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## Nonbusiness Bad Debts – Is the Taxpayer Getting the Business?

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## CONCLUSION

In the past, the states employing the Grand Jury system have experienced a vast multitude of perplexing problems. Each day ingenious defense counsel conceive new technicalities upon which to take advantage of delaying the expeditious handling of cases at the Grand Jury Stage of proceeding.

Many authorities have said that the Grand Jury should be abolished in toto; the "raison d'être" has long since departed. Yet, has the day arrived where we can abandon this democratic institution and rely on politically appointed officers to perform its functions? These safeguards were obtained in our criminal jurisprudence slowly, by battle and sacrifice. Most of the criticisms of the Grand Jury System could be alleviated by the impaneling of more competent men to serve as Grand Jurors.

The Florida Statutes are a major step in the right direction. No Grand Jury in this country can boast of having the facilities that are presently available to the Florida Grand Juries. True, there are dangers of infiltration into this body by criminals and incompetents, but this is true of any democratic institution. A vigilant "public eye" is necessary to make certain that such a condition does not come to pass. By having competent jurors and making them aware of their tremendous powers, the Grand Jury can become the greatest single force in our community for decent local government. At the same time it will keep the prosecution of the people by the people.

HUBERT G. ROBERTS

## NONBUSINESS BAD DEBTS—IS THE TAXPAYER GETTING THE BUSINESS?

### THE PROBLEM

With all taxable years beginning after December 31, 1942, the taxpayer who had suffered bad debts was faced with a problem. This problem was created by Section 124(a) of the Revenue Act of 1942<sup>1</sup> which added a new concept to federal tax law—the nonbusiness debt.<sup>2</sup> The breakdown of existing bad debts into two different classes was required by this new concept. The individual<sup>3</sup> taxpayer had to determine whether his bad debt came under the general rule<sup>4</sup> of business bad debts

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1. 56 STAT. 798 (1942).

2. The pertinent provision has been incorporated into the code as INT. REV. CODE § 23 (k)(4).

3. INT. REV. CODE § 23 (k)(4) expressly provides that corporate taxpayers are not covered by its terms.

4. INT. REV. CODE § 23 (k)(1) [which provides for the general deduction against ordinary income of any bad debts becoming worthless within the taxable year subject to enumerated exceptions such as Section 23 (k)(4)].

or under the new rule for nonbusiness bad debts. If it were a nonbusiness debt, the loss resulting therefrom was treated as a short-term capital loss, *i.e.*, in the absence of other capital transactions, the capital loss could be offset against ordinary income only to the extent of \$1,000.00 in any one taxable year.<sup>5</sup> Likewise, a nonbusiness debt is not deductible when found to be "partially worthless," while the business bad debt may be deducted to the extent that it does become worthless.<sup>6</sup>

The advantage in treating the debt under the general rule is obvious,—there is an immediate one hundred per cent deduction from ordinary income in the year the bad debt occurs with no limitations of the capital loss carry-over.<sup>7</sup> The business bad debt is also included within the provisions of the operating loss carry-over<sup>8</sup> section. In the alternative, if classified as a nonbusiness debt, there is an offset against long-term capital gain income taxable at the maximum twenty-six percentum rate.<sup>9</sup>

In defining a nonbusiness debt, Congress said that:

The term 'non-business' debt means a debt other than a debt evidenced by a security . . . and other than a debt the loss from which the worthlessness of which is incurred in the taxpayer's trade or business.<sup>10</sup>

This definition was explained to the taxpayer by the Treasury Department, in its regulations,<sup>11</sup> as follows:

b) The character of the debt for this purpose is *not* controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but *is* to be determined by the relation which the loss resulting from the debts becoming worthless bears to the trade or business of the taxpayer. If that relation is a *proximate one* in the conduct of the trade or business in which the taxpayer is engaged *at the time the debt becomes worthless*, the debt is not a non-business debt for the purposes of this section. (Emphasis supplied).

