Ordinary versus Capital Losses on Business Investments

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Ordinarily, the term "investment" denotes a capital transaction, and the word "business" denotes one that involves ordinary income or ordinary loss. Of course, in the title, the word "investment" is used as a broader, generic term. The real question is whether the money advanced was an investment or whether it was a debt incurred in the trade or business.

There are three basic rules of income tax strategy:

1. To divide the income eggs into as many baskets as possible to lessen the impact of graduated rates,
2. To have transactions involving a gain treated as a capital transaction, and
3. To have transactions involving a loss treated as a noncapital or ordinary loss.

The third, of course, is the subject of this article. It is a problem that affects everyone, and it is actually more apt to affect the small taxpayer than the large one. It is a problem that will plague the general practitioner and the accountant, if they do not keep themselves aware of its possibilities, more than it will plague the tax specialist.

Three Stages of Planning

This is so because the question whether a loss will receive capital or fully deductible treatment should be asked (a) every time a business is organized, (b) while the business is being operated and one is squarely confronted with it, and (c) whenever the business fails. Too often, the attorney or accountant-tax specialist may be called in only at this third step (c) to handle it as a specific problem.

There will be an attorney, however, who will have a part in the organization of almost every business, and he will usually continue as the attorney for the business he has organized. There will also be an accountant who will be doing work during the operation of every business. It is this attorney's and this accountant's responsibility for giving guidance in this field in the first and second steps to try to minimize the tax problem that will develop in the third step.

Three Types of Entity

Using the terminology of the title, "business investments," or as it
is preferable to say, money, may be advanced to one of three types of entity.

The first, the individual proprietorship, raises few tax questions involving losses, since they are suffered and usually can be taken year by year.

Second, the partnership losses can usually be taken year by year by the partners, as in the case of an individual proprietorship. Questions could arise unless a limited partner is clearly in the business of the partnership. A loan question could arise as to what year the same became a bad debt.

Third, losses suffered in a corporate failure do cause some difficult tax problems to the person who has advanced it money. When such a failure occurs, the losses that may be suffered are generally of two types: one by the person who has bought stock, and the other by the person who has made loans to the corporation. Then there is a third, "grey" area, that of the capital contribution which, quite often, though advanced in the form of a loan and actually intended as a loan, may be held by the Internal Revenue Service, and sometimes the courts, to be a contribution to capital.

Emphasis on Losses on Loans

Most of this discussion will be concerned with losses resulting from advances to corporations for purposes other than the purchase of stock. Stock losses are more clearly defined by statute and do not ordinarily raise as many problems as loans. There is generally no question that a purchase of stock is just that. Certificates are usually issued, and it is clearly identifiable. Unless the taxpayer holds the stock primarily for sale to customers in the ordinary course of his trade or business, stock losses will ordinarily be given capital gains treatment.\(^1\) Worthless stock will be treated like a sale or exchange on the last day of the year in which it becomes worthless.\(^2\)

Another reason for devoting more time to the question of losses on loans is my intimate connection with Whipple v. Commissioner,\(^3\) recently decided by the United States Supreme Court. My work on the case began in December 1953 when a client, A. J. Whipple, asked me for advice regarding his Mission Orange Bottling Company in Lubbock, Texas. He informed me that the bad financial condition of his bottling operations had become worse and that he could not continue in business.

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\(^1\) Int. Rev. Code of 1954, § 1221(1): "Capital Asset Defined.—For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

\(^2\) Int. Rev. Code of 1954, §§ 165(g) (1), (2) (A), (B).

without additional funds. He declared that he was anxious to keep the bottling operations alive because he had $40,000 to $45,000 invested in the building he was leasing which was primarily designed for a bottling operation, and it would not rent or sell to anyone for much if put to any other use. He said, though, that the corporation already owed him almost $80,000 and he thought that before he did anything he needed some advice. In other words, we had been called in at step (c) of those three steps in the life of a business discussed earlier—the time it had become a financial failure.

Obviously, when one is first called in at this late date, he is handicapped in what he can do for a client. Actually, in this case, it could not strictly be said that this was so. I had organized Mission Orange Bottling Company, was a small stockholder in it, and, along with an accountant, had been generally in touch with its operations, and had given occasional legal advice on broad matters of policy. As the firm operated in Lubbock, however, the everyday legal and accounting questions had been worked out locally.

**Duty During Steps (a) and (b)**

Probably both the accountant and I had been guilty of not giving enough thought during stages (a) and (b) to the possibility of step (c). We had not been thinking much of this phase of our client's business or advising him, except when asked to on specific questions.

When the corporation was originally organized and the bottling assets were purchased from Mr. Whipple, who had personally operated the plant for some months, some thought was given to the tax consequences of having him own the building and lease it to the bottling company, but after that we had given little thought to what the tax consequences would be if the business ended in failure.

This is fairly easy to do in the case of a successful client such as Mr. Whipple, who had been in some twenty-five or thirty enterprises that he had organized with various partners over a period of twelve or fourteen years. Every single one before this had been successful, and whatever tax problems he had were those involving the first two rules of tax strategy rather than the third—how to treat a possible loss.

In the state of the law existing at that time, there may not have been anything that we could have foreseen to advise our client that would have actually changed the outcome of the case, had it been contested by the Government all the way; but there were some steps we could have advised him to take, which will be discussed in detail later, that would have bolstered his position to where a satisfactory settlement might have been made. In any case, both the accountant and I learned our lesson.

In the state of the law today, there definitely are some warnings that can be given all clients, and planning in the case of some clients will
make their chances considerably better for receiving favorable tax treatment on a bad debt loss.

But back to the problem that was facing us in December 1953 involving step (c) to which all advice and planning in all three steps must ultimately be directed.

*Always Have Two Hurdles*

In trying to take a deduction for an advance made to a corporation as a bad debt, one, of course, *always* has two hurdles to get over in order to establish:

1. that the advances made created a debt, and
2. that the debt has become bad.

A corollary of this second item is to establish the year in which the debt became bad.

The transactions which usually determine the first of these generally take place during stages (a) and (b), and it is there that the planning should be done to get over the first hurdle of establishing it as a debt, to distinguish from that shadowy, in-between advance to a corporation mentioned earlier—a contribution to capital.

The second, the debts becoming bad, is an event that takes place in stage (c), and it is not too late in stage (c) to take steps that will establish that the debt has become bad. It may be too late, however, to take steps that will establish the debt as becoming bad in the year that is most favorable tax-wise for the client. The test is: When did the debt actually become bad?

The accountant and I advised Mr. Whipple to make such transactions which resulted in his ending up at the end of 1953 with all the creditors of the corporation but himself paid off, with substantially all of the tangible assets of the corporation transferred to him in cancellation of a portion of his indebtedness computed at the book value of these assets, and with the corporation owing him $56,975.10, with no assets out of which to pay him.

We evidently planned this close-out transaction properly, since it was stipulated in the Tax Court by the Government:

1. that the $56,975.10 bad debt balance to A. J. Whipple after this transaction was a debt, and
2. that it became worthless in the year 1953.

*Third Big Hurdle Left*

This left us, however, still with the third hurdle, which was stipulated to be the sole issue—whether it would be classified as a business bad debt under the then section 23(k)(1) or a nonbusiness bad debt

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4 "(1) General Rule.—Debts which become worthless 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
under the then section 23(k)(4) of the Internal Revenue Code of 1939.

