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Investment Motive Precludes Ordinary Loss Treatment

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In a recent Tax Court decision the IRS won the case but may have lost the war. The case departed from prior decisions by recognizing a possible dual purpose in a business investment. Yet by finding that any substantial investment motive will preclude ordinary loss treatment under the Corn Products *doctrine, the court may have created a boon to taxpayers in similar gain situations.*

Petitioner corporation, a raw wool processor and seller, organized a subsidiary[1] to manufacture woolen cloth. Petitioner's primary motive for creating the subsidiary was to have a "captive" customer for its processed wool.[2] However, the petitioner also expected that the subsidiary would return a profit.[3] The subsidiary was operated for 9 years, and suffered a loss in all but 2 of those years.[4] At the end of this period the subsidiary was liquidated, leaving no assets after all its debts were paid. Petitioner took an ordinary loss deduction on the stock. The Commissioner of Internal Revenue determined a deficiency in petitioner's federal income tax, contending that the losses on the stock should be treated as capital rather than ordinary losses. On petition, the United States Tax Court *held:* The existence of a substantial investment motive precludes the application of the doctrine[5] of *Corn Products Refining Co. v.*

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1. Petitioner owned 72 percent of the stock of the subsidiary.

2. The court found that the wool industry had generally encountered economic difficulties during the 1950's and 1960's. Specifically, between 1956 and 1961, the petitioner's sales had dropped from $9.5 million to $3 million. W.W. Windle, 65 T.C. No. 62, P-H TAX CT. REP. & MEM. DEC. ¶ 65.62 at 391 n.1 (Jan. 7, 1976). The petitioner decided to organize the subsidiary when one of its better customers went out of business. The petitioner bought the equipment of the prior customer for use by the subsidiary. *Id.* at 392.

3. Prior to purchasing the stock in the subsidiary petitioner investigated the profitability of a wool mill in that area. Studies were conducted and forecasts made on expected sales, material requirements, expenses, and profit for the next 2 years. The results of these studies indicated that the subsidiary would make a profit. *Id.*

4. Petitioner continued to operate the subsidiary even after it became obvious that it would never return a profit because the petitioner wanted to preserve its captive customer. The petitioner fulfilled about 99 percent of the subsidiary's material requirements and knew that as long as the subsidiary continued to operate petitioner would be able to make profitable sales to it, even if the subsidiary was not profitable. The court found that the petitioner received profits of between 8.4 percent and 20.7 percent on all its sales to the subsidiary, even in those years when the subsidiary was losing money. *Id.* at 393.

5. *See* text accompanying notes 12-13, *infra*. The doctrine basically holds that gain or loss from the sale of property traditionally considered a capital asset will be treated as

Commissioner,[6] and the stock loss must be treated as capital loss rather than ordinary loss. *W. W. Windle*, 65 T.C. No. 62, P-H TAX CT. REP. & MEM. DEC. ¶ 65.62 (Jan. 7, 1976).

Section 1221 of the Internal Revenue Code[7] defines "capital asset" as all property held by the taxpayer except those assets specifically excluded under its provisions.[8] The classification of property as a "capital asset" is important because, with one important exception,[9] a taxpayer will not realize a capital gain or loss unless the asset sold or exchanged falls within the classification. Since capital gains and losses are treated differently from ordinary gains and losses,[10] it is important in many situations to ascertain whether the asset sold or exchanged is a capital asset. If the sale or exchange results in a gain, the taxpayer will try to classify it as a capital gain,

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ordinary gain or loss if the property was purchased in connection with the taxpayer's business.

6. 350 U.S. 46 (1955).

7. Unless otherwise specified, all references to the Internal Revenue Code are to the 1954 code.

8. The types of property excluded are:

a. stock in or other inventory property;

b. property held primarily for sale to customers in the ordinary course of business;

c. depreciable property used in trade or business;

d. real property used in trade or business;

e. accounts and notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade, inventory, or property held for sale to customers;

f. copyrights, literary, musical, or artistic compositions, letters or memorandums, or similar property held by:

i. a taxpayer whose personal efforts created such property or

ii. a taxpayer for whom such property was prepared or produced or

iii. a taxpayer whose basis in the property for purposes of determining gain from sale or exchange, is determined, in whole or in part, by reference to the basis of the property in the hands of one of the first two taxpayers mentioned in a and b;

g. federal or state obligations issued on a discount basis and payable without interest, at a fixed maturity date not exceeding 1 year from the date of issue. INT. REV. CODE OF 1954, § 1221.