Paragraph (c) of the regulation goes on to illustrate six examples of debts that have or have not a proximate relation to the taxpayer's trade or business when the loss from the debt occurs.<sup>12</sup>

5. INT. REV. CODE §§ 23 (k)(4), 117 (d)(2).

6. INT. REV. CODE § 23 (k)(1). The Revenue Act of 1921 (42 STAT. 227, 1921) was the first act to permit the use of the reserve method to scientifically provide for estimated bad debts.

7. INT. REV. CODE § 117 (e).

8. INT. REV. CODE § 122 (d)(5).

9. INT. REV. CODE § 117 (c)(1)(B).

10. INT. REV. CODE § 23 (k)(4).

11. U. S. Treas. Reg. 118, § 39.23 (k)-6 (1943), as amended by T.D. 5458, 1945 CUM. BULL. 45 [which adopts the language of the House Ways and Means Committee H.R. REP. NO. 2333, 77th Cong., 2d Sess. 77 (1948)].

12. An example of which is illustration (1) in which A sells his business, . . . retains an account receivable. The worthlessness of this account is treated as a nonbusiness bad debt.

However, much of this harsh treatment has been alleviated by the proposed Revenue Act of 1954. In a press release dated January 22, 1954, the House Ways and Means Committee announced:

At present a business bad debt is limited to a debt which becomes bad while the taxpayer is carrying on a trade or business. A committee provision<sup>13</sup> treats a bad debt as a business bad debt if the debt was incurred in a business even though the taxpayer was not carrying on the business when the debt became bad.<sup>14</sup>

The proposed bill,<sup>15</sup> as stated in the Committee Report, excludes from the definition of a nonbusiness bad debt, any debt, either created in the course of the trade or business of the taxpayer or acquired by him in the course thereof *without regard* to the relationship of the debt to a trade or business of the taxpayer at the time that the debt became worthless. This is an addition to the present exclusion of a debt becoming worthless in the course of the trade or business of the taxpayer.<sup>16</sup>

In all events, under the present law or under the proposed law, the problem of interpreting "trade or business" remains, and will continue to vex the practitioner. The term "trade or business" has been found in the Internal Revenue Code from the Code's inception, and it has received many interpretations.<sup>17</sup>

The Treasury Department attempts to clarify the meaning of "trade or business" as the phrase appears in Section 23(k)(4) of the Internal Revenue Code. The regulations state:

The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is "incurred in trade or business" under section 23(e) (1).<sup>18</sup>

However, to fully understand the judicial construction of the more recent cases, it is necessary to refer to an early Court definition of the term "business" as it appeared in another tax law.

13. H. R. 8300, 83rd Cong., 2d Sess. (1954) § 166 (d)(2)(B) [wherein a nonbusiness debt is defined as a "debt created or acquired (as the case may be) in connection with a taxpayer's trade or business" as opposed to the existing § 23 (k)(4) ". . . from the worthlessness of which is incurred in the taxpayer's trade or business." (emphasis supplied)].

14. 4 P-H 1954 FED. TAX SERV. ¶ 66,543 (1954).

15. This comment was prepared in early April, 1954 after the passage of House Bill 8300 but prior to any Senate action on The Revenue Act of 1954.

16. H.R. REP. No. 1337, 83rd Cong., 2d Sess. (1954). In the general explanation, the Committee specifically tells how the result of illustration (1) of the existing Regulations, *op. cit. supra* notes 11 and 12, will be reversed.

17. *E.g.*, Daily Journal Co. v. CIR, 135 F.2d 687, 688 (9th Cir. 1943); Fackler v. CIR, 133 F.2d 509, 510 (6th Cir. 1943); See Harding v. United States, 113 F. Supp. 461, 463 (Ct. Cl. 1953) (where the Commissioner adopted inconsistent stands as to the meaning of "trade or business" in an identical fact situation).