It was found that the state of the law as far as interpretation of these sections at that time is concerned was, as expressed by Rabkin & Johnson, as follows:

In the few cases thus far decided, the courts have been rather liberal in finding that a debt was incurred in the taxpayer's business. In the first test under the statute, a broker sold a stock exchange seat acquired as a membership "dividend," and part of the selling price became uncollectible. The Tax Court allowed the full deduction on the ground that the sale was "closely related to the business of owning and using a stock exchange membership for the production of income," even though the taxpayer was not in the business of selling seats.

The courts apparently hold that the debt is fully deductible if the stockholder was not a mere "investor" but was active in the conduct of the corporation's business. In any case, it is a business debt where the stockholder's business was organizing and promoting various enterprises, one of which was the debtor corporation. The tax court has classified a loan by a stockholder to the corporation as "nonbusiness" because he "was not in the business of making loans," even though he was active in the affairs of the corporation. A similar result has been sustained where the taxpayer, although active in the debtor corporation and an organizer of several other corporations, had made the loan in question while the corporation was controlled by another person, and had taken control only to protect his loan.

Two Theories to Sustain Business Bad Debt

We believed that the facts of Mr. Whipple's case might establish that he was either in the business of organizing and financing corporations and taking an active part in their management within the meaning of Vincent C. Campbell and Henry E. Sage, or was engaged in the business of acquiring, owning, financing, equipping, and leasing a plant for the operation of the bottling business on authority of Maloney v. Spencer.

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. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness debt, as defined in paragraph (4) of this subsection.

5 "(4) Nonbusiness Debts.—In the case of a taxpayer, other than a corporation, if a 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. The term 'nonbusiness debt' means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

7 Id. 35.01 (2) (3).
8 11 T.C. 510 (1948).
9 15 T.C. 299 (1950).
10 172 F. 2d 638 (9th Cir. 1949).
By the time the return was audited and a deficiency assessed, the Maloney case had been cited with approval in the Fifth Circuit case of Giblin v. Commissioner.\(^1\)

In the Giblin case, taxpayer, a lawyer, made loans in previous years to corporations which he organized and promoted and in which he held stock. He devoted a large part of his time to such enterprises, apart from his practice of law. Although he made no other such loans in the taxable year except the one in question which became worthless, it was found that he was still engaged in the business of seeking out business opportunities, and promoting, organizing, and financing them. Accordingly, the loss in the taxable year was a business bad debt deductible under 1939 Code section 23(k)(1), and not a nonbusiness bad debt under 1939 Code section 23(k)(4).

The court in the Giblin case reversed the Tax Court's denial of the deduction on the ground that taxpayer was "not in the business of making loans to corporations."\(^2\) The court points out that the taxpayer did not have to prove this. Instead he proved and was entitled to a deduction on the ground that he was "regularly engaged in the business of seeking out business opportunities, promoting, organizing and financing them. . . ."\(^3\)

With this favorable decision in our own circuit, we petitioned the Tax Court for determination of the deficiency.

In 1941, A. J. Whipple was a construction superintendent and an estimator for a lumber yard. In that year, he formed a partnership with W. E. Brown for the construction of houses, and from then to the year 1953, his activities were extensive in organizing and managing corporations, partnerships, and joint ventures with some twenty-one different people, covering a wide variety of businesses: the construction of houses, a rental corporation, a supply house, a tile distributorship, apartment houses, a bottling business, a retail lumber yard, a shingle distributorship, a retail building materials yard, an equipment rental corporation, a club, subdivision of real estate, and the sale of lots which involved putting in streets, sewers, and water lines.

In addition he bought and operated a restaurant, promoted an oil venture, organized a soft drinks distributorship, and entered into the vending machine business. He was asked to help promote, raise money for, and handle other enterprises, such as a cinder block business in 1953 and a lumber yard promotional liquidation deal after that.

In connection with the Mission Orange Bottling Company on which the bad debt loss in question was suffered, the Tax Court found as follows:

\(^{12}\) 23 P-H Tax Ct. Mem. at 933.
\(^{13}\) 227 F. 2d at 696.
On April 17, 1951, Mr. Whipple acquired an option to purchase the Mission Orange Bottling Co., a sole proprietorship owned by D. C. Casey. On April 21, 1951, Mr. Whipple, as lessee, rented the premises occupied by Casey's business for 20 months, effective May 1, 1951, for $150 per month. On April 25, 1951, Mr. Whipple obtained a franchise from the Mission Dry Corporation entitling him to produce, bottle, distribute and sell Mission beverages in certain counties in Texas. On April 27, 1951, petitioner purchased the bottling machinery and equipment from Casey for $46,225. He conducted this business as a sole proprietorship under the name Mission Orange Bottling Co. until approximately July 1, 1951 when he sold the bottling machinery and equipment to Mission Orange. He did transfer the franchise to Mission Orange.

Mission Orange was organized on June 8, 1951, with an authorized capital stock of $20,000, with Mr. Whipple owning 88% of it, the local manager 10%, and his attorney 2%.

The charter of Mission Orange was amended on December 8, 1952 to increase the authorized capital stock to $40,000, at which time 5 other stockholders put money into the corporation. This left Mr. Whipple with 79.5%.

In 1952 Mr. Whipple erected a bottling plant on land which he purchased in Lubbock, Texas. The land and building cost a total of $43,601.70. On July 14, 1952, Mr. Whipple leased this plant to Mission Orange for a 10-year term, beginning August 1, 1952, with an option to renew. The prescribed rental was $500 per month for the first 3 years and $500 per month plus 1% of gross sales thereafter. In his 1952 and 1953 returns Mr. Whipple claimed a deduction for depreciation of the bottling plant in Lubbock. These returns reflect that petitioner received no rent during either year for that building.

Mr. Whipple, directly or indirectly, made cash advances to Mission Orange of $48,550 in 1952 and $6,750 in 1953. He paid Mission Orange's expenses amounting to $2,975.76 during the years 1951 through 1953 and received refunds and credits totaling $4,388.50. The balance due to Mr. Whipple by Mission Orange on December 1, 1953, including the amount of $25,502.50 owed him as the result of his sale of the bottling assets to the corporation in July 1951, was $79,489.76.

On December 15, 1953, Mr. Whipple advanced Mission Orange $48,000 to pay general creditors and on the same date received a transfer from Mission Orange of bottling machinery, equipment and an automobile which had a total book value of $70,414.66. The net amount due by Mission Orange to Mr. Whipple on December 31, 1953, was $56,975.10. This debt became worthless in 1953.

On September 1, 1951, Mr. Whipple acquired stock of a corporation known as Mason Root Beer. This corporation owned a franchise to bottle and sell Mason root beer in Amarillo, Texas.

Mr. Whipple had a vending machine arrangement with Ideal,
Indiana, which sold vending machines to the trade. Mission Orange had no interest in this venture.\textsuperscript{14}

\textit{Additional Money Lender Theory}

When we investigated in detail all of Mr. Whipple's operations in preparing the case for trial, we discovered he had made a number of loans to his various corporations, partnerships, fellow shareholders, and partners throughout the years 1951-1953. His income tax returns for 1951, 1952, and 1953 reflected interest income of $1680 received from sixteen different corporations, partnerships, and individuals in 1951, income totaling $2285 from sixteen different corporations, individuals, and partnerships in 1952, and $1747 from four different corporations, individuals, and partnerships in 1953.