9. Under section 1231 of the Internal Revenue Code, gains or losses arising from:

a. the sale, exchange, or involuntary conversion of real property and depreciable personal property used in a trade or business and held for more than 6 months; and

b. the involuntary conversion of capital assets whether personal or held for income producing purposes held for more than 6 months.

These section 1231 assets will be grouped together. If the grouping produces a net gain, each gain or loss is classified as a capital gain or loss. If the grouping produces a net loss, each gain or loss is ordinary income or loss.

10. *See* INT. REV. CODE OF 1954, §§ 1201-02, 1211-12.

while if a loss results, it is to the taxpayer's advantage to seek an ordinary loss.

Corporate stock has traditionally been held to fall within the ambit of the definition of a "capital asset" since stock is not among the specific exclusions of section 1221.[11] Therefore, any sale of stock (other than by a dealer)[12] will usually result in either a capital gain or loss. However, in addition to the specific exclusions to the definition of "capital asset" imposed by Congress, the courts have added certain limitations. These limitations have resulted from an effort on the courts' part to concentrate on congressional intent. Instead of providing a liberal interpretation to the definition of "capital asset," they have tried to determine whether the property in question was the type of property Congress sought to classify as a "capital asset."

One of the more significant limitations on the scope of "capital asset" created by the courts is that a gain or loss arising from a sale or exchange which is closely related to the taxpayer's business or trade should not be treated as a capital gain or loss, regardless of whether the property in question falls within one of the statutory exceptions.[13] The leading case establishing this principle is *Corn Products Refining Co. v. Commissioner*.[14] The taxpayer in *Corn Products* was a manufacturer of starch, syrup, and other corn derived products. Due to a drought, the price of corn rose to a level at which the taxpayer was unable to buy corn at a price which would allow it to compete with cane and beet products. In order to circumvent this dilemma the taxpayer bought corn futures. Thus, when delivery dates approached, Corn Products could take the corn it needed and sell its excess futures. The taxpayer made a gain on the sale of the futures and reported it as if the futures were capital assets. In affirming both the Tax Court and the Second Circuit, the Supreme Court held that profits arising from the sale of the corn futures were ordinary income and not capital gain. The Court recognized that the corn futures did not literally come within any of the

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11. *See* Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion*, 65 YALE L.J. 401, 406 n.28 (1956).

12. A dealer in securities is one who is engaged in the purchase and resale of securities for profit. Because the securities are held by him for sale to his customers, the profit or loss which results is ordinary income. INT. REV. CODE OF 1954, § 1221(1); *see* Frank v. Commissioner, 321 F.2d 143 (8th Cir. 1963).

13. E. COLSON, CAPITAL GAINS AND LOSSES 49 (1975).

14. 350 U.S. 46 (1955).

specific statutory exceptions of the definition of capital asset in section 117(a)[15] of the Internal Revenue Code. The Court concluded, however, that ordinary asset treatment was warranted since Congress intended profits and losses arising from the ordinary operation of a business to be treated as ordinary income or loss, not capital gain or loss.

> Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress . . . . Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.[16]

Therefore, although corporate stock had traditionally been considered a capital asset, with the advent of the *Corn Products* doctrine, ordinary gain and loss treatment was available. Taxpayers were able to deduct as ordinary losses, sales of corporate stock if the stock was acquired in connection with the taxpayer's trade or business.[17] Subsequent to *Corn Products*, a myriad of cases arose in which the taxpayer incurred losses on the sale of stock and tried to make full use of the doctrine. When any connection existed between the stock and the taxpayer's business an ordinary loss was sought.[18]

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15. Section 117(a) is the 1939 Code predecessor of section 1221.

16. 350 U.S. at 51-52.

17. Although the *Corn Products* doctrine was first established in a gain situation, it can readily be applied to a transaction in which a loss is involved. In Commissioner v. Bagley & Sewal Co., 221 F.2d 944 (2d Cir. 1955), the Second Circuit held, prior to *Corn Products*, that ordinary loss treatment could be afforded a loss incurred on the sale of securities purchased as a business requirement. The taxpayer had entered into a contract through another corporation which required him to perform services for the government of Finland. Finland required the taxpayer to post government bonds as security for his performance. After the contract had been completed, the taxpayer sold the bonds at a loss. The court, in allowing ordinary loss treatment, likened the loss on the bonds to the cost of a surety bond which would have been fully deductible. *Id.* at 946. Together with *Corn Products*, *Bagley* forms the basis for the "*Corn Products* doctrine."