18. U. S. Treas. Reg. 118, § 39.23 (k)-6 (1943).

## THE HISTORY

In 1911, Mr. Justice Day, speaking for the court in *Flint v. Stone Tracy Co.*<sup>19</sup> said, "Business is a very comprehensive term and embraces every thing about which a person can be employed." Six years later, in *Von Baumbach v. Sargent Land Co.*,<sup>20</sup> the court again approved this broad definition.

By 1932, however, the court undertook to limit this all inclusive definition.<sup>21</sup> A taxpayer sought to deduct the cost of worthless stock of insolvent corporations which had been organized by him to exploit his inventions. The court held, "Ownership of all the stock is not enough to show that creation and management of the corporation was a part of his ordinary business."<sup>22</sup> The rationale that the "business" of the corporation was separate and distinct from the "business" of its sole stockholder, was based upon the separate entity doctrine then prevailing.<sup>23</sup>

In *Deputy v. Du Pont*,<sup>24</sup> Mr. Justice Frankfurter, in a concurring opinion, defined—carrying on any trade or business—to mean the "holding of one's self out to others as engaged in the selling of goods and services." It remained for Mr. Justice Reed, in *Higgins v. C.I.R.*,<sup>25</sup> to state that the definition of "business" as used in *Flint v. Stone Tracy Co.* is not controlling in a dissimilar inquiry. Since the definition originally given to "business" in *Flint v. Stone Tracy Co.* involved the issue of certain corporations coming under the Corporation Tax Law<sup>26</sup> which levied a tax on corporations engaged in business, it can be readily seen that Mr. Justice Day's definition is all but expressly overruled for current tax purposes.

The court through Mr. Justice Reed in the *Higgins* case said:

Only those are deductible which relate to carrying on a business.<sup>27</sup>

To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case . . . .  
all expenses of every business transaction are not deductible.

The present rule for determining what constitutes trade or business seems to be Mr. Justice Reed's statement that each case is decided on its own individual facts, tempered by Mr. Justice Frankfurter's definition in the concurring opinion. Various factual situations do exist along with

19. 220 U.S. 107, 171 (1911).

20. 242 U.S. 503 (1917).

21. *Dalton v. Bowers*, 287 U.S. 404 (1932); *Burnet v. Clark*, 287 U.S. 410 (1932).

22. *Dalton v. Bowers*, 287 U.S. 404, 410 (1932).

23. See *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 442 (1934).

24. 308 U.S. 488, 499 (1940).

25. 312 U.S. 212 (1941).

26. 36 STAT. 11, § 38 (1909).

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all expenses of every business transaction are not deductible.

27. *Higgins v. CIR*, 312 U.S. 212, 217 (1941).

several dissimilar rulings of law on what *appear* to be similar factual situations.

With the view in mind that a taxpayer can be engaged in more than one trade or business,<sup>28</sup> a study of the cases defining "trade or business" as it pertains to business bad debts, is now in order.

#### THE FACTS

Prior to 1934, deductions for losses<sup>29</sup> and bad debts<sup>30</sup> were thought to be interchangeable.<sup>31</sup> In the *Spring City Foundry* case,<sup>32</sup> it was stated that Sections 23(e) and 23(k) of the Internal Revenue Code are mutually exclusive. However, in determining whether the loss or the debt is attributable to the trade or business of the taxpayer, the definition of "trade or business" is the same.<sup>33</sup>

There is general agreement that the business of the corporation is not the business of its stockholders or officers.<sup>34</sup> Nevertheless, as the taxpayer becomes interested in many corporations, as he takes a stronger financial and managerial interest in them, his loans to these organizations may be said to occur within the course of his trade or business as a *promoter* of business enterprises.<sup>35</sup> The *Higgins* case held that the full time management of one's investments of securities does *not* constitute a trade or business, so a gray area appears to exist; the cloudy area being, the distinction between the active investor and the passive financier.<sup>36</sup>

Bad debts that represented the partial purchase price of seats on an exchange, and which arose out of partnership agreements were held to have a proximate relationship to the business of the taxpayer.<sup>37</sup> These cases are of importance because they appear to allow a partner to deduct a bad debt that has arisen out of partnership activity, as a business bad

28. *Birch Ranch & Oil Co. v. CIR*, 152 F.2d 874 (9th Cir. 1946); *Brya v. Keith*, 257 Fed. 133 (E.D. N.Y. 1919); T.D. 1989, 16 TREAS. DEC. 83 (1914); I.T. 2751, XIII-1 CUM. BULL. 43 (1934).