This, we believed, might be the basis for his being in the business of loaning money. Therefore, it was urged before the Tax Court that the bad debt loss was a proximate cause of his being in the business of (1) financing corporations and loaning money, in addition to that of (2) dealing in enterprises by promoting, organizing, financing, and managing corporations, partnerships, and joint ventures under the authority of the \textit{Campbell},\textsuperscript{16} \textit{Sage},\textsuperscript{16} \textit{Macy}\textsuperscript{17} and \textit{Giblin}\textsuperscript{18} cases, and (3) acquiring, owning, expanding, equipping, and leasing bottling plants under the authority of \textit{Maloney v. Spencer}.\textsuperscript{19} We also claimed (4) that he was actually in the business of bottling soft drinks, and (5) that a combination of these activities constituted a business out of which the bad debt loss resulted. Therefore, we were urging five possible theories upon which the loss could be held as a business bad debt loss.

As to the contention that Mr. Whipple was in the business of lending money, the Tax Court found that the bulk of his loans were to corporations and partnerships in which he had an investment, and stated that it "cannot find that the purpose of these loans was other than to protect that investment. Such lending activity does not constitute a trade or business."\textsuperscript{20}

The court went on to say that the remaining loans were to fellow shareholders and partners and it could not find that lending activity of this nature constituted a trade or business. Then the court pointed out that even if it did constitute a trade or business, there was no evidence that Mission Orange ever paid him any interest or was ever obligated to do so.

\textit{Supervision During Step (b) Important}

Here it becomes obvious that careful supervision of a client's busi-

\textsuperscript{15} Vincent C. Campbell, \textit{supra} note 8.
\textsuperscript{16} Henry E. Sage, \textit{supra} note 9.
\textsuperscript{17} J. Noel Macy, 18 P-H Tax Ct. Mem. 621 (1949).
\textsuperscript{18} Giblin \textit{v. Commissioner}, \textit{supra} note 11.
\textsuperscript{19} Note 10 \textit{supra}.
\textsuperscript{20} Note 14 \textit{supra}, at 218.
ness activities during stage (b), the operation stage, in preparation for the possibility of stage (c), the failure stage, would have dictated that some interest be paid back and that, from time to time, instead of being simply open loans, promissory notes be set up providing for interest. The establishment of promissory notes, and, if there was no payment, the formal renewal of them, would also be valuable to a taxpayer in those cases where he is having difficulty in overcoming the hurdle of his advances being claimed by the Internal Revenue Service as a contribution to capital.

The Tax Court then found that Mr. Whipple was not in the bottling business, stating that "petitioner's relation to Mason Root Beer and Mission Orange as a shareholder, officer or employee does not place him in the business in which the corporations were engaged."\(^{21}\)

As to our contention that Mr. Whipple was in the business of organizing, promoting, and financing corporations, the Tax Court said:

Individually petitioner was in the construction or real estate business. What petitioner fails to recognize is a distinction between carrying on one business through a corporate form which of course requires some organizing and financing and the business of dealing in corporations which may likewise require some financing arrangements.

His purpose in forming the 14 corporations was to facilitate his construction and real estate business and not to develop them for sale as going businesses to customers in the course of the business of promoting.\(^{22}\) (Emphasis added.)

The Tax Court failed to make any finding or mention of the petitioner's contention that he was in the business of acquiring, equipping, leasing, and operating bottling plants. Nor did it mention the contention that a combination of petitioner's activities constituted a business.

The United States Court of Appeals for the Fifth Circuit held that the finding of the Tax Court as to petitioner's contention that he was in the business of loaning money and the bottling business was not clearly erroneous.\(^{23}\)

The Two Rules of the Giblin Case

As stated earlier, we had originally placed considerable reliance on the case of *Giblin v. Commissioner*\(^{24}\) in filing our petition for redetermination before the Tax Court, but the *Holtz case*,\(^{25}\) cited by the Tax Court, had interpreted Giblin's use of the words "dealer in enterprises" as meaning that the taxpayer must show that he had organized corporations for sale, in order to qualify for bad debt treatment. The

\(^{21}\) Id. at 219.

\(^{22}\) Id. at 218.


\(^{24}\) Note 11 supra.

\(^{25}\) Holtz v. Commissioner, 256 F. 2d 865 (9th Cir. 1958).
Giblin case had appeared to adopt two different rules, one being the "passive investor" rule originally laid down in the case of Foss v. Commissioner, for which the court in Giblin cited five other cases, not one of which involved forming a corporation for sale. However, it later cited in the opinion one that would appear to require the taxpayer, in order to qualify for business bad debt treatment, to have organized and promoted the corporations for sale.

We obtained a copy of the transcript of the Giblin case and found that there was virtually no evidence, even in the eleven pages of his own testimony, of Giblin ever having disposed of any of the corporations he had formed, except in liquidation. I pointed this out on oral argument, as well as later in the briefs. Nevertheless, he indicated that in coining the phrase "dealer in enterprises" he had in mind forming corporations for sale.

In affirming the Tax Court's decision on the question of taxpayer's qualifying as being in the business of promoting, organizing, financing, and managing corporations, the majority of the court of appeals cited the Giblin case and quoted from a different part of the opinion in the Giblin case than the one cited by us in our brief.

Thus, in its decision in the Whipple case, by citing that portion of its opinion in the Giblin case where the rule of "dealing in enterprises" and forming and disposing of corporations was contained, it was pretty clear that the Fifth Circuit had adopted this as an essential requirement before the organization, financing, and management of corporations could constitute a business within the meaning of section 23(k)(4).

26 75 F.2d 326 (1st Cir. 1935). The court in the Giblin case was certainly not laying down the requirement that corporations must be formed for sale as the correct legal standard when it stated: "Both the Tax Court and the Courts of Appeals have recognized the type of activity engaged in by petitioner as satisfying the requirement of "carrying on any trade or business" when such activity has been sufficiently extensive to warrant the conclusion that the individual involved is more than a passive investor." (Emphasis added.) 227 F.2d at 696.

27 "Taxpayer did not seek to show that he was engaged in the business of making loans. Neither did he seek to have the Tax Court 'pierce the corporate veil' and find that he was engaged in the restaurant business or in any of the other businesses which he had promoted and dealt with during the preceding twenty years. What he did seek to prove was that he was regularly engaged in the business of seeking out business opportunities, promoting, organizing and financing them, contributing to them substantially 50% of his time and energy and then disposing of them either at a profit or loss..." (Emphasis added.) Ibid. We further stated in our brief: "Petitioner's right to deduct the amount of the cancelled debt depends not upon his showing, as the Tax Court seemed to think, that he was in the business of lending money, but rather that he was regularly engaged in the business of 'dealing in enterprises,' during the course of which he operated either as a proprietor, as a stockholder, as a partner or a lender or in a combination of these capacities, contributing to each enterprise his own initiative and energy, and such financial backing as it required." Brief for Petitioner.

28 Note 23 supra.
Conflict Among Circuits

This decision appeared to create a conflict between the Fifth Circuit,\textsuperscript{29} and the First,\textsuperscript{30} Third,\textsuperscript{31} Sixth,\textsuperscript{32} and Eighth,\textsuperscript{33} Circuits, and the Court of Claims.\textsuperscript{34} On the basis of this conflict, petition for certiorari was filed and granted in October 1962.

