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Rule 14a-8 appears preferable to the alternative, which permits management to employ corporate resources for social ends without being accountable to anyone but itself.[94] As the *Medical Committee* court said:

> [T]here is a clear and compelling distinction between management's legitimate need for freedom to apply its expertise in matters of day-to-day business judgment, and management's patently illegitimate claim of power to treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilections.[95]

HARVEY L. HANDLEY III

BAD DEBT DEDUCTION FOR SHAREHOLDER-CREDITOR UNDER PROXIMATE RELATION TEST

Section 166 of the Internal Revenue Code of 1954 provides for a deduction for a business bad debt in the year the debt becomes worthless.[1] When a taxpayer takes a business bad debt deduction he must establish that a true indebtedness exists,[2] that the debt has become

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[94]*See* Bayne, Caplin, Emerson & Latcham, *supra* note 2.

[95]432 F.2d at 681.

[1]INT. REV. CODE OF 1954, § 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.
> ....
> (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
> ....
> (2) Nonbusiness debt defined.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—
> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

[2]TREAS. REG. § 1.166-1(c) (1960), states that only a bona fide debt qualifies for purposes of INT. REV. CODE OF 1954, § 166:

> A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166.

See, e.g., Curry v. United States, 396 F.2d 630 (5th Cir. 1968); United States v. Henderson, 375 F.2d 36 (5th Cir. 1967); *cf.*, REV. RUL. 458, 1969-2 CUM. BULL. 33. For a discussion of the distinction between debt and equity in corporate situations see *American Processing & Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967).

worthless during the taxable year,[3] and that the indebtedness was created in connection with his trade or business.[4] When a true indebtedness has been established, the business or nonbusiness nature of the debt is a question of fact.[5] One of the tests applied to determine whether a debt was created in connection with taxpayer's trade or business so as to qualify as a business bad debt rather than as a nonbusiness bad debt is the "proximate relation" test.[6] Under the proxi-

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[3]In determining whether a debt is worthless, the district director is to consider all the pertinent evidence because the worthlessness of a debt is a question of fact. TREAS. REG. § 1.166-2(a) (1960). *See* American Processing & Sales Co. v. United States, 371 F.2d 842, 851 (Ct. Cl. 1967); United States v. Collier, 104 F.2d 420, 424 (5th Cir. 1939). For a discussion of the worthlessness of a debt, see Ohl, *The Deduction for Bad Debts: A Study in Flexibility and Inflexibility*, 22 TAX LAW. 579 (1968).

[4]Note 1 *supra*. This comment deals with establishing the connection of the debt to taxpayer's trade or business, when taxpayer is a shareholder-employee who has loaned money to his corporation and thus become a shareholder-creditor of the corporation. It should be noted that the shareholder who advances money to his corporation risks having the advance declared a contribution to capital. Note 21 and accompanying text *infra*. If taxpayer-shareholder's advance to the corporaiton is a capital contribution, it becomes part of his investment in the stock of the corporation and results in a capital loss under INT. REV. CODE OF 1954, § 165(g) if his stock becomes worthless. *See* 2 P-H 1970 FED. TAXES ¶ 14,731. *See also* Spillers v. Commissioner, 407 F.2d 530, 532 (5th Cir. 1969). For special problems involved with worthless securities see 2 P-H 1970 FED. TAXES ¶ 14,290. For other tax considerations involved with loans by shareholders to corporations see *Tomlinson v. 1661 Corporation*, 377 F.2d 291 (5th Cir. 1967). *But see* INT. REV. CODE OF 1954, § 385.

Taxpayer has the burden of proving the existence of a proximate relation between his trade or business and the creation of the debt. *See* United States v. Byck, 325 F.2d 551, 552 (5th Cir. 1963); *cf.* Spillers v. Commissioner, 407 F.2d 530, 534 (5th Cir. 1969); Syer v. United States, 380 F.2d 1009, 1010 (4th Cir. 1967); United States v. Clark, 358 F.2d 892, 895 (1st Cir. 1966).

