Taxation - Requirement for Business Bad Debt Deductions

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Although the immediate issue of *Gulbankian* concerned only one area of legal ethics, the case is indicative of problems that occur when courts act in their role as disciplinarian of the legal profession. First, the courts must remain cognizant that attorneys receive guidance for their professional conduct from the American Bar Association, through its published opinions, as well as from the courts themselves. Also, courts that have adopted the Code of Professional Responsibility should explain and supplement it whenever the need and opportunity arise. This technique is preferable to the course of conduct adopted by the West Virginia Supreme Court of Appeals. Although the Code of Professional Responsibility is less skeletal than its predecessor, it is a new body of law with little judicial interpretation of its provisions. The court in *Gulbankian* attempted to establish needed guidelines for the bench and bar. It neglected, however, to define clearly the important concepts of solicitation and conscious influencing. Finally, attorneys can avoid some problems of misapplication of the Code by appropriate preventive action. The attorneys in *Gulbankian* might have prevented the whole question of impropriety, with all its damaging effects on their professional stature, by having their clients manifest in one of several manners their voluntary intentions to have the attorneys serve as attorney for probate or executrix.

*Bert Michael Whorton*

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**Taxation — Requirement for Business Bad Debt Deductions**

Taxpayer owned 44 percent of the stock in a construction corporation that he founded jointly with his son-in-law and in which he held the position of president at a salary of $12,000 per year. His total yearly income from the corporation and other sources amounted to approximately $40,000. Taxpayer claimed $162,000 as a business bad debt deduction on his 1962 income tax return. He had paid this amount as indemnity to a casualty company that fulfilled bid and performance bonds when the construction corporation defaulted on its contracts. The resulting debt of the corporation to taxpayer became worthless when the corporation went into receivership. The Internal

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[[It should be clearly understood that in disciplinary proceedings for disbarment or suspending or annuling the license of an attorney at law the action taken must depend upon the facts and circumstances in each particular case and it is not intended by the decision in this proceeding to establish any uniform or particular type of disciplinary action for any given case.]]
Revenue Code provides that a business bad debt may be deducted from ordinary income; a nonbusiness bad debt must be treated as a short-term capital loss, which is less favorable to the taxpayer.\(^1\) The regulations provide that a business bad debt is one that has a "proximate relation" to the taxpayer's trade or business.\(^2\) Taxpayer maintained that the requirement of "proximate relation" was satisfied if a "significant" motivation for making the indemnity payment was to protect his salaried position as president of the corporation.

The district court, in a jury trial, allowed the deduction based on the "significant" motivation standard.\(^3\) The Court of Appeals for the Fifth Circuit affirmed.\(^4\) The Supreme Court granted certiorari. Held, reversed, judgment n.o.v. for the United States ordered. When a taxpayer seeks to deduct a loss as a business bad debt, the proper test of whether the bad debt has a "proximate relation" to the taxpayer's trade or business is that of "dominant" motivation and mere

\(^1\) INT. REV. CODE of 1954, § 166 provides:
Bad debts.
(a) General rule.—
(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

\(^2\) Treas. Reg. § 1.166-5(b) (1960) provides:
(b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

\(^3\) Generes v. United States, 67-2 U.S. Tax Cas. ¶ 9754 (E.D. La. 1967).
\(^4\) United States v. Generes, 427 F.2d 279 (5th Cir. 1970).
"significant" motivation will not suffice. *United States v. Generes*, 405 U.S. 93 (1972).\(^5\)

The issue presented in *Generes* has been a prolific source of litigation primarily because of the vague wording of the regulations. They provide that for a bad debt loss to be fully deductible from ordinary income as a business bad debt, it must bear a "proximate relation" to "the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless."\(^6\) Specifically, the Court in *Generes* was called upon to decide whether "proximate relation" requires that the taxpayer incurring the bad debt loss have as his "dominant" motivation the desire to protect or further his employment or business, or whether this desire must be simply a "significant" motivation.

Prior to *Generes*, a conflict existed between holdings in the Second and Seventh Circuits. In *Weddle v. Commissioner*,\(^7\) where the taxpayer was both president of a corporation and its principal stockholder, the Second Circuit adopted the "significant" motivation test for determining whether the loss could be deducted as a business bad debt. In referring to the regulations use of the term "proximate" to describe the relation the debt must bear to the taxpayer's business, the court made an analogy to tort law. It reasoned that where there are several causes for a particular harm, any one of them may be found proximate although perhaps less important than other causes.\(^8\) Applying this tort concept of proximate cause to the regulations' use of the term "proximate relation," the Second Circuit concluded that the bad debt loss could be proximately related to the taxpayer's trade or business without having been motivated primarily by business reasons. Hence the proper standard would be one of "significant" rather than "dominant" motivation.\(^9\)

In his concurring opinion in *Weddle*, Judge Lumbard advocated the "dominant" motivation test. He noted that unless the taxpayer's salary is so small as to be valueless, its preservation will be on his mind as he makes the loan, regardless that his investment is of far greater worth. The question of whether a "significant" motivation is present where the taxpayer is both an investor and a salaried em-

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\(^{5}\) Petition for rehearing by *Generes* was denied by the Supreme Court on March 27, 1972. 405 U.S. 1033 (1972).