29. INT. REV. CODE § 23 (e) (2).

30. INT. REV. CODE § 23 (k) (1).

31. See *Bank of London and South America Ltd.*, 17 B.T.A. 1263 (1929), *acq.*, X-2 CUM. BULL. 4 (1931) (Both the Commissioner and the taxpayer argued that the alleged loss was and was not, either a bad debt or loss, making no distinction between the two concepts).

32. *Spring City Foundry Co. v. CIR*, 292 U.S. 182 (1934); Charles G. Berwind, 20 T. C. No. 114 (1953).

33. See U. S. Treas. Reg. 118, § 39.23 (k)-6 (1943) quoted in the body of this comment.

34. *Van Dyke v. CIR*, 291 U.S. 642 (1933); *Burnet v. Clark*, 287 U.S. 410 (1932); *Dalton v. Bowers*, 287 U.S. 404 (1932); *Omaha Nat. Bank v. CIR*, 183 F.2d 899 (8th Cir. 1950); *Fred A. Bihlmaier*, 17 T.C. 620 (1951), *acq.*, 1952-1 CUM. BULL. 1 (1953); *Jan. G. J. Boisservain*, 17 T.C. 325 (1951). *But cf.* *CIR v. People's Pittsburg Trust Co.*, 60 F.2d 187 (3d Cir. 1932); *Ralph C. Holmes*, 37 B.T.A. 865 (1938).

35. See *CIR v. Stokes' Estate*, 200 F.2d 637 (3d Cir. 1953); *Maloney v. Spencer*, 172 F.2d 638 (9th Cir. 1949); *Jacob Mark*, P-H 1951 TC MEM. DEC. ¶ 51, 225, 10 TCM 702 (1951); *Henry Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 3 (1951); *Valentine E. Macy*, P-H 1949 TC MEM. DEC. ¶ 49, 009, 8 TCM 713 (1949); *Vincent C. Campbell*, 11 T.C. 510 (1948), *acq.*, 1949-1 CUM. BULL. 1 (1949).

36. See *Foss v. CIR*, 75 F.2d 326, 328 (1935).

37. *Harding v. United States*, 113 F. Supp. 461 (Ct. Cl. 1953); *Robert Cluett III*,

debt. *Query*: if the partners can deduct the debt severally, why can the individual not deduct the debt if it arises from a similar 'business' transaction arising from the taxpayer's corporate activities?<sup>38</sup>

In reviewing the cases, it is interesting to note that in close situations, where the Tax Court finds the making of loans to a corporation to be the trade or business of the taxpayer, the Tax Court treats additional advances in succeeding years after the debt was first determined to be worthless (by the taxpayer), as capital contributions.<sup>39</sup> Another 'debt' that is not deductible as a business bad debt is the satisfaction of a moral obligation; *i.e.* a debt not legally binding on the taxpayer.<sup>40</sup>

The main point of contention appears to be in those situations where the taxpayer is one who promotes, organizes, invests in, directs, manages a number of enterprises, and (in the course of his alleged "business activity") makes a loan to one of the enterprises.