18. For cases where an ordinary loss was upheld *see, e.g.*, John F. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964) (restauranteur purchased stock in a corporation to acquire the lease to land upon which he wished to operate a restaurant); Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963) (taxpayer purchased stock in a corporation in order to maintain the exclusive right to sell goods to it); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (publisher purchased stock in a paper mill to insure a supply of newsprint); Ancel Greene & Co., 38 T.C. 125 (1962) (taxpayer purchased stock of a mortgage

In *Windle* the court found that there was dual purpose on the part of the taxpayer when the stock was purchased. It ascertained a legitimate business-related purpose for acquiring the stock. However, the court also determined that there was a nonbusiness investment purpose for the acquisition, which would require treatment of the stock as a capital asset were it the sole motivation for the acquisition. Traditionally, the courts have attempted to circumvent this dual purpose problem, preferring to force the fact situation to fit within a singular "business purpose" test,[19] while ignoring the realistic alternative that a dual purpose probably exists. Additionally, the courts have applied any of four different formulas to the fact pattern before them in order to determine whether the purpose behind the purchase of the property falls within the singular "business

association as a prerequisite to the sale of a mortgage to the association); Mississquoi Corp., 37 T.C. 791 (1962) (a paperboard manufacturer purchased debentures of a paper mill in order to insure a supply of raw materials); Electrical Fittings Corp., 33 T.C. 1026 (1960) (electrical parts manufacturer purchased stock in a foundry to insure a supply of needed castings). *Contra*, Duffy v. Lethert, 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963) (paper producer purchased stock in a publishing company in order to guarantee a buyer. The loss on the stock sale was held not to be ordinary loss).

19. *See* Steadman v. Commissioner, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970). In *Steadman*, the taxpayer had been retained as a corporation's attorney. Subsequent to the formation of the corporation, a need for additional funds arose and one of the corporation's creditors offered to purchase the stock. This stock purchase would have given the creditor control over the corporation and as a result his law firm would assume the corporation's legal matters. In order to prevent usurpation of his position, the taxpayer purchased a large number of the shares himself. Despite the influx of additional capital, the corporation was unable to solve its financial difficulties and went bankrupt. Both the Tax Court and Sixth Circuit allowed ordinary loss treatment, finding a purely business motive behind the purchase. Charles W. Steadman, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970). One Tax Court judge dissented, having difficulty with finding that Steadman lacked any investment purpose. 50 T.C. at 383-84 (dissenting opinion).

In *Waterman* the taxpayer was a seller of yarn who had purchased stock in a wool mill which supplied him with his inventory. The purpose behind the stock purchase was to enable the taxpayer to become the exclusive sales agent for the corporation. The agency proved to be a failure and upon its termination the taxpayer sold the stock at a loss. The court found that an ordinary loss deduction was justified based on its finding of a business rather than an investment motive behind the acquisition. 419 F.2d at 854-55. The dissent doubted that the facts supported this conclusion, citing the desire of the corporation that its exclusive agent be an investor, as an indication of the taxpayer's motivation. 419 F.2d at 861 (dissenting opinion).

These cases are examples of the potential difficulties and possible distortions which flow from a strict "business purpose or nonbusiness purpose" category approach. Although the decisions appear to reach the correct result, the facts of these cases strongly infer at least some investment purpose existed in the purchase.

purpose" test.

The fact that various courts have applied four different formulas[20] in order to determine whether an apparent capital asset was acquired with a sufficient "business purpose," and should therefore be given ordinary gain or loss treatment, has generated substantial unpredictability. These formulas are: (1) the substitute for deductible expense formula; (2) the underlying asset formula; (3) the benefit to business formula; and (4) the integral part of the corporate business formula.

The first and most restrictive of these formulas is also the one adopted by the Internal Revenue Service.[21] An asset will produce ordinary gain or loss only where the taxpayer's motive for the acquisition of the asset is one which would qualify the cost of the item as a deductible expense. The most typical example of this situation has been where the taxpayer acquired stock in a corporation in order to assure himself a supply of a product needed for his trade or business.[22] The courts view the stock acquisition as necessary if the taxpayer is to continue generating ordinary income in his business.