\(^{7}\) 325 F.2d 849 (2d Cir. 1963).

\(^{8}\) Id. at 851.

\(^{9}\) Id.
ployee would invariably be answered in the affirmative. Stating his belief that there is no accurate basis for determining the relative percentages of business and nonbusiness motivation, Judge Lumbard advocated the "dominant" motivation standard as the only workable test.

In 1969 the Seventh Circuit, following the same reasoning as Judge Lumbard, adopted the "dominant" motivation test in Niblock v. Commissioner. The court cited the Supreme Court's decision in Whipple v. Commissioner for the proposition that the regulations contemplate a meaningful distinction between bad debt losses connected with the taxpayer's business and those concerned with the business of the corporation. Feeling a clear distinction essential, the Seventh Circuit held the "dominant" motivation standard to be "the only test that will inject sufficient certainty into the interpretation of section 166 . . . ." Only the Fifth Circuit specifically decided between the Second and Seventh Circuit tests, and that decision brought about granting of certiorari by the Supreme Court.

In adopting the test of "dominant" motivation in Generes, the Supreme Court provided a clear standard for lower courts to follow and further clarified a confusing area of income tax law. The result was also in line with earlier Supreme Court decisions in Putnam v. Commissioner and Whipple v. Commissioner.

In Putnam, taxpayer organized a corporation, supplied the necessary capital, and proceeded to loan money to the corporation and guarantee various debts. At the time of the guarantee the corporate entity still existed even though it had ceased doing business and had

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10 Id. at 852.
11 Id. The Supreme Court incorporated Judge Lumbard's reasoning into its decision in Generes, 405 U.S. at 104.
12 417 F.2d 1185 (7th Cir. 1969).
14 417 F.2d at 1187.
15 In a case arising within the Fifth Circuit's jurisdiction, after the court of appeals had already adopted the "significant" motivation standard, the Tax Court felt obliged to follow that test although voicing its agreement with the "dominant" motivation standard. Smith v. Commissioner, 55 T.C. 260 (1970). Millsap v. Commissioner, 387 F.2d 420, 422-23 (8th Cir. 1968), and Lundgren v. Commissioner, 376 F.2d 623, 628 (9th Cir. 1967), offer implied support of the "significant" motivation standard. In Stratmore v. United States, 420 F.2d 461, 463 (3d Cir. 1970), the court held the taxpayer had failed to produce sufficient evidence to establish even a "significant" business motivation and, therefore, it was unnecessary to decide between the two standards.
16 United States v. Generes, 427 F.2d 279 (5th Cir. 1970).
17 352 U.S. 82 (1956).
disposed of its assets. The Court was faced with the issue of whether taxpayer's loss was fully deductible as a loss "incurred in any trans-
action entered into for profit, though not connected with [his] trade or business" or whether it was a bad debt and, hence, deductible only as a short-term capital loss. It determined that a loss due to the inability of a guarantor to recover from the debtor is by its nature a bad debt. The Court further determined that such a bad debt was not connected with the taxpayer's business and could be deducted only as a nonbusiness debt within the meaning of 1939 Code section 23(k)(4) [predecessor of 1954 Code section 166(d)(1)(b)]. Here, however, the taxpayer was not an employee but a mere investor.

In Whipple the Court sought to define the difficult concept of "proximate relation." The holding pointed out that the 1942 amend-
ment to section 23(k) of the 1939 Code [predecessor of 1954 Code section 166(d)] was intended to allow full deduction of a bad debt only where the debt was proximately connected with an enterprise recognized as a trade or business by the income tax laws. The Court noted that this concept does not apply to all income-producing activi-
ties, and denied the taxpayer's contention that investing in a corpo-
ration and performing certain managerial services constituted a trade or business.

