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Income Tax--Deductions--Loans by Employee to Corporation Deductible as Business Bad Debts

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Taxpayer, a corporate employee, was required to advance loans to the corporation as a requisite for holding his job. These loans subsequently became worthless, and the taxpayer deducted the amount as a business bad debt. The Tax Court disallowed this deduction on the grounds that it was a nonbusiness debt. *Held,* reversed. Rendering services for pay is a trade or business within the meaning of INT. REV. CODE OF 1954, § 166 (d) (2) (A). Loans made in furtherance thereof are deductible as business bad debts when they become worthless. *Trent v. Commissioner,* 291 F.2d 669 (2d Cir. 1961).

The dilemma involved in the determination of what constitutes a "trade or business" has provided the courts with a prolonged flow of litigation. The term appears repeatedly throughout the Internal Revenue Code of 1954, but the bulk of litigation stems from the interpretation of §§ 162 (a), 166 (d) (2) (A), and 172 (d). If an expense is an ordinary and necessary one incurred in carrying on any trade or business, it is fully deductible under § 162 (a). A nonbusiness debt is only partially deductible. INT. REV. CODE OF 1954, §§ 166 (d) and 172 (d). The importance of having a worthless debt classifed under § 162 (a) is thus readily apparent.

Earlier litigation has concerned the employee - investor situations in which the courts were called upon to decide whether investments by corporate officers could be considered a "trade or business" within the scope of the predecessor of § 172. In *Dalton v. Bowers,* 287 U.S. 404 (1932), the taxpayer was an inventor, and the loss he sought to carry over under the predecessor of § 172 resulted from the worthlessness of the stock of one of several companies which he controlled. The Court disallowed this deduction, stating that the taxpayer's trade or business was that of an inventor and the amount expended for the stock was an investment. See also *Burnet v. Clark,* 287 U.S. 410 (1932). The *Dalton* and *Clark* decisions were followed in *McGinn v. Commissioner,* 76 F.2d 680 (9th Cir. 1935), wherein the court ruled that losses incurred in following a trade or business of being a corporate officer did not result from the operation of a trade or business. This ruling does not logically follow from the *Dalton* and *Clark* cases which did not decide this issue, but rather decided that advances by an employee to a corporation to protect his investment were not attributable to a trade or business.

Previous to *Dalton v. Bowers, supra,* and *Burnet v. Clark, supra,* it had been held that where a taxpayer has three businesses and suffers a loss in one, the other two are not considered a trade or business for the purpose of reducing the net operating loss under the predecessor of § 172. *Hughes v. Commissioner,* 38 F.2d 755 (10th Cir. 1930). The ruling in this case and also that in *McGinn v. Commissioner, supra,* were held to be erroneous in *Folker v. Johnson,* 230 F.2d 906 (2d Cir. 1956). In this case the taxpayer had nonbusiness deductions, and asserted that his income resulting from being a corporate officer and employee was not income from a trade or business. The court held that the taxpayer was engaged in the trade or business of rendering services for pay. The same result was also reached in *Batzell v. Commissioner,* 266 F.2d 371 (4th Cir. 1959); *Pierce v. Commissioner,* 254 F.2d 885 (9th Cir. 1958); *Roberts v. Commissioner,* 258 F.2d 634 (5th Cir. 1958); *Overly v. Commissioner,* 243 F.2d 576 (3d Cir. 1957). The rejection of *Hughes v. Commissioner, supra,* seems justified since that case rested on a finding that the legislative intent behind the relevant statute was solely to protect industries against postwar deflation of inventory values. Comment, 70 HARV. L. REV. 733 (1957).

The decisions of the employee-investor cases have lost much of their effect due to the enactment of the 1954 Code which allows all ordinary and necessary expenses related to property held for the production of income to be deducted. INT. REV. CODE OF 1954, § 212. However, the problem is still paramount in situations where the taxpayer possesses no income-producing property, but has expenses related to his trade or business of being a salaried employee as in the principal case.