In such situations, the taxpayer is usually occupied with one principal business and finds great difficulty in meeting his burden<sup>41</sup> of proving that the various loans were made in the course of *another* trade or business in which he is *also* occupied; the promotion of business enterprises. A strong positive definition of what constitutes a "promoter of businesses" has never been judicially derived, although there have been some indications as to the characteristics of a "promoter."<sup>42</sup>

The Commissioner has taken the stand that making loans to sundry businesses is not a usual business activity of any taxpayer, unless that taxpayer is regularly engaged in the business of making loans.<sup>43</sup> He has recognized exceptions,<sup>44</sup> but regularly seems to reclassify business bad debts deductions to non-business bad debt deductions when they involve a debt of the taxpayer's corporation. The Tax Court has frequently taken

8 T.C. 1178, *acq.*, 1947-2 CUM. BULL. 2 (1947); *cf.* Isaac P. Keeler, 23 B.T.A. 467 (1931).

38. See Guterman, *Some Problems in the Deductions for Bad Debts*, 63 HARV. L. REV. 832, 834 (1950).

39. O.D. Bratton, P-H 1953 TC MEM. DEC. ¶ 53, 241, 12 TCM 747 (1953); Fred A. Bihlmaier, 17 T.C. 620 (1951), *acq.*, 1952-1 CUM. BULL. 1 (1952). See *Lander v. Self*, Civil No. 1985, E.D. Ark., Oct 23, 1950, 4-PH 1951 FED. TAX SERV. ¶ 72, 522 (1951) (The judge instructed the jury to determine: If an advance to a corporation was to protect the taxpayer's investment, the loss was a capital loss; if the advance was *intended* to be a loan, the loss would be deductible in full as a loan. The jury found that the taxpayer's *intent* was that the advance be treated as a loan, and judgment was given on the taxpayer's intent.)

40. *Friedman v. Delaney*, 171 F.2d 269 (1st Cir. 1948); *W. A. Dallmeyer*, 14 T.C. 1282, *acq.*, 1950-2 CUM. BULL. 2 (1950) [In such situations, deductions also are not allowable under Section 23 (e)(2)].

41. *New Colonial Ice Co. v. Helvening*, 292 U.S. 435 (1934), *approved*, *White v. United States*, 305 U.S. 281 (1938); *Redman v. CIR* 155 F.2d 319 (1st Cir. 1946); *Cittadine v. CIR* 139 F.2d 29 (4th Cir. 1943).

42. *A. Kingsley Ferguson*, 16 T.C. 1248, 1257-1258 (1951) (where Judge Disney discusses the characteristics of a promoter).

43. See *Henry E. Sage*, 15 T.C. 299, 303 (1950), *acq.*, 1951-1 CUM. BULL. 3 (1951).

44. *Henry E. Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 3 (1951); *Vincent C. Campbell*, 11 T.C. 510 (1948), *acq.*, 1947-1 CUM. BULL. 1 (1949) (Both

the liberal view that the making of loans to business enterprises, in the course of a taxpayer's business of promoting business enterprises<sup>45</sup> or for other business purposes,<sup>46</sup> is the incurring of a debt that is deductible under Section 23(k) (1) of the Internal Revenue Code.

Judge Tietjens of the Tax Court has proposed to further extend the Tax Court's liberal rule by stating that a:

. . . taxpayer can be engaged in the business of organizing, operating, and financing a *single* corporation as well as a number of corporations and that a taxpayer so engaged . . . should be entitled to the same bad debt treatment.

This view was expressed in the dissent in the *Ferguson* case,<sup>47</sup> the appeal of which is now pending before the Sixth Circuit.

The line presently is drawn between "passive investors"<sup>48</sup> and "active financiers."<sup>49</sup> The *Smith* case<sup>50</sup> involved one of five equal stockholders in a Canadian farming corporation, who had made disproportionate loans to the corporation. The taxpayer, the general manager of a Buffalo department store, devoted his weekends to the management of the farm. Upon the bankruptcy of the corporation, the Canadian Bankruptcy Court treated these advances as a secondary type debt, inferior to the claims of outside creditors, but superior to the capital.<sup>51</sup> In rejecting the taxpayer's contention that he was an active manager of business enterprises, the Court of Appeals in reversing the Tax Court, adopted Judge Disney's dissent<sup>52</sup> and noted that since the taxpayer was not regularly engaged in loaning money to businesses (the view of the Commissioner), the debt was not attributable to any trade or business of the taxpayer.