The Internal Revenue Service adopted this position in Revenue Ruling 58-40:[23]

> Stocks, bonds or other securities, which are purchased pursuant to a contract performed in the regular course of business or are purchased solely for the purpose of obtaining inventory, under certain circumstances, do not constitute capital assets. Gain or loss resulting from the sale of such stocks, bonds or other securities constitutes ordinary gain or loss in some cases and, in other cases, is to be reflected in the cost of the goods acquired for the year in which the gain is realized or the loss sustained.

20. For a more complete discussion of these formulas see Javaras, *Corporate Capital Gains and Losses—The* Corn Products *Doctrine*, 52 TAXES 770, 772-92 (1974).

21. *See* note 23 *infra*.

22. *See, e.g.*, Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958) (department store purchased stock in a dress manufacturer in order to retain the dress line); F.S. Services, Inc. v. United States, 413 F.2d 548 (Ct. Cl. 1969) (marketer of petroleum products acquired stock in a petroleum refinery in order to acquire supplies); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (publisher purchased stock in a paper mill to insure a supply of newsprint); Western Wine & Liquor Co., 18 T.C. 1090 (1952) (wholesale liquor dealer bought stock in a distilling corporation in order to acquire inventory); Tulane Hardwood Lumber Co., 24 T.C. 1146 (1946) (plywood wholesaler purchased debentures of newly formed plywood manufacturer to insure inventory). *Contra*, Gulftex Drug Co., 29 T.C. 118 (1957) (taxpayer bought stock in a distilling corporation in order to acquire inventory, but continued to hold stock for 8 years after the whiskey inventory was secured).

23. 1958-1 CUM. BULL. 275.

A second formula that has been used by the courts, and one which is somewhat less restrictive than the "substitute for a deductible expense" formula, is to look at the "underlying asset." Under this formula, an asset will not be treated as capital where the taxpayer's purpose in acquiring the property was really to acquire an *underlying asset* which would clearly produce ordinary income or loss upon *its* sale.

The principal case representing this position is *John F. Grier Co. v. United States.*[24] In *Grier*, the taxpayer corporation, which operated restaurants, had negotiated for the purchase of a particular club. Subsequently, the taxpayer learned that the premises were in the possession of a corporate lessee, and the lessor would not consent to an assignment of the lease. Thus, rather than an assets acquisition, as originally contemplated, the taxpayer purchased 100 percent of the stock of the lessee corporation.

In upholding the taxpayer's claim for ordinary loss treatment when the stock was sold 3 years later, the Seventh Circuit found that:

> Corporate stock is not invariably classified as a capital asset. To ascertain whether stock is bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business, all surrounding circumstances must be considered. The substance, as distinguished from the form of the taxpayer's actions determines whether the sale of the stock results in ordinary gain or loss . . . .
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> The . . . stock had value to someone who wished to operate the Club. [The taxpayer] bought the stock and retained it only to secure the assets as an incident to the conduct of its restaurant business and not for investment.[25]

Grier thus supports the proposition that stock will be considered an ordinary asset when the stock is acquired by a taxpayer to gain actual use and control of the stock's underlying assets and those underlying assets are of a kind which would receive ordinary gain or loss treatment upon their disposition, given the nature of the taxpayer's business and the nature of the underlying assets.

The third formula, adopted by some courts, is to find that an asset traditionally considered a capital asset will receive ordinary

24. 328 F.2d 163 (7th Cir. 1964).
25. *Id.* at 165.

gain or loss treatment where the purpose for its acquisition was to "benefit the taxpayer's business." The typical situation to which this formula is applied is the "captive market" stock purchase,[26] as exemplified by the facts of *Windle*. In this type of situation, the taxpayer purchases stock in another company to create what could be termed a requirements contract for the taxpayer's product. Thus, since the taxpayer is trying to benefit his *business*, the courts using this approach are looking to the business nature of the source of the gain or loss.

The last and most liberal formula is to find an ordinary gain or loss on a stock sale of a subsidiary where a corporate taxpayer can prove that the subsidiary is an integral part of the corporate business even though there is no direct benefit to the taxpayer corporation.[27] The rationale is that a corporate parent should be able to

26. *See, e.g.*, Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963) (taxpayer purchased stock in corporation in order to maintain the exclusive right to sell goods to it); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970) (see discussion of case, note 19 *supra*); Weather-Seal, Inc., 22 CCH Tax Ct. Mem. 471 (1963) (manufacturer of storm doors incorporated its regional distributors to give stock as an incentive to the branch manager. It repurchased stock of unsuccessful outlets at a loss).

