sued by the guarantor. It would appear that more equitable results would be attained if dual worthlessness were required in all cases.

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