In the *Washburn*<sup>53</sup> case, the taxpayer, a retired attorney, organized a number of enterprises in different industries. He actively managed the various companies that were exploiting timber lands; he organized a railroad to develop the timber lands, but was forced to sell the railroad stock at a loss. In rejecting the taxpayer's attempt to carry over the loss,

cases acquiesced to by the Commissioner involve taxpayers, whose trade or business did not consist of loaning money. Sage was a promoter; Campbell was in the coal business.)

45. *Weldon D. Smith*, 17 T.C. 135 (1951), *rev'd*, 203 F.2d 310 (2d Cir. 1953); *Estate of J. Stoddell Stokes*, P-H 1951 TC MEM. DEC. ¶ 51, 343, 10 TCM 1111 (1951), *aff'd*, 200 F.2d 637 (3d Cir. 1953); *Jacob Mark*, P-H 1951 TC MEM. DEC. ¶ 51, 225, 10 TCM 702 (1951). *But cf.*, *A. Kingsley Ferguson*, 16 T.C. 1248 (1951).

46. *Jacob Mark*, P-H 1951 TC MEM. DEC. ¶ 51, 225, 10 TCM 702 (1951); *Henry E. Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 3 (1951); *Vincent C. Campbell*, 11 T.C. 510 (1948), *acq.*, 1949-1 CUM. BULL. 1 (1949).

47. *A. Kingsley Ferguson*, 16 T.C. 1248, 1259 (1951). Judge Murdock joined in the dissent.

48. *Weldon D. Smith v. CIR*, 203 F.2d 310 (2d Cir. 1953), *cert. denied*, 74 Sup. Ct. 27 (1953); *Omaha Nat. Bank v. CIR*, 183 F.2d 899 (8th Cir. 1950), *affirming sub. nom.*, *L. F. Crofoot*, P-H 1949 TC MEM. DEC. ¶ 49, 236, 8 TCM (1949).

49. See notes 45 and 46 *supra*.

50. 203 F.2d 310 (2d Cir. 1953).

51. *Weldon D. Smith*, 17 T.C. 135, 141 (1951).

52. *Id.* at 147.

53. 51 F.2d 949 (8th Cir. 1931).



the Board of Tax Appeals was "unable to find therein the 'operation of any trade or business regularly carried on.'"<sup>54</sup> On the basis of several decisions of the Board of Tax Appeals the Circuit Court of Appeals for the Eighth Circuit, reversed the decision and held the taxpayer to be in the business of managing his investments. The aforementioned B.T.A. decisions were handed down subsequent to the decision of the B.T.A. in the *Washburn* case, but prior to the Court of Appeals decision and were predicated upon Mr. Justice Day's broad definition in *Flint v. Stone Tracy Co.* The Treasury Department announced its non-acquiescence to all the B.T.A. decisions.<sup>55</sup>

Another decision of the Eighth Circuit casts some doubt on the *Washburn* decision. It is factually distinguishable, however. In *Omaha National Bank v. C.I.R.*<sup>56</sup> the taxpayer attorney "protected his investment" by incorporating a restaurant that was then under construction. He was then joined by the promoter (the original debtor) of the restaurant as a fellow stockholder and proceeded to look solely to the corporation for the repayment of the loan originally made to the promoter as an individual. The court held that the debt was not incurred in the trade or business of the taxpayer on the grounds that the corporation was a separate entity from the taxpayer and the business of the corporation is not the business of the taxpayer.