27. *See* Schlumberger Technology Corp. v. United States, 443 F.2d 1115 (5th Cir. 1971). In *Schlumberger* the taxpayer was a manufacturer of electronic mineral exploration and measuring equipment. It purchased two companies to aid in its business, a computer manufacturer and a military electronic systems developer. The Fifth Circuit found an ordinary loss on the sale of the stock by finding that the acquisitions were designed to further the taxpayer's business. Even though the businesses of the subsidiaries were not related to the taxpayer's primary business, they found a business purpose in the desire to improve volume.

In addition, the court dismissed two of the IRS's traditional arguments against ordinary loss treatment. The IRS had argued that ordinary loss treatment should be limited to cases where the transaction was a "temporary business expedient." *Id.* at 1121. In addition, the court rejected the IRS's contention that ordinary loss treatment should be reserved for a acquisition made to protect an existing business rather than to expand the business. *Id.*

It would appear that the *Schlumberger* court believed that the *Corn Products* doctrine was meant to cover any acquisition made for a business purpose. *Accord*, Midland Distributors, Inc. v. United States, 481 F.2d 730 (5th Cir. 1973) (ordinary loss treatment denied on liquidation of subsidiaries because there was no business need for their acquisition); Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971) (In *Dearborn* a furniture manufacturer and distributor bought stock in a lumber manufacturer in order to guarantee a supply. The court denied ordinary loss treatment on the sale of stock based on a finding that since only 10 percent of the lumber sales went to the taxpayer, there was a substantial investment motive not related to the taxpayer's business); Chemplast, Inc. 60 T.C. 623 (1973), *aff'd*, 35 Am. Fed. Tax R.2d 75-461 (3d Cir. 1974) (ordinary loss deduction allowed taxpayer corporation for unrecovered advances to its subsidiary formed to acquire its services since advances were integrally related to taxpayer's business); Pittsburgh Reflector Co., 27 CCH Tax Ct. Mem. 377 (1968) (ordinary loss allowed where taxpayer, a lighting fixture manufacturer, sold stock it had acquired in a Canadian corporation which assembled and distributed the taxpayer's products).

obtain an ordinary loss treatment on the disposition of stock of a subsidiary if it can be established that the subsidiary was acquired or created in order to conduct a portion of the parent's business even though the parent will not receive any direct benefit.

An examination of these four formulas indicates the difficulty facing the courts and taxpayers in establishing the proper status to be given the property in question. These four approaches demonstrate that the courts have uniformly taken the position that it must be first ascertained whether the asset was acquired primarily for a "business purpose," in which case it would be treated as an ordinary asset, or for an investment purpose, which would result in capital gains or loss treatment. The confusion has resulted from the use of different formulas by different courts to determine whether a business or investment purpose exists. *Windle* is significant in that, unlike these varied decisions, it recognizes the possibility of a *dual* purpose and obviates the necessity for various formulas to unnaturally force a fact pattern within a rigid and singular business purpose test.

In contrast to the judicial confusion found in the stock purchase area, it is interesting to note the position taken by the courts when dealing with bad debt deductions. Section 166 of the Internal Revenue Code allows an ordinary loss deduction for bad debts incurred in the taxpayer's trade or business.[28] The situation is analogous to

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28. Section 166 provides in part:

(a) General Rule—

(1) Wholly worthless debts—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) Nonbusiness Debts—

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

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

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined—For purpose of paragraph (1), the term "nonbusiness debt" means a debt other than (A) a debt created or acquired (as the case

the stock purchase problem, in that the court must determine whether the loan was made for a business purpose or an investment purpose.

United States v. Generes[29] is the leading case which specifically addresses itself to the test for allowing a bad debt deduction. In *Generes* the taxpayer indemnified a surety of a corporation in which he was a 44 percent stockholder and employee. The corporation went into receivership and Generes took the loss as an ordinary loss. Generes claimed that his sole motive for signing the indemnification agreement was to protect his job. In rejecting this claim, the Court adopted a test which required a threshold determination that the business purpose be the "dominant and primary motivation" behind the loan before it can be afforded ordinary loss treatment. The Court concluded that Generes lacked such motivation and his real purpose was to protect his investment in the corporation.