[5]Treas. Reg. § 1.166-5(b)(2), T.D. 6403, 1959-2 CUM. BULL. 77, provides that the question whether a debt is a nonbusiness debt is a question of fact in each particular case. *See* Higgins v. Commissioner, 312 U.S. 1212, 1217 (1941). INT. REV. CODE OF 1954, § 166(d)(1) provides that a nonbusiness bad debt shall be considered a loss from the sale or exchange of a capital asset held for not more than six months, and subject to the limitations of section 1211. Note 28 *infra*. It must be submitted that it is more desirable for taxpayer to be able to deduct the bad debt from ordinary income as a business bad debt than to be required to deduct the bad debt as a capital loss. It is normally the case that it is more desirable to treat losses as ordinary income, than capital losses, particularly where taxpayer derives most of his income from salary.

[6]Treas. Reg. § 1.166-5(b)(2), T.D. 6403, 1959-2 CUM. BULL. 77, provides the basis for using the proximate relation of taxpayer's trade or business to the debt as a test for a business debt:

> ... the character of the debt is to be determined by the relation which the loss resulting from the debt's 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 comes within the exception provided by that subparagraph. (emphasis added)

The Supreme Court indicated approval of the proximate relation test in mate relation test, there are two conflicting and somewhat subjective criteria currently utilized to determine if the relation between a debt and taxpayer's trade or business is a proximate one: the strict "primary and dominant purpose" test and the liberal "significant motivation" test.[7]

In *United States v. Generes*,[8] taxpayer was president of a close corporation engaged in construction work. He owned forty-four per cent of the stock and received a salary of $12,000 per year. His duties as president required him to obtain financing for the corporation and to secure bid and performance bonds on construction jobs undertaken by the company. In addition, in his individual capacity, taxpayer advanced money to the corporation from time to time.[9] Taxpayer executed a

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Whipple v. Commissioner, 373 U.S. 193 (1963). In remanding the case to the Tax Court the Court in *Whipple* stated:

> Moreover, there is no proof (which might be difficult to furnish where taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise *proximately related* to maintaining his trade or business as an employee. (emphasis added)

373 U.S. at 204. In addition to using the proximate relation test, taxpayer may show he is in the business of promoting corporations or in the business of making loans. Note 20 *infra*. Taxpayer is also allowed to deduct as business bad debts those bad debts which occur in "the course of" taxpayer's trade or business as distinguished from those that occur "in connection with" his trade or business. INT. REV. CODE OF 1954, § 166(d)(2)(B). *See* Whipple v. Commissioner, 373 U.S. 193, 205 (1963), where the Court instructed the Tax Court to determine if the loan in issue was incurred in taxpayer's business of being a landlord.

[7]The basis for the significant motivation test was established by the majority in *Weddle v. Commissioner*, 325 F.2d 849, 851 (2d Cir. 1963), while the basis for the primary and dominant purpose test was set out in the concurring opinion in *Weddle*. 325 F.2d at 852-53. The significant motivation test was adopted in *Generes v. Commissioner*, 427 F.2d 279 (5th Cir. 1970), while the primary and dominant purpose test was adopted in *Niblock v. Commissioner*, 417 F.2d 1185 (7th Cir. 1969).

[8]427 F.2d 279 (5th Cir. 1970).

[9]Generes was also president of a local bank. In *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963), the Court stated that service to more than one corporation might lend support to a finding that taxpayer was in the business of promoting corporations. Note 19 *infra*. However, Generes did not rely on the "promoter doctrine" for establishing a trade or business. Note 20 *infra*. In *Trent v. Commissioner*, 291 F.2d 669, 670-71 (2d Cir. 1961), the court discusses the meaning of the phrase "in connection with taxpayer's trade or business," and the concept of losses and expenses in the Internal Revenue Code. First, a trade or business consists of holding one's self out to others as engaged in selling goods or services for pay. Secondly, there is another class of activity which is pecuniarily motivated but not a trade or business. Finally, there is a third class of activity with no pecuniary motivation. A business bad debt is designed to alleviate those losses incurred in the first class, while a nonbusiness bad debt is designed to alleviate some of the losses in the second class of activity.