In the *Omaha Nat'l Bank* case the Eighth Circuit has not overruled *Washburn* but distinguishes a hopeless fact situation. The *Washburn* case is probably still the law under our present limited definition of "business".<sup>57</sup> It has been asserted that the recent *Smith* decision is in conflict with the older *Washburn* decision, and that the Supreme Court should have granted certiorari to clarify the rule.<sup>58</sup> With the refusal of the Supreme Court to grant certiorari,<sup>59</sup> the question remains unanswered.

54. *J. L. Washburn*, 16 B.T.A. 1091, 1095 (1929), *non-acq.*, X-2 CUM. BULL. 105 (1931).

55. *Washburn v. CIR*, 51 F.2d 949, 954-955 (8th Cir. 1931) wherein is cited *Glen M. Averill*, 20 B.T.A. 1196 (1930), *non-acq.*, X-2 CUM. BULL. 80 (1931); *E. D. Anthony*, 20 B.T.A. 5 (1930), *non-acq.*, X-2 CUM. BULL. 79 (1939); *Elmore L. Potter*, 18 B.T.A. 549 (1929), *non-acq.*, X-2 CUM. BULL. 97 (1939); *W. H. Ostenberg*, 17 B.T.A. 738 (1929), *non-acq.*, X-2 CUM. BULL. 97 (1939); *Edward H. Baker*, 17 B.T.A. 733 (1929), *non-acq.*, X-2 CUM. BULL. 80 (1931); *T. I. Crane*, 17 B.T.A. 733 (1929), *non-acq.*, X-2 CUM. BULL. 84 (1931).

56. 183 F.2d 899 (8th Cir. 1950).

57. This view is based on the following recent cases: *Maloney v. Spencer*, 172 F.2d 638 (9th Cir. 1949); *Henry E. Sage*, 15 T.C. 299 (1950), *acq.*, 1951-1 CUM. BULL. 1 (1951); *Vincent C. Campbell*, 11 T.C. 510 (1948), *acq.*, 1949-1 CUM. BULL. 1 (1949). The two Tax Court cases are based on the *Washburn* decision, but the *Maloney* case does not cite *Washburn* and holds that the regularity of the taxpayer's activities, gives them the status of a "trade or business." The fact that the Commissioner acquiesced in the two Tax Court cases indicates a trend that the Commissioner accepts a wider test to determine the trade or business of the taxpayer. The facts of the *Washburn* case are analogous to all three cases.

58. 2 CCH 1954 FED. TAX REP. ¶ 213 A (1954) (by implication).

59. *Weldon D. Smith v. CIR*, 74 Sup. Ct. 27 (1953).

60. 172 F.2d 638 (9th Cir. 1949).

In *Maloney v. Spencer*,<sup>61</sup> the Ninth Circuit upheld the District Judge's decision<sup>61</sup> in a case involving the obligations of the taxpayer's corporation which he was operating as packing plants. The court held that the taxpayer was engaged in the regular business of acquiring, leasing and equipping food processing plants, and the bad "debts" as they were recorded on the books of both the corporation and the taxpayer, were deductible under the general rule. The court emphasized the "regularity of the taxpayer's activities" as opposed to the "isolated or occasional transactions."<sup>62</sup>

The Third Circuit held that in a case where an individual organizes corporations to exploit patents, a debt involving one of these corporations is an expense of the taxpayer's regular business.<sup>63</sup> The First Circuit held that a person of property who actively manages both the property and the corporation in which his property is invested is carrying on business within the statute.<sup>64</sup> While the latter decision was based on *Washburn*, it is an approving opinion of the Eighth Circuit's reasoning.

By a count of the circuits, it appears that the active participation of a stockholder in his corporate activities is likened to the carrying out of a trade or business. The *Smith* case seems to be distinguishable factually in that *Smith* was a "passive investor," but a closer examination of the cases shows that, there, the court approved the Commissioner's contention that the taxpayer must be regularly engaged in the business of making loans.