Like the Tax Court, the majority opinion of the court of appeals failed to make any mention of the other two theories which had been presented and assigned as error.\textsuperscript{35} Judge Hutcheson wrote a vigorous dissent.\textsuperscript{36}

In view of the findings of the Tax Court against us on the points involving the business of lending money and the bottling business, we spent little time in our brief and none on argument urging them before the Supreme Court. Instead we concentrated on the other three.

First, we tried to show that congressional history, in light of the interpretation by the cases, did not justify the requirement imposed by the Fifth Circuit that corporations must be formed for sale.

Second, we argued that the bad debt was a result of Mr. Whipple's activities in acquiring, owning, expanding, equipping, and leasing real estate and equipment within the rule of Maloney v. Spencer.\textsuperscript{37}

Third, we contended that the taxpayer's engaging in a combination of activities generating large sums of ordinary income constituted a business in itself.

\textsuperscript{29}See also Holtz v. Commissioner, \textit{supra} note 25, and Wheeler v. Commissioner, 241 F. 2d 883 (2d Cir. 1957).
\textsuperscript{30}Foss v. Commissioner, 75 F. 2d 326 (1st Cir. 1935).
\textsuperscript{31}Commissioner v. Stokes' Estate, 200 F. 2d 637 (3rd Cir. 1953).
\textsuperscript{32}Mays v. Commissioner, 272 F. 2d 788 (6th Cir. 1959).
\textsuperscript{33}Washburn v. Commissioner, 51 F. 2d 949 (8th Cir. 1931).
\textsuperscript{34}Maytag v. United States, \textit{supra} note 23.
\textsuperscript{35}"4. The Tax Court of the United States erred in failing to make any finding as to petitioners' contention that petitioner, A. J. Whipple, was in the business of acquiring, owning, expanding, equipping, and leasing bottling plants and other equipment, out of the conduct of which business the $56,975.10 bad debt loss resulted in the calendar year 1953.
"5. The Tax Court of the United States erred in finding that petitioner was not engaged in a combination of activities which together constituted a business, out of the conduct of which business the $56,975.10 bad debt loss resulted in the calendar year 1953." Brief for Petitioner.
\textsuperscript{36}"The taxpayer in the Cluett case was certainly not in the business of selling stock exchange seats, and Mr. Campbell was not in the business of selling coal companies. Yet the government contends, and the tax court and the majority have erroneously held, that in order for the loss to be deductible, taxpayer Whipple must show that the numerous corporate enterprises which he promoted, financed, and managed were formed by him for sale. This extension of the restriction on the qualification of business bad debts continued for by commissioner and tax court considerably restricts the remedy which Congress provided for curing the mischief it had in mind. I think it clear that such restriction was never contemplated by Congress. Indeed the contention pressed here emasculates a clearly intended remedial law." 301 F. 2d at 113.
\textsuperscript{37}Note 10 \textit{supra}.
Congressional History

Prior to the Revenue Act of 1942\(^{28}\) which inserted section 23(k)(4), there was no distinction made in the Code between business and non-business bad debts. The treatment accorded to bad debts was the same whether it occurred in a trade or business or otherwise, and such bad debts were deductible in full. In a case\(^{39}\) involving the very first year of applicability of the new section 23(k)(4), the court stated that “the legislative history of Section 23(k)(4) indicates that its principal purpose was to place a limitation upon the losses from bad debts, such as loans to relatives or friends which had no connection with the business of the lender.”\(^{40}\)

The Supreme Court, however, in the case of *Putnam v. Commissioner*\(^{41}\) said about section 23(k)(4):

> The section was part of the comprehensive tax program enacted by the Revenue Act of 1942 to increase the national revenue to further the prosecution of the great war in which we were then engaged. It was also a means of minimizing the revenue losses attributable to the fraudulent practices of taxpayers who made to relatives and friends gifts disguised as loans. Equally, however, the plan was suited to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments.\(^{42}\) (Emphasis added.)

The key word there, of course, is “investments.” If it is an “investment” within the meaning of the word the way the courts use it, they will give it capital treatment. For this reason, I feel that the title which has been assigned to this article, “Ordinary vs. Capital Losses on Business Investments,” as far as loans are concerned, might be begging the question.

I do not disagree with the statement in the *Putnam* case of the purpose of that section of the Code, for I believe the question essentially is whether the loan is an investment or is made in connection with carrying on a trade or business. Actually, the *Putnam* distinction is close to the *Foss* case’s\(^{43}\) “more than passive investor” rule. It is interesting to note, however, that the Supreme Court in the *Whipple* case,\(^{44}\) instead of quoting from the language which it had previously enunciated in *Putnam* on congressional intent, paraphrased that previous opinion as follows:

> 23(k)(4) was intended to accomplish far more than to deny full deductibility to the worthless debts of family and friends. It was

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\(^{28}\) Ch. 619, § 124(a), 53 Stat. 13.

\(^{29}\) Robert Cluett III, 8 T.C. 1178 (1947).

\(^{30}\) Id. at 1179.

\(^{31}\) 352 U.S. 82 (1956).

\(^{32}\) Id. at 90-92.

\(^{33}\) Note 30 *supra*.

\(^{34}\) Note 3 *supra*. 
LOSSES ON BUSINESS INVESTMENTS

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.\textsuperscript{45}

Prior to that, in the Supreme Court's opinion in the \textit{Whipple} case, it had gone back to 1916 to point out that the concept of engaging in a trade or business, as distinguished from other activities pursued for profit, was not new to the tax laws.\textsuperscript{46} The Court pointed out that this pattern had been followed elsewhere in the Code; \textit{e.g.}, sections 23(a)(1) and (2)—"Ordinary and Necessary Expenses," 23(e)(1) and (2)—"Losses," 23(1)(1) and (2)—"Depreciation," and 22(d)(5)—"Net Operating Loss Deductions." In 1942, Congress added section 23(a)(2) for expenses incurred in transactions entered into for profit.

Because of the \textit{Putnam} case, and since the committee reports\textsuperscript{47} themselves make it clear that section 23(k)(4) was intended to refer to "trade or business," as distinguished from "transactions entered into for profit," we conceded this in our briefs. Therefore, the question turned on what constitutes "trade or business," and the Court, in my opinion, has yet to give a clear definition as such.

\textit{Two Requirements for Trade or Business}

I think that all interpretations of the term "trade or business," as distinguished from a transaction entered into for profit, include a requirement of activity and perhaps continuity of transactions. That distinguishes the case of the person who forms many corporations from the one who forms only one. What I think the Tax Court was saying, and Judge Tuttle of the Fifth Circuit was groping for, was that a business is not created merely by activity.\textsuperscript{48}

\textit{In addition, this activity must create some ordinary income} to the taxpayer. That is why they said that where a taxpayer promotes and organizes corporations for sale, he is in the business, because the sale of those corporations would, of course, bring ordinary income to him as a result of those activities. With this I agree. But because organ-

\textsuperscript{45} Id. at 201.
\textsuperscript{46} Revenue Act of 1916, ch. 463, \S 5, 39 Stat. 756, distinguished the broad veins of income or profit producing activities from those satisfying the narrow category of trade or business.
\textsuperscript{47} "The determination whether a debt is incurred in the trade or business is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by Sec. 23(e) is incurred in the trade or business under para. 1 of that section. 23(e) IRC 1939 provides: \ldots Losses by individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise —1. if incurred in trade or business; or 2. if incurred in any transaction entered into for profit, though not connected with the trade or business."
\textsuperscript{48} "To be sure, the presence of more than one corporation might lend support to a finding that the taxpayer was engaged in a regular course of promoting corporations for a fee or commission. \ldots." \textit{Whipple} v. \textit{Commissioner}, 373 U.S. at 202.
izing corporations for sale constitutes a business by the creation of income from such sale, it does not follow that the *only* way the organization and management of corporations can constitute a business is when they are formed for sale. A sale is not the *only* way of creating ordinary income. In fact, the Supreme Court recognized one other way which had been admitted by the Solicitor General in his brief as constituting a business—that of promoting corporations for a fee or commission.