A problem has arisen in cases such as Generes where the stock-
holder is also an employee of the corporation. The issue is whether

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19 INT. REV. CODE of 1939, ch. 1, § 23(e)(2), 53 Stat. 13 (now INT. REV. CODE of 1954, § 165(c)(2)).
21 352 U.S. at 85.
22 Id. at 92-93.
23 Id. at 91. The 1942 amendment was intended to narrow the range of what was deductible as a business bad debt. It was an integral part of the Revenue Act of 1942, a comprehensive tax program designed to raise revenue necessary to conduct World War II. By this amendment Congress narrowed section 23(k) to exclude full deduction of bad debts arising from the same source.
24 In Whipple, the taxpayer was controlling stockholder and manager of several corporations. He sold certain equipment owned individually by him, leased a plant on land owned individually by him, and made a loan to one of the corporations. The Court held that the debts arising from these transactions were not business bad debts because they did not result from a trade or business of the taxpayer. 373 U.S. at 201.
25 This followed long-established decisions that set forth the principle that the identities of corporations and their shareholders are separate and the business of one is not the business of the other. See Higgins v. Commissioner, 312 U.S. 212 (1941); Deputy v. Dupont, 308 U.S. 488 (1940); Burnet v. Clark, 287 U.S. 410 (1932); Dalton v. Bowers, 287 U.S. 404 (1932).
26 There were 179 such cases pending at the appellate conference level of
the loan from which the bad debt arose was made to protect the taxpayer's investment, his salaried position, or both. And, if both, how may the courts determine which takes precedence?27

If, as the Supreme Court decided in Whipple, a loss arising out of an investment is not, standing alone, a business bad debt loss, then the Court in Generes reasoned that it would be strange to allow the deduction where the taxpayer is an employee of the corporation, but is primarily motivated by his investment interests.28 The Court felt that "dominant" is a more precise term than "significant" — more easily applied and more in the spirit, if not the letter, of the regulation.29

Obviously the decision in Generes creates a difficult situation for a particular class of taxpayers. It is now virtually impossible for an employee-investor whose salary from the corporation is of less value than his investment to claim a business bad debt deduction for a loan or indemnification that becomes worthless. Therefore, most taxpayers who lend money to a corporation in which they hold both stock and a salaried position could lose the value of the loan if the corporation fails and also suffer serious tax consequences. In short, the decision in Generes appears to have largely foreclosed the avenue of full deductibility from ordinary income to taxpayers who fall within this dual classification.

There appears no compelling reason other than consistency for the Supreme Court's decision in Generes. Had the Court chosen to construe the language of the regulations strictly, it is difficult to escape the conclusion that the "significant" motivation standard would have been adopted. The use of the word "proximate" originated in tort law, so it might reasonably be assumed that analogies to tort law were considered when the regulations were drafted. Since the accepted

the Internal Revenue Service at the time the petition for certiorari was filed in Generes. Brief for the Petitioner at 14, United States v. Generes, 405 U.S. 93 (1972).

27 The Code does not provide for a division of bad debt losses into portions related to the employment of the taxpayer and portions related to the investment. Although both business and nonbusiness motivations are present, the debt must be deducted entirely as a business bad debt or entirely as a nonbusiness bad debt. Int. Rev. Code of 1954, § 166(d).

28 405 U.S. at 104.

29 Id. at 104-05. Implied in the Court's decision in Generes is the idea that the "significant" motivation standard would almost invariably result in a decision for the taxpayer, even where little business motivation is present. Strangely enough, in Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963), which established the "significant" motivation standard, the decision went against the taxpayer.
meaning of "proximate cause" does not exclude substantial but non-dominant causes, a strict interpretation of the regulations might reasonably lead one to arrive at the "significant" motivation test as that intended by the draftsmen.

The Court, however, has opted for a decision consistent with its own earlier holdings. The decision is justifiable since "dominant" motivation is a more precise test. Perhaps the major importance of the decision in Generes is not that the Court adopted one test over the other, but that it did adopt a test by which similar cases can be decided consistently by lower courts in the future.

Joseph S. Beeson

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U.C.C. — Statute of Limitations — Conflicts Between Personal Injury and Sales Contract Statutes of Limitations

In October, 1966, Roy Lee Heavner purchased a trailer and eight new Uniroyal truck tires. Mr. Heavner was operating this vehicle in April of the following year when an accident occurred resulting in damage to the trailer and severe injuries to himself. In September, 1970, Heavner brought an action against Uniroyal, the tire manufacturer, and Pullman, the seller of the trailer, asserting that both were liable for breach of express and implied warranties. Uniroyal and Pullman moved to have the personal injury action dismissed on the grounds it was barred by the two year New Jersey statute of limitations governing personal injury actions. Heavner contended that he

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1 Heavner also sought relief on the grounds of strict liability in tort, strict liability for misrepresentation, and negligence.

2 N.J. STAT. ANN. § 2A:14-2 (1952) provides:

"Every action at law for an injury to the person caused by the wrongful act, neglect or default of any person within this state shall be commenced within 2 years next after the cause of any such action shall have accrued." This is similar to W. VA. CODE ch. 55, art. 2, § 12 (Michie, 1966), which provides a two year limitation on the commencement of actions to recover for personal injury but does not require the injury to be the result of the wrongful act, default, or neglect of another.