The *Leo L. Pollak*<sup>65</sup> case does pose a possible solution to the taxpayer's dilemma. There the taxpayer endorsed the corporation's notes and was required to pay the notes when the corporation became insolvent. The Tax Court rejected the taxpayer's argument that there was no debt owing to the taxpayer by the corporation until the taxpayer began to make payments to the bank. The corporation, the taxpayer contended, being hopelessly insolvent, was incapable of owing a debt for tax purposes at the time the taxpayer's payments to the bank were made. The payments, argued the taxpayer, were in the nature of a loss deductible under Section 23 (e) (2) of the Internal Revenue Code; i.e., a transaction entered into for profit. The Tax Court, in rejecting the argument, stated that the lack of the debtor's assets controlled the situation. The non-existence of the debtor and the taxpayer's argument of Section 23 (e) (2) were inapplicable. The Court of Appeals reversed, pointing out that the payments were made in fulfillment of pre-existing legal obligation, and not because of any present expectation of repayment by the principal debtor. The

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61. *Spencer v. Maloney*, 73 F. Supp. 657 (D. Ore. 1947).

62. *Burnet v. Clark*, 287 U.S. 410 (1932); *Dalton v. Bowers*, 287 U.S. 404 (1932).

63. *CIR v. Stokes' Estate*, 200 F.2d 636 (3d Cir. 1953).

64. *Foss v. CIR*, 75 F.2d 326 (1st Cir. 1935).

65. *Leo L. Pollak*, 20 T.C. 211 (1953), *rev'd*, 209 F.2d 57 (3d Cir. 1954).

pre-existing legal obligation was found to be a transaction entered into for a profit. This decision was based on the doctrine of *Eckert v. Burnet*<sup>66</sup> in which Mr. Justice Holmes announced that payments on an endorsed note are deductible only in the year the payments are made, not in the year the notes go into default.

In deciding the *Pollak* case, the Third Circuit approves *Allen v. Edwards*,<sup>67</sup> a case which shows the extent this doctrine, if successful, can be used to avoid the harsh treatment of Section 23 (k) (4). It should be noted that Sections 23 (e) and 23 (k) are mutually exclusive;<sup>68</sup> in order to apply the *Pollak* rule, the obligee corporation must be totally unable to ever repay the notes made good by the endorser.

#### CONCLUSION

It would seem then, that if the "passive investor" guarantees bank loans to his favored corporations instead of making them himself, he is assured more favorable tax treatment in the event of a corporate failure. This inequality in the treatment of taxpayers who do not have the machinery to arrange for a third party to make an advance to the corporation, either through lack of counsel or because of a very immediate need for funds, can best be rectified by a clear expression of legislative intent broadening the definition of "business" as it pertains to the bad debt section.

If the present *Pollak* case be approved, the term "trade or business" as used in Section 23 (e) will differ from its meaning in Section 23 (k) (4). This is not the intention of Congress.<sup>69</sup>

Should the *Pollak* case and its approval of *Allen v. Edwards*<sup>70</sup> prevail, a modification of Section 23 (k) (4) will be in order. Section 23 (k) (4) was initially enacted to prevent the abuse of deducting loans that were made with no expectation of being repaid.<sup>71</sup> The section is now being applied to restrict the one man corporation. It is respectfully recommended that any debt arising from a taxpayer's business activity (as used in the broadest meaning) be deductible in full.

MOSES J. GRUNDWERC

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66. 283 U.S. 401 (1931).

67. 114 F. Supp. 672 (M.D. Ca. 1953); see *Fox v. CIR* 190 F.2d 101 (2d Cir. 1951); Abraham Greenspon, 8 T.C. 431 (1947), *acq.*, 1947-1 CUM. BULL. 2 (1947); *cf.* *Kate Baker Sherman*, 18 T.C. 746 (1952), *acq.*, 1952-2 CUM. BULL. 3 (1952).

68. See notes 11 and 32 *supra*.

69. *Ibid.*

70. 114 F. Supp. 672 (M.D. Ca. 1953).

71. MERTENS, LAW OF FEDERAL INCOME TAXATION § 30.24 (1953 Ed.).