A business bad debt deduction was allowed in *Trent* because he was a corporate employee engaged in the trade or business of rendering services to the corporation for pay. 291 F.2d at 676.

blanket indemnity agreement in 1958 with the corporation as applicant and taxpayer as one of the indemnitors.[10] In 1962, the corporation defaulted on a job and taxpayer was forced to pay the casualty company an indemnity of $162,104.57. The corporation eventually went into receivership, and taxpayer, as a subrogated creditor, was unable to collect this amount from the corporation.[11] On his federal income tax return for 1962, taxpayer deducted the amount of the indemnity as a business bad debt and filed claim for refund through a net operating loss carryback arising from the unused portion of his 1962 business bad debt deduction.[12]

The Court of Appeals for the Fifth Circuit in *Generes* affirmed the district court's finding that the bad debt was a business bad debt and thus fully deductible under section 166 of the Internal Revenue Code of 1954.[13] The majority adopted the significant motivation test, first enunciated in *Weddle v. Commissioner*,[14] as the criterion for establishing a proximate relation. The court in *Generes* upheld the district court's instruction to the jury that

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[10]Under this agreement taxpayer, as an individual, agreed to hold harmless the Maryland Casualty Company from any loss sustained as a result of its bonding the construction jobs of the corporation. At the same time, Maryland Casualty Company agreed to increase the surety credit of the corporation from approximately $1,000,000 to $1,500,000 and to a total credit line of $2,000,000 for all jobs bonded by them. 427 F.2d at 281. In *Putman v. Commissioner*, 352 U.S. 82, 85 (1956), the Supreme Court held that the loss sustained by the guarantor unable to recover from the debtor is, by its very nature, a loss from the worthlessness of a debt. INT. REV. CODE OF 1954, § 166(f) provides specifically for a deduction for payments as a guarantor of a noncorporate obligation, the proceeds of which are used in debtor's trade or business, if the debt is worthless. Note 3 *supra*. *See also* Treas. Reg. § 1.166-8(b), T.D. 6403, 1959-2 CUM. BULL. 77, which deals with guaranty of a corporate debt.

[11]In *Putnam v. Commissioner*, 352 U.S. 83 (1956), the Supreme Court held that

> .... *instanter* upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes.

352 U.S. at 85. This time frame is important to a guarantor attempting to take a bad debt deduction because INT. REV. CODE OF 1954, § 166(a)(1) provides that the deduction is allowed in the year the debt becomes worthless. The Court in *Putnam* stated that the debt is an asset of full value in the creditor's hands because it is backed by a guaranty. Usually, the debtor is not able to reimburse the guarantor, and in such cases, the value is lost the instant the guarantor pays the creditor.

[12]The Internal Revenue Service disallowed the net operating loss carryback on the ground that taxpayer's payments to Maryland Casualty Company did not give rise to a business bad debt. 427 F.2d at 281. INT. REV. CODE OF 1954, § 172 provides that a taxpayer whose business deductions exceed his business gross income can carry the loss back three years and then forward five years. *See* 2 P-H 1970 FED. TAXES ¶ 14,560.

[13]Generes v. United States, CCH 1967-2 STAND. FED. TAX REP. ¶ 9754.

[14]325 F.2d 849 (2d Cir. 1963).

> [a] debt is *proximately related* to the taxpayer's trade or business when its creation was *significantly motivated* by the taxpayer's trade or business, and it is not rendered a nonbusiness debt merely because there was a non-qualifying motivation as well, even though the non-qualifying motivation was the primary one.[15]

The dissent advocated adopting the more stringent primary and dominant purpose test espoused by Chief Judge Lumbard's concurrance in *Weddle*[16] and adopted by the Seventh Circuit in *Niblock v. Commissioner*.[17]

Where the taxpayer-shareholder is a creditor of his own corporation, he can establish a proximate relation between the debt and his trade or business only if, under either test, he can first establish that his trade or business is distinct from that of the corporation.[18] Taxpayer's trade or business is not necessarily that of the corporation merely because he is employed by the corporation.[19] If he cannot qualify as a "promoter" or is not in the business of making loans,[20] he must

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[15]427 F.2d at 282 (emphasis added).