Although Mr. Whipple had made no claim of having organized his corporations for sale or for a fee, what he did actually organize them for was to provide him with entities that would pay him salaries, would pay him rent, and would pay him interest, all of which are sources of ordinary income on which he paid taxes at ordinary rates.

It was pointed out in our briefs and emphasized on oral argument that a combination of these activities for the years 1952 and 1953 generated a total of $94,658.71 of ordinary income. An additional $56,376.28 was received from partnerships and joint ventures during those two years.

I will quote from our briefs and go into some detail on our oral argument, not from any mistaken pride of authorship or idea of trying to prove what a good job we did (the Supreme Court's opinion would

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49 "These activities were of the type which were reasonably calculated to, and in petitioner, A. J. Whipple's case did, generate substantial amounts of ordinary income from sources separate and distinct from the conduct of the particular businesses of the corporations themselves. Through all these activities, for the most part carried on separate from the particular business of the corporations themselves, petitioner generated ordinary income in the years 1952-1953 in the form of salaries, in the form of rents and in the form of interest in the total amount of $94,658.71. Had this soft drinks enterprise been a success the income from all three of these sources would have undoubtedly been greater and, as a result of his efforts to make it so, the $56,975.10 bad debt loss in question resulted." Brief for Petitioner, pp. 76-77.

50 "As has been shown, petitioner, A. J. Whipple, was over a long period of years, including the years 1952 and 1953, very extensively engaged in all three of these activities as well as other 'business' activities, and paid tax on ordinary income received from them in the total amount of $94,478.71 as follows:

<table>
<thead>
<tr>
<th></th>
<th>1952</th>
<th>1953</th>
</tr>
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<tbody>
<tr>
<td>Salaries</td>
<td>$29,400.00</td>
<td>$33,450.00</td>
</tr>
<tr>
<td>Interest</td>
<td>2,285.35</td>
<td>1,747.59</td>
</tr>
<tr>
<td>Rent</td>
<td>15,570.58</td>
<td>12,025.19</td>
</tr>
<tr>
<td>Totals</td>
<td>$47,255.93</td>
<td>$47,222.78</td>
</tr>
</tbody>
</table>

"Petitioner also paid tax on $56,376.28 ordinary income received from partnerships and joint ventures that he had organized as follows:

In 1952 $29,198.37
In 1953 $27,177.91

Total $56,376.28

"The combination of his business activities rewarded him with ordinary income totaling $150,854.99 during those two years. An integral part of petitioner's business activities was the financing of the corporations, partnerships and joint ventures which he had formed." Reply Brief for Petitioner, p. 17.
certainly refute that), but in order for you to be able to evaluate what the Court really had before it to pass upon, and what in fact it did decide, and what in fact it did leave open.

If we tried the case over, it would be tried differently, and certainly its presentation on appeal could have been improved, but there is one thing that I think should be pointed out about the facts of this case. Although in some aspects of a business bad debt case it was a "cripple," I feel that on the important "promoter, organizer, multiple corporation" issue the facts were about as strong for a showing of promoting, organizing, managing, and financing corporations constituting a business separate and apart from that of the corporations as you are likely to get.

I feel that the main purpose of this discussion is to present you with enough facts and to let you understand fully the argument made to the Court, upon which you can make your own judgment as to what chance your case, with different facts and different arguments, has of being decided differently.

The Solicitor General in his brief cited Dalton v. Bowers and Burnett v. Clark. We pointed out a clear distinction between the Dalton case and that of the petitioner, in that in the Dalton case the taxpayer sought to establish an identity between his own business and that of the corporation. We pointed out that petitioner's activities of organizing, financing, and managing corporations, partnerships, and joint ventures was certainly not the business of bottling soft drinks, subdividing real estate, running a restaurant, leasing equipment, selling lumber, or building houses. Actually, the reason Mr. Whipple organized all these corporations, partnerships, and joint ventures was to provide him with a way of making a good living without having to go out in the field any more and build houses. It was his organizational ability, his finances, his knowledge, his managerial capabilities, that brought these about. And it was to these efforts that he devoted his full time.

What we had tried to make clear in our brief and on oral argu-

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51 287 U.S. 404 (1932).
52 287 U.S. 410 (1932), reversing 59 F. 2d 1031 (D.C. Cir. 1931), reversing 19 B.T.A. 859 (1930).
53 "The great bulk of the salaries of $29,400 in 1952 and $33,450 in 1953, plus the partnership income of $29,198.37 in 1952 and $27,177.91 in 1953 received by petitioner were not for the conduct of the actual business in which the corporations and partnerships were engaged, but for managing them. He certainly didn't nail any boards, serve any steaks to customers in his restaurant or cap any bottles. In fact, he was not actively engaged in the day to day operation of any of his corporations unless its problems demanded some special concentrated attention, except as it involved matters of policy, of finance, coordination or cooperation with some of his other enterprises." Reply Brief for Petitioner, p. 19.
54 "What was recognized by the Court in Foss v. Commissioner . . . and has been the basis of the long line of cases that have followed it since, is that, in order to organize, arrange for and keep in touch with the financing of, coordinate the various activities of, and make the general policy decisions for
ment was that promoting, organizing, managing, and financing many corporations, partnerships, and joint ventures called for energy, time, skill, and resources that were not present in the case of forming only one corporation; that therein lay a sound distinction between the multiple corporation cases and those involving only loans to a single corporation.

Mr. Justice White questioned me on this considerably in oral argument and perhaps I only confused him. In any case, I am not quite sure that I ever got it across.

Certainly, he did not go along with it, as can be seen by the statement in his opinion that “if full-time service to one corporation does not alone amount to a trade or business, which it does not, it is difficult to understand how the same service to many corporations would suffice.”

In the Clark case, one in which the taxpayer was a majority stockholder in the Bowers Dredging Company, the Tax Court found that “with respect to the loss of $68,000 resulting from petitioner's endorsement of the Bowers Company note, he testified that in endorsing the notes he was seeking to protect his investment in his stock.” (Emphasis added.)

You have, therefore, the question of whether the loans are made to protect an investment. As pointed out earlier, the Putnam case had declared that the purpose of a law is to put loans in the form of an investment in the same category as other investments. The Supreme Court in Clark was saying that if the loan was made for the purpose of protecting an investment, it is, in effect, an investment. Therefore, the question remaining to be determined was what the purpose of taxpayer Whipple’s loans were. The Solicitor General’s opening statement was:

The principal issue in this case is whether a taxpayer who organizes, manages and finances a number of corporations, but seeks no financial reward from these activities other than the benefits which inure to him as a stockholder, can properly claim that he as an individual is in a business separate and distinct from the business of the corporation. (Emphasis added.)

a group of enterprises, as in the Whipple case varying from a retail lumber yard to a restaurant, to various phases of a soft drink enterprise in Lubbock and Amarillo, rental properties, promotion of oil deals, subdivision of real estate in Pasadena, Angleton and Bellaire, construction of houses in different locations, managing an equipment rental corporation and other activities, would necessarily take such extensive time, thought and efforts of the taxpayer, completely separate from the actual business operations of each of the enterprises themselves, as to constitute a business in itself, which does not exist in the case of the single corporation. This is the basis of the decisions of the cases of multiple corporations. Reply Brief for Petitioner, p. 22.