The similarities between the stock purchase and the bad debt situations raise a forceful argument for the application of the same test to both. In each situation, the taxpayer channels money into a company in which he has both a business purpose and an investment interest. In each, the determining factor is the weight given by the court to the business purpose vis-a-vis the investment interest underlying the transaction. The ultimate outcome of both transactions is the same in that the taxpayer provides funds for the use of the corporation, which in turn, increases his financial interest in that company. Based on these similarities, it is submitted that to apply different tests (i.e., the "business purpose" test which is concerned only with the finding of a business purpose as opposed to the "primary motivation" test which recognizes the possibility of more than one purpose) to a transaction depending on whether it takes the form of a stock purchase or a loan is not sound.

In *Windle* the court departed from the "business purpose" test which had been applied in prior cases. Rather than trying to ascertain the presence or absence of a business purpose, the court took a more realistic position and recognized the presence of a dual motive.

> On the basis of the entire record we have found that petitioner's predominant motive in acquiring [the subsidiary] stock was to

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.

29. 405 U.S. 93 (1972).

acquire a captive customer, and that its secondary reason was to make an investment in a business it expected to succeed and grow.[30]

The finding of a secondary investment motive was based on the fact that the taxpayer first had undertaken study to determine the projected profits of the subsidiary prior to the acquisition. The court acknowledged that the investment could only have been a secondary motivation since the taxpayer held on to the subsidiary for a period of 9 years in which the subsidiary lost money in all but 2.

The Internal Revenue Service argued that if the taxpayer had any investment motive at all, even a secondary one, that motive would taint the business nature of the transaction and thus the property must be deemed a capital asset.[31]

In examining the prior law, the tax court easily distinguished two of the three cases relied on by the IRS — *Midland Distributors, Inc. v. United States*[32] and *Duffy v. Lethert*[33] — by finding that in both cases the predominant, if not sole purpose for the stock acquisition, was an investment motive. However, the third case raised by the IRS, *Dearborn Co. v. United States*,[34] was found to be persuasive because investment was not the sole motivation. The Tax Court found that *Dearborn* stood for the proposition that:

> [B]ecause the parent was motivated by a substantial investment motive, the stock acquired was a capital asset in the taxpayer's hands, even though the principal reason for acquiring the stock was to acquire the company's supply and production facilities, a business purpose.[35]

While discussing the confusion in the area, the *Windle* court referred to two Court of Claims cases which had been decided on the same day. In *Agway, Inc. v. United States*,[36] the court refused to apply the *Corn Products* doctrine. The taxpayer in *Agway* had purchased stock in order to obtain a source of supply, but the court found that there was also an investment motive. Relying on

30. P-H TAX CT. REP. & MEM. DEC. ¶ 65.62 at 398.
31. *Id.* at 400.
32. 481 F.2d 730 (5th Cir. 1973).
33. 63-1 U.S. Tax Cas. ¶ 9442 (D. Minn. 1963).
34. 444 F.2d 1145 (Ct. Cl. 1971) (see discussion of this case at note 27 *supra*).
35. P-H TAX CT. REP. & MEM. DEC. ¶ 65.62 at 400, *citing* Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971).
36. 524 F.2d 1194 (Ct. Cl. 1975).

Dearborn, Agway held "that *Corn Products* will be applied in this court to purchases of company stock to obtain a source of supply, only if there is *no* substantial investment intent."[37]

In contrast to its holding in *Agway*, the Court of Claims in *Union Pacific Railroad Co. v. United States*,[38] found that where the parent railroad corporation held stock in a subsidiary railroad corporation, the stock would not be given capital asset treatment. The court implied, rather, that *some* investment motive, so long as it was not primary, would enable the taxpayer to meet the business purpose test, and thus allow ordinary gain or loss treatment.[39]

The *Windle* court indicated that the Court of Claims position was equivocal as a result of its inconsistent positions in *Agway* and *Union Pacific*. It further concluded that its own precedents were not controlling since no decision had directly faced or decided the mixed-motive situation found in *Windle*. Thereupon, the Tax Court determined that stock purchased with *any* substantial investment purpose is a capital asset even if there is a more substantial business motive. The court gave two reasons for its decision.

First, it felt that by expanding the existing *Corn Products* doctrine so as to include mixed-motive cases, the area of uncertainty would increase and thus taxpayers would be presented with greater opportunity to claim ordinary losses on unsuccessful investments. Second, in what appears to be a reaction to the ever increasing expansion of *Corn Products*, the court held that "there must be limits to the liberties we can take with the statutory language of section 1221."[40]

In determining what constitutes a "substantial" investment motive the court adopted the three-pronged test found in *Dearborn*: (1) no premium over fair market value was paid for the stock; (2) the investment was permanent rather than temporary; and (3) an investment profit was anticipated.