[16]325 F.2d at 852-53. Chief Judge Lumbard rejected the significant motivation test because he felt application of this test will always result in a judgment for taxpayer. He recognized the fact that where a shareholder-employee makes loans to the corporation, two fundamental motivations will be involved, that of protecting his salary interest and that of protecting his investment. He concluded that

> ...to measure the proximateness of the relationship between the loan and the taxpayer's status as a corporate employee by asking whether the latter provides a "significant"—although not dominant—motivation is to pose a question which invariably will be answered in the affirmative.

325 F.2d at 852.

The majority in *Weddle* imported the notion from tort law that a proximate cause may be "secondary to another contributing cause" to derive the significant motivation test. 325 F.2d at 851. Chief Judge Lumbard rejected this importation because proximate cause embodies objective factors, such as time, foreseeability, and space, that cannot apply in a dissection of different motivations toward a similar objective. 325 F.2d at 852.

[17]417 F.2d 1185 (7th Cir. 1969).

[18]In discussing the development of the meaning of "trade or business," the Court in *Whipple* held that taxpayer must demonstrate that he is engaged in a trade or business. Devoting one's time and energy to the affairs of the corporation, without more, is not a trade or business, because the taxpayer can be looking for a return on his investment. However, the Court did not hold that working for a corporation cannot be a trade or business, but warned that when taxpayer can establish a trade or business, care must be taken to distinguish bad debts arising from his own business and those arising from activities peculiar to an investor. 373 U.S. at 201-02.

[19]Whipple v. Commissioner, 373 U.S. 193, 202-04 (1963); Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961). *See also* Kelly v. Patterson, 331 F.2d 753 (5th Cir. 1964).

[20]Under the so-called "promoter doctrine," taxpayer can take a business bad debt deduction if he can show he is in the business of buying, developing, promoting and selling corporations. Whipple v. Commissioner, 373 U.S. 193, 202-03 (1963). For a

prove that the creation of the debt was essential to protect his job in the corporation.[21]

In spite of his corporate employment, the taxpayer who is a shareholder-creditor runs the risk that his advances to the corporation will be declared contributions to capital or nonbusiness bad debts, because they were made to protect his investment.[22] It is clear that if the debts are made purely for investment purposes, taxpayer may not take a business bad debt deduction under section 166,[23] because the debt fails to qualify as being "proximately related."[24] Consequently, the proximate relation of the debt to taxpayer's trade or business becomes difficult to establish when taxpayer has both a job in the corporation to

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discussion of the promoter doctrine see Note, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code*, 75 HARV. L. REV. 589, 592 (1962). Closely related to the promoter doctrine are cases that hold a taxpayer who is not in the business of making loans and financing corporations cannot take a business bad debt deduction. In *United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967), it was held that not only did taxpayer have to establish that he was involved in a continuous course of conduct of making loans, but that the particular loan involved must be "proximately related" to taxpayer's loan-making activities.

[21]*E.g.*, Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961), (holding that loans made by a corporate employee to an employer were "proximately related" to his trade or business where he would have been fired had he not made the loans). In *Weddle* and *Generes*, which relied on the *Trent* case, the corporate employees sought to be treated as though the corporation's demise was tantamount to their having been fired. This "constructive firing" approach is similar to that used in *J. T. Dorminey*, 26 T.C. 940 (1956) and *Tony Martin*, 25 T. C. 94 (1955). *See* Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949). *But see* United States v. Worrell, 398 F.2d 427 (5th Cir. 1968). For discussions of the *Trent* case see Comment, 37 N.Y.U.L. REV. 143 (1962); Comment, 39 N.D. L. REV. 121 (1963); Note, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code*, 75 HARV. L. REV. 589, 595 (1962).