55 373 U.S. at 202.
56 Burnett v. Clark, supra note 52.
57 Id., 19 B.T.A. at 864.
58 Putnam v. Commissioner, supra note 41.
59 Brief for Respondent.
We pointed out in our reply brief that the statement, "but seeks no financial rewards from these activities other than the benefits that inure to him as a stockholder," was begging the question, the question really being, "What financial rewards was he seeking from these activities? Were they those which inure to him only as a stockholder, or were they those that inure to him as a result of activities other than those of a stockholder?"

We went on to point out that the activities of a landlord, from which rent is received, of an officer, from which salary is received, and of a lender, from which interest was received, were not those of a stockholder. These, as pointed out earlier, generated over a two year period ordinary income of $94,658.71, whereas, as pointed out in our reply brief, his income from investments was negligible.60

Yet the Supreme Court, in the face of this, begged the question in much the same way the Solicitor General did, when it stated its opinion:

Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business, since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.61

(Emphasis added.)

In view of the facts of the Whipple case, it is difficult to understand the significance of these words. This is the exposition of a sound legal doctrine, but it doesn't explain the decision on the Whipple facts.

Logically, it appeared that the evidence presented met all of the requirements of a trade or business, in that it was shown that (1) ex-

60 "A realization on the value of an investment can come about in only one of two ways. It may come in dividends or by the sale of the investment. Contrasted with the $94,478.71 received by petitioner from rent, interest and salaries the petitioner received only $3,300 from dividends in the years 1952-1953 . . . and the Tax Court correctly found that he did not form the corporations for sale. . . . Therefore, the rule sought by the respondent simply has, and can have, no applicability to the case before this Court." Reply Brief for Petitioner, p. 6.

61 373 U.S. at 202.
tensive activities were carried on over a period of 14 years, (2) the business was that of organizing, managing, and financing corporations, and not the business of the corporations themselves, (3) large sums of ordinary income were the reward, and (4) by the objective tests of dollars and cents, the purpose of the loans was the repayment of large sums of ordinary income, as distinguished from meager investment income.

What then was the real rule laid down by the Supreme Court on which it actually based its decision? In my opinion, the real crux of the decision is contained in the Court's statement that "one who actively engages in serving his own corporations for the purpose of creating future income through these enterprises is [not] in a trade or business. . . . To the extent that [the following cases] hold or contain statements to the contrary, we disprove of such cases. . . ." (Emphasis added.)

In other words, if the future income is to come from the corporations themselves, even though such income as rent and salaries certainly do not come from investments in the corporation, they are nevertheless classified as investment income, because they come from a corporation in which the lender had an investment. For the organization and, apparently, the management of the corporation to constitute a business, the income which is to be derived apparently must come from some other source than the corporation itself, either in the form of a fee to be paid by some third party, or a purchase price to be paid by some third party.

As pointed out in our briefs, the cases in which a promoter who is forming corporations either for a free or for sale lends them money are virtually non-existent. (Sage is the only one.)

On our point involving the leasing business, the Court remanded the case to the Tax Court.

62 Maytag v. United States, supra note 23; Mays v. Commissioner, supra note 32; Commissioner v. Stokes' Estate, supra note 31; Foss v. Commissioner, supra note 30; Washburn v. Commissioner, supra note 33; Henry E. Sage, supra note 9; Vincent C. Campbell, supra note 8; and Robert Cluett III, supra note 39. The Maytag case was one where the court permitted the taxpayer to pierce the corporate veil by attributing the business of the corporation to the individual; the others, for the most part, involve to some extent at least the organizer, promoter, of multiple corporations theory.

63 373 U.S. at 203.

64 "Furthermore, the real promoter would never be financing the corporation. If he had the funds to do so, he would not have to promote ventures. In the words of Professor Ballantine, quoted by respondent . . . 'The primary function of the promoter is to find an enterprise and interest investors in financing a proposed corporation to take over.'" (Emphasis added.) Brief for Petitioner.

65 "We are concerned, however, with the evidence as to petitioner's position as the owner and lessor of the real estate and bottling plant in which Mission Orange did business. The United States does not dispute the fact that in this regard petitioner was engaged in a trade or business but argues that the
As far as the Supreme Court's decision is concerned, they held it definitely determined that you can qualify for business bad debt treatment if (1) you are a taxpayer engaged in a regular course of promoting corporations for either (a) a fee, or (b) a profit on their sale; or (2) you are a landlord of a corporation to whom you advanced money. In addition, it impliedly approved of the doctrine laid down by *Trent v. Commissioner* that advances made by a salaried employee for the purposes of saving his job would qualify.

**Corporate Executive Theory**

It also indicated that the general question of whether working as a corporate executive for a salary may be a trade or business is still open for consideration. In these two cases, there may be a chink in the Government's armor.

There might be the danger here, though, of the Court's finding that if the officer is also a big stockholder, the loan, rather than being made to help his trade or business of being an officer, was to protect his investment as a stockholder. In *Folker v. Johnson*, apparently the taxpayer was not a stockholder. In *Trent*, he was forced to buy stock the way he was forced to make loans.

I would also like to point out a statute covering a very narrow field from which a strong argument can be made for this proposition. I am referring to section 7701(a) (26) of the Internal Revenue Code of 1954 and section 48(d) of the Internal Revenue Code of 1939, both of which read as follows:

> Trade or Business.—The term trade or business includes the performance of the functions of a public office.

If a public office is a business, why are not the functions of a private office also a business? This statute and other legislative history were urged before the Court by Mr. Earl Q. Kullman of New York on a petition for rehearing in the *Whipple* case, and, although the petition was overruled, I recommend a reading of the petition for not only some authorities and persuasive argument, but some very interesting things that are brought to light in connection with the availability from the worthless debt was not proximately related to petitioner's real estate business. While the Tax Court and the Court of Appeals dealt separately with assertions relating to other phases of petitioner's case, we do not find that either court disposed of the possibility that the loan to Mission Orange, a tenant of petitioner, was incurred in petitioner's business of being a landlord. We take no position whatever on the merits of this matter but remand the case for further proceedings in the Tax Court."

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66 291 F. 2d 669 (2d Cir. 1961).
67 Folker v. Johnson, 230 F. 2d 906 (2d Cir. 1956).
69 Note 67 supra.
bility of committee hearings, or rather the unavailability, to taxpayer's counsel.

Of course, lending money could clearly constitute a business, but there is always the question, which the Tax Court found to be true in the Whipple case, of the taxpayer's lending activities being for the purpose of protecting his investment.

Loans to Taxpayer's Independent Business

In the area of planning, therefore, I should reiterate, as mentioned before, the importance of formalizing the obligations of the corporation.