Despite the enunciation of this three-pronged test, the court apparently relied most heavily on the anticipated profit factor. It is suggested here that the findings of fact by the court, while called a "substantial investment motive" were, in terms of commercial reality, nothing more than a "secondary investment motive." The mere

37. *Id.* at 1201 (emphasis added).
38. 524 F.2d 1343 (Ct. Cl. 1975).
39. *Id.* at 1359.
40. P-H TAX CT. REP. & MEM. DEC. ¶ 65.62 at 402.

taking of precautionary profit studies can hardly be termed a "substantial" investment motive in light of business realities. In addition, the fact that the taxpayer held on to the subsidiary for 9 predominately nonprofit years certainly warrants against a finding of a "substantial" investment motive. It is further contended that an "investment motive," no matter how it is characterized, can be found in virtually every stock acquisition. The Tax Court, by recognizing the dual motive possibility behind the stock purchase in *Windle*, made a rational step towards recognition of business reality. However, the "substantial investment purpose" test of *Windle*, adopted apparently as a result of the ever increasing expansion of *Corn Products* under the confused "business purpose" test, is unrealistic. It will not permit an ordinary loss deduction in those cases in which the stock purchase is for a legitimate business motive. Certainly, it is reasonable to expect that a stock purchase may be made as a result of a business need, yet still offer a substantial investment opportunity. It is submitted that under this "substantial investment motive" test the *Windle* court was forced to distort the facts of the case in order to reach its desired result and yet avoid conflict with the *Corn Products* doctrine.

Logic dictates that a more reasonable approach to take would be to adopt the "primary purpose test" used in *Generes*. That is, the predomiant motive behind the acquisition of the stock should be the determining factor in ascertaining the status of the asset. Thus, if there is a primary business motive, the presence of a secondary investment motive should not result in the disallowance of ordinary loss treatment. The adoption of such a test would produce results which allow an ordinary loss deduction when the asset is purchased due to a primary business motivation. It would, nevertheless, still limit the deduction to a capital loss when it cannot be established that the purchase provides no more than an incidental benefit to the business of the taxpayer.

A significant sidelight to this case provides an ironic twist. At approximately the same time that the IRS was presenting its briefs in *Windle*, Revenue Ruling 75-13[41] was issued. The question presented in the Revenue Ruling was whether an employee-stockholder could receive ordinary loss treatment on stock that had become worthless. In ruling against the taxpayer, the IRS followed *Generes*

41. 1975-2 CUM. BULL. 67.

and held that "whether the sale or exchange of shares of stock gives rise to ordinary as opposed to capital gain or loss depends upon whether the taxpayer purchased and held the stock with a *predominant business motive as distinguished from a predominant investment motive.*"[42]

Thus the IRS argued in *Windle* that the presence of *any* investment motive will destroy ordinary asset treatment while in the Revenue Ruling the IRS contended that it is the *predominant* motive which controls. The reaction of taxpayers is readily predictable. Taxpayers seeking ordinary losses will go to the Court of Claims and argue that their predominant motive was a business purpose under the Revenue Ruling; taxpayers seeking capital gains will go to the Tax Court and argue *Windle*, claiming that they had *some* investment motive in the transaction.

Another ironic twist is that the IRS argued a position in *Windle* which would make capital gains treatment seemingly easy to obtain. It is difficult to conceive of a gain situation resulting from a stock transaction where the taxpayer would be unable to establish *any* investment motive.

The *Windle* decision has placed the IRS in an uncomfortable corner. It is suggested that the IRS implore the taxpayer in *Windle* to appeal the case so that the IRS can concede it.

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Accused's Silence During Custodial Interrogation May Not Be Used to Impeach Credibility

Pursuant to Miranda, *a defendant has a right to remain silent during custodial interrogation. As a concomitant of that right, a recent United States Supreme Court decision held that a defendant's failure to offer exculpatory statements during such an investigation may not be used in the subsequent trial for the purpose of impeachment as a prior inconsistent statement. The author criticizes the majority's failure to base its decision on constitutional, rather than evidentiary grounds, as this leaves the door open for future use of "silence" for other purposes at trial.*

42. *Id.* at 68 (emphasis added).