The 1954 Code provides for specific expenses which may be deducted from gross income if such expenses are attributable to a trade or business other than rendering services by the taxpayer as an employee. INT. REV. CODE OF 1954, § 62 (1). This implies that the performance of services by the taxpayer as an employee is a trade or business for other purposes. This interpretation has been applied to the term "trade or business" in § 172. See *Folker v. Johnson,* 230 F.2d 906 (2d Cir. 1956); *Anders Lagreide,* 23 T.C. 508 (1954); *Hill v. Commissioner,* 181 F.2d 906 (4th

Cir. 1950). Where the purpose of the two statutory provisions is similar, a consistent interpretation is desirable. The net operating loss defined in § 172 is utilized in the statutory scheme by taking a deduction as provided in § 166. *Folker v. Johnson, supra.* However, the various circuits have not placed a consistent interpretation upon the term "trade or business" even within this one section of the Code. Some circuits have allowed a corporate officer to deduct ordinary and necessary expenses incurred as a direct result of being such an employee. See *Hochschild v. Commissioner,* 181 F.2d 817 (2d Cir. 1947), (expenses of corporate officer in defending suit arising out of his duties); *Schmidlapp v. Commissioner,* 96 F.2d 680 (2d Cir. 1938), (unreimbursed entertainment expenses); *Commissioner v. Peoples-Pittsburgh Trust Co.,* 60 F.2d 187 (3d Cir. 1932), (legal expenses of board chairman in defending against charges of unlawful filing of tax returns). In all of the above situations the taxpayer-officer was required to make expenditures by his corporate employer. The principal case appears to fall within this same pattern. The taxpayer did not make the advances to the corporation to protect his investment, as was conceded by the Commissioner in the Tax Court. He likewise was not engaged in other trades or businesses, which differentiates this case from the earlier employee-investor cases.

The distinction about which the issue revolves appears to be whether such loans or expenses were required by the corporate employer as a necessary element of the taxpayer's employment. This distinction was pointed out in *Noland v. Commissioner,* 269 F.2d 108 (4th Cir. 1959). The court held that if an employee voluntarily pays or guarantees the corporation's obligations, his expenses may not be deducted on his personal return. The court went on to say that there was not sufficient proof to support the taxpayer's contention that the expenses he incurred were required by his employer. This ruling strongly implies that where there is adequate proof of the expenses being required of the taxpayer by the corporation, they would be deductible under § 162 (a).

Diametrically opposed to this position is the holding in *Wheeler v. Commissioner,* 241 F.2d 883 (2d Cir. 1957). The court ruled that the only instance where a shareholder or officer may deduct debts of his corporation is where his business can be considered to be the "promoting and financing of business enterprises." This was promulgated upon the decision in *Henry E. Sage,* 15 T.C. 299

(1950), which held that a corporate officer's expenses are deductible if his business is promoting and investing in various corporations. However, the Tax Court did not say that this was the only instance in which such expenses or debts were deductible. The language in *Wheeler* is strong and direct, but was discounted by the court in the principal case as being too broad. The *Wheeler* case is supported by dictum in *Commissioner v. Smith,* 203 F.2d 310 (2d Cir. 1953).

The Tax Court in the principal case below relied upon *Rollins v. Commissioner,* 276 F.2d 368 (4th Cir. 1960). The court stated that activities of an individual as a stockholder, officer, and director of a corporation in conducting the business of the corporation do not amount to the carrying on of a personal trade or business by the taxpayer. The taxpayer was a lawyer, and this was merely an investment which could not be classified as his trade or business. This employee-investor decision is not controlling upon the facts in the principal case.

The holding that an employee who is required to make advances to his employer as a requisite to his employment may deduct them when they become worthless is equitable, and reasonably interprets the legislative intent behind §§ 162 (a) and 166 (d). A sole proprietor may deduct bad debts arising from his trade or business, and it is unreasonable to assume that Congress would penalize a taxpayer who incurred like expenses because he is not fortunate enough to have his own business. The factual situation which gave rise to this case is a rare one, but it appears that cases arising under similar facts should follow this ruling.

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Income Tax—Embezzled Funds Represent Taxable Income

P embezzled 738,000 dollars during the years 1951-1954 and failed to report these amounts as income. Despite a prior Supreme Court ruling which held that embezzled funds are not taxable, *P* was convicted of willful evasion of the federal income tax. The Supreme Court granted certiorari. *Held,* affirmed. Embezzled funds are included as income of the embezzler and subject to federal income tax. *P's* conviction reversed on other grounds. *James v. United States,* 81 S.Ct. 1052 (1961).