It is suggested that a taxpayer who regularly loans money to corporations and partnerships in which he is interested would do well to form a separate lending entity, preferably in the form of a joint venture with someone else, or at least set up a separate bank account, perhaps under an assumed finance company name, to keep the funds segregated. He should charge and collect interest, be careful to receive some repayment on all loans where possible, charge high enough rates of interest to indicate that the loans are being made for their earnings rather than to protect the lender's investment, and make it a point to lend money to some persons, at least, outside of the corporations or partnerships in which he has an interest. The primary purpose really must be that of the business of lending money for the return to be obtained, not that of helping or protecting investment.

There is another line of cases allowing business bad debt deductions which are rather hard to categorize. In general, it could be said that they involve stockholder loans to corporations which have the effect of helping the business being carried on by the stockholders themselves. Perhaps the best example of this is Tony Martin,70 in which the taxpayer advanced money to a corporation organized to rehabilitate his career after bad publicity during World War II.

In Fisher Brown,71 the taxpayer, a wholesale distributor of furniture, advanced and loaned money to his son-in-law, a manufacturer of furniture, and when the business failed, the Tax Court properly allowed the taxpayer the loss as a business debt, since the loan was made "for the purposes connected with his business as a distributor of furniture..."72

The remand in the Whipple case leaves an area for planning advantageous rental arrangements. Before you assume, however, that this is an easy way out in the rental arrangement, I remind you that a

72 Id. at 967. Cf. Putnam v. Commissioner, 224 F. 2d 947 (8th Cir. 1955). A good collection of such cases is contained in an article by Alex Cohen in 1963 J. TAXATION (July). Query whether the case of Mays v. Commissioner, supra note 32, at least some language of which was overruled, falls in this category.
LOSSES ON BUSINESS INVESTMENTS

final decision has not been made on the proximate relationship question. Furthermore, you should read how the United States Court of Appeals for the Ninth Circuit in *Holtz v. Commissioner*\(^{73}\) distinguished *Maloney v. Spencer*,\(^{74}\) also a Ninth Circuit case, on this issue. I think it is significant to point out that in the *Whipple* case the rental arrangement, unlike the interest and salary ones, was in writing and clearly an obligation of Mission Orange, although actually it was never able to pay any rent. Although the 1954 Code\(^{75}\) did not make any subsequent changes as to what would constitute a business of the taxpayer, it did relieve one hardship under the 1939 Code whereby a debt, although incurred in the taxpayer's trade or business, was not treated as a business bad debt if, at the time it became worthless, the taxpayer was no longer in that business.

It also added a paragraph (f) giving business bad debt treatment to individual guaranty endorsement or indemnification of a noncorporate obligation, the proceeds of which were used in the trade or business of the borrower, where the obligation of the borrower to whom such payment was made was worthless at the time of the payment.

After the *Putnam* decision,\(^{76}\) rules governing the payment of guaranties of corporate obligations have been treated the same as bad debts. Whether they are business or nonbusiness bad debts will be determined by exactly the same factors as in the case of a direct obligation. One other thing might be said about guaranties. They would usually be free of any of the dangers of being classified as contributions to capital, since they are not paid until actually enforced.

As far as ordinary indemnity is concerned, it has been held that

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\(^{73}\) Note 25 *supra*.

\(^{74}\) 172 F. 2d 638 (9th Cir. 1949).

\(^{75}\) *Int. Rev. Code of 1954, § 166:*

"(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 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."

(This subsection appears as amended by the Technical Amendment Act of 1958, effective with respect to taxable years beginning after December 31, 1958, and ending after August 16, 1954. This amendment struck out the words "a taxpayer's trade or business" in section 166(d)(2)(A) and inserted in lieu thereof "a trade or business of taxpayer."

\(^{76}\) *Putnam v. Commissioner, supra* note 41.
it creates a loss, rather than a bad debt, because no principal becomes
obligated to the taxpayer by reason of the indemnity payment. 77

Advances to Corporate Subsidiaries

The field in which the Government claim of capital contribution
is apt to be most far reaching is that of advances to corporate sub-
sidiaries. 78 This is pointed up in the June 1963 decision by the Fourth
Circuit in the case of Jewell Ridge Coal Co. v. Commissioner. 79

In that case, it was held that a coal mining corporation's purchase
of a railroad's outstanding indebtedness when it acquired control of
the railroad, and the subsequent advances to the railroad, constituted
contributions to capital, and not loans. The court pointed out that
whether the advances are loans or capital is an ascertainment of fact
with the burden on the taxpayer. It then went on to cite the rule as
follows:

The essential difference between a "stockholder" and a
"creditor" is that the stockholder intends to embark upon the
Corporation adventure, taking the risk of loss attendant upon it
that he may enjoy the chances of profit. The creditor, on the
other hand, does not intend to take such risks so far as they
may be avoided, but merely to lend his capital to others who
do intend to take them. 80

This case seemed to have been decided under the "risk capital"
theory developed by the Second Circuit, which is one of a line of
recent cases departing from what was considered a long established
doctrine whereby the courts generally were willing to accept a debt
if the parties clearly intended to create one. In this field, a lack of
formality can be fatal, but it takes considerably more than formality
to assure the taxpayer of getting bad debt treatment.

A development of this field which has plagued us all is the "thin
Corporation" rule in which, in spite of all intent on the part of the
taxpayer and the debtor corporation to create a bona fide debt, if the
ratio of debt to capital is high, the Internal Revenue Service, and some-
times the courts, 81 may hold it to be a contribution to capital.

Loans after organization of the corporation seem to be the subject
of a more liberal approach, and, if made by the same stockholder, may
bolster those made at the time of incorporation.

78 Treas. Reg. § 1.263(a)-2(g); Esmond Mills v. Commissioner, 11 P-H Tax
Ct. Mem. 845 (1942), aff'd, 132 F. 2d 753 (1st Cir.), cert. denied, 319 U.S.
80 Id., 318 F. 2d at 698.
81 Isidor Dobkin, 15 T.C. 31 (1950), aff'd, 192 F. 2d 392 (2d Cir. 1951). Cf. where
loans were made by the same stockholder later: Arthur v. McDermott, 13
T.C. 468 (1949).
In Prentice-Hall's *Tax Ideas* some of the other pitfalls of intercorporate debt are pointed out, such as the fact that where the parent is owed a debt by the subsidiary, any distribution on the subsidiary's stock would be considered, if the subsidiary is insolvent, as a payment on the debt and not on the stock. Thus, it would not be a tax-free liquidation.

They pointed out also that the effect of a liquidation where the parent is indebted to the subsidiary being to eliminate the debt, the Commissioner may contend that the parent has received income from forgiveness of debt or as a constructive dividend. It is suggested that prior to liquidation the parent should pay the debt with cash and property, which would come back to the parent as liquidating dividends. Of course, it may also file a consolidated return.

On the other hand, section 165(g)(3) gives a noncapital loss treatment to a domestic corporation on the securities of an affiliated corporation, if more than 95% of each class of stock is owned directly by the taxpayer and more than 90% of its aggregate gross receipts is from operating income.

We have touched only briefly on the problems of proving that a debt has become bad. In general, suit may be required to prove uncollectibility, unless the taxpayer can show that it would be futile.

On the other hand, when satisfied that a debt is recoverable 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. It would appear, at first thought, that to prove stock worthless would be easier, since the stockholder is behind the creditor in collecting in an insolvent corporation. The Treasury Department often takes the position, though, that as long as the corporation remains alive, new money may be put into the corporation and its business begin to thrive. Furthermore, there is no such thing as partially worthless stock. In the case of stock, you must also prove not only that it is worthless, but the year in which it became worthless. This latter is apt to be more difficult than the first, and generally the courts will require that the proof of the particular year should be established by some identifiable event.

The establishment of a loss can be made by a bona fide sale of the stock at a nominal consideration, but this does not necessarily establish the year in which the claimed loss could be taken, since the stock may have become worthless in a year earlier than that of the sale. Of course, bankruptcy would be a clear establishment of the loss and probably of the year of its becoming worthless. Liquidation of the corporation, if the liabilities exceed the assets, is also generally a clear way of estab-

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82 § 7,009.17, at 6162.
lishing a loss, and reorganizations can be clear establishments of such loss.

But there are many times when the stock may have really become worthless prior to this time in cases of small corporations that are simply allowed to become defunct without going bankrupt, without being reorganized, and without being liquidated. It is not when a taxpayer ascertains that it is worthless, it is when the stock actually becomes worthless, that a loss is incurred.

There are many cases in which either the taxpayer has been unable to prove the worthlessness of the stock or its cost. But, on the other hand, there are also many cases in which the evidence has been sufficient. If taxpayer's corporation did in fact become worthless, you should be able to find some theory upon which to prove it in one of these cases.

**Losses On Small Business Stock**

In the case of stock in certain small business corporations, Congress in 1958 passed the Small Business Corporation Act which gave tax relief by allowing a full loss on worthless stock. The purpose of this law is set out briefly in the House committee report as follows:

84 INT. REV. CODE OF 1954, § 1244:

"(a) General Rule.—In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as a loss from the sale or exchange of an asset which is not a capital asset.

(b) Maximum Amount or any Taxable Year—For any taxable year the aggregate amount treated by the taxpayer by reason of this section as a loss from the sale or exchange of an asset which is not a capital asset shall not exceed—

(1) $25,000, or
(2) $50,000, in the case of a husband and wife filing a joint return for such year under section 6013.

(c) Section 1244 Stock Defined—

(1) In General.—For purposes of this section, the term 'section 1244 stock' means common stock in a domestic corporation if—

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan.
(B) at the time such plan was adopted, such corporation was a small business corporation,
(C) at the time such plan was adopted, no portion of a prior offering was outstanding,
(D) such stock was issued by such corporation, pursuant to such plan, for money or other property (other than stock and securities), and
(E) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock is sustained (or if such corporation has not been in existence for 5 taxable years ending before such date, during the period of its taxable years ending before such date, or if such corporation has not been in existence for one taxable year ending before such date, during the period such corporation has been in existence before such date), derived more than 50 percent of its aggregate gross receipts from
Losses on small-business stock: This section provides ordinary loss rather than capital loss treatment on the sale or exchange of small-business stock. This treatment is available only in the case of an individual and only if he is the original holder of the stock.

This provision is designed to encourage the flow of new funds into small business. The encouragement in this case takes the form of reducing the risk of a loss for these new funds. The ordinary loss treatment which the bill accords shareholders in small corporations in effect is already available to proprietors and partners. They report directly the earnings from these business ventures and thus ordinary losses realized by a proprietorship presently constitute ordinary losses to the proprietor or partner. As a result, from the standpoint of risk taking, this

sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this subparagraph only to the extent of gains therefrom); except that this subparagraph shall not apply with respect to any corporation if, for the period referred to, the amount of the deductions allowed by this chapter (other than by sections 172, 242, 243, 244, and 245) exceed the amount of gross income.

Such term does not include stock if issued pursuant to the plan referred to in subparagraph (A) after a subsequent offering of stock has been made by the corporation.

“(2) Small Business Corporation Defined.—For purposes of this section, a corporation shall be treated as a small business corporation if at the time of the adoption of the plan—

(A) the sum of

(i) the aggregate amount which may be offered under the plan plus

(ii) the aggregate amount of money and other property (taken into account in an amount, as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time) received by the corporation after June 30, 1958, for stock, as a contribution to capital, and as paid-in surplus, does not exceed $500,000; and

(B) the sum of—

(i) the aggregate amount which may be offered under the plan, plus

(ii) the equity capital of the corporation (determined on the date of the adoption of the plan),

does not exceed $1,000,000.

For purposes of subparagraph (B), the equity capital of a corporation is the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders). . . .

(3) Relationship To Net Operating Loss Deduction.—For purposes of section 172 (relating to the net operating loss deduction), any amount of loss treated by reason of this section as a loss from the sale or exchange of an asset which is not a capital asset shall be treated as attributable to a trade or business of the taxpayer.

“(4) Individual Defined.—For purposes of this section, the term ‘individual’ does not include a trust or estate.”

See also § 1372 on the election by a small business corporation to be taxed as a partnership.
bill places shareholders in small corporations on a more nearly equal basis with these proprietors and partners.85

We have discussed one of the three basic rules of income tax strategy—to have transactions involving the losses treated as an ordinary business loss, rather than a loss on a capital investment. The consequence of having a loss determined as a capital loss is that such losses can only be offset against capital gains, except for $1,000 per year per stockholder for six years. Here is one place where community property states still have the advantage. The privilege of offsetting the capital losses against capital gains will, in the first place, of course, generally cut the amount of losses that can be taken in half. More important, though, as a practical matter it will generally result in the small businessman not being able to offset or take over $1,000 per year of this loss, because this type of taxpayer is not apt to have any large capital gain against which it can be offset.

We have seen that although a taxpayer is not in a business, but enters into a transaction for profit, he can take an ordinary loss for expenses and a casualty loss on this transaction. A taxpayer must, however, report as a capital loss a loan in connection with such transaction.

I have discussed some of the problems of avoiding what is intended as a loan being classified as a contribution to capital. We have reviewed some of the practical problems of proving that a loss has actually occurred and showing the year in which it occurred. In this review of the law, we have seen the differences between losses on stocks and on loans. Most of this discussion has, of course, been devoted to the various factors involved in taking a business bad debt loss, especially one resulting from a stockholder's advances to a corporation. I hope I have made it clear that the attorney and the accountant owe their client a duty not only of careful tax planning at the time a corporation is organized, but a constant vigil throughout the period of its operation to prepare for the most favorable tax treatment should the corporation fail.

A careful analysis of the Whipple case shows that it has narrowed the business bad debt rule to one which places the enterprising, energetic, imaginative, ambitious small businessman in the same category with the person who has inherited a fortune and retires to manage his investments from a chateau in France.86

The Supreme Court in the Putnam case87 said that the nonbusiness bad debt section 23(k)(4) was passed by the Revenue Act of 1942

86 Higgins v. Commissioner, 312 U.S. 212 (1941), cited by the Supreme Court in the Whipple case.
87 Putnam v. Commissioner, supra note 41.
"to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments."\(^{88}\)

In view of passage of the Small Business Corporation Act in 1958, giving ordinary loss on stocks\(^{89}\) in these corporations to "encourage the flow of new funds into small business," and the Supreme Court's decision in the *Whipple* case, it is clear that there is now a necessity for legislation which will put losses suffered on loans to small businesses on the same footing as losses on stocks.

From 1942 to 1963, we have, therefore, made the complete circle.

\(^{88}\) *Id.* at 92.

\(^{89}\) INT. REV. CODE OF 1954, § 1244.