[22]An individual shareholder is not engaged in a trade or business by virtue of his investment. Higgins v. United States, 312 U.S. 212 (1941). If taxpayer were making the loans to protect his investment there could be no proximate relation between the debt and taxpayer's trade or business because there would be no trade or business. If the taxpayer is looking only for a return on his capital through dividends, interest or other gain, he will be treated as an investor. Whipple v. Commissioner, 373 U.S. 193, 202 (1963); United States v. Worrell, 398 F.2d 427 (5th Cir. 1968); Kelly v. Patterson, 331 F.2d 753, 757 (5th Cir. 1965); United States v. Byck, 325 F.2d 551 (5th Cir. 1963).

[23]Whipple v. Commissioner, 373 U.S. 193, 202 (1963). Many taxpayers argue, in the alternative, that if the loss is not deductible as a business bad debt, it is deductible under INT. REV. CODE OF 1954, § 165(c)(2) as a loss from a transaction entered into for profit, though not connected with a trade or business. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934), held that code provisions for losses and those for bad debts are mutually exclusive. *Accord*, Putnam v. Commissioner, 352 U.S. 82, 87 (1956). *See* Stratmore v. United States, 420 F.2d 461 (3d Cir. 1970). *See also* Walsh v. Commissioner, 313 F.2d 389 (4th Cir. 1963); United States v. Keller, 308 F.2d 424 (9th Cir. 1962); Spillers v. Commissioner, 407 F.2d 530 (5th Cir. 1969).

[24]Note 22 *supra*.

protect as well as an investment in the corporation to manage.[25] Evidence of investment management militates against evidence of job protection so that a problem arises as to what degree of motivation can be attributed to investment management before taxpayer will be disqualified for a business bad debt deduction.

Accordingly, in *Trent v. Commissioner*,[26] where taxpayer was a minority shareholder and the possibility of investment management slight, the court concerned itself with taxpayer's corporate employment and allowed a business bad debt deduction. However, under *Weddle* and *Generes*, where the possibility of investment management is great, it would not matter how much motivation is attributed to investment management so long as taxpayer could show "significant motivation" in protecting his employment;[27] and that but for his advances to the corporation, taxpayer would have lost his job.[28] To the contrary is the primary and dominant purpose test adopted in *Niblock*,[29] and advocated by the dissent in *Generes*, under which the taxpayer must show that his primary and dominant purpose in extending a loan to his corporation was to protect his employment.[30] Both the dissent in *Generes* and the majority in *Niblock* relied on the concurring opinion in *Weddle*, which emphasized the necessity of distinguishing bad debts arising in taxpayer's own business from bad debts arising out of activities peculiar to an investor concerned with corporate business.[31] The

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[25]*See* Whipple v. Commissioner, 373 U.S. at 204.

[26]291 F.2d 669 (2d Cir. 1961).

[27]United States v. Generes, 427 F.2d 279, 283 (5th Cir. 1970).

[28]In the *Trent* case, taxpayer proved he was fired for refusing to make further loans to his corporation. By the same token, the court in the *Generes* case stated that the corporation would have ceased to exist without taxpayer's guarantee. However, in *Weddle*, taxpayer was not allowed a business bad debt deduction because it was shown that taxpayer's guarantee of the loan was not made to preserve his corporate employment; but rather that the loan was obtained at the same time the corporation agreed to purchase taxpayer's daughter's stock in the corporation. 325 F.2d at 852. *But see* Treas. Reg. § 1.166-5(b), T.D. 6403, 1959-2 CUM. BULL. 77. which states that the use to which borrowed funds are put is of no consequence in determining if the relation is proximate.

[29]417 F.2d 1185 (7th Cir. 1969).

[30]Although a court examines the motive involved in creating the debt, the relation that prompted that motive must also exist at the time the debt becomes worthless under the proximate relation test. Treas. Reg. § 1.166-5(b)(2), T.D. 6403, 1959-2 CUM. BULL. 77. *See* Hickerson v. Commissioner, 229 F.2d 631 (2d Cir. 1956). Because of the problems involved in determining when a debt is worthless, a fact that may not be known until some time after it has become worthless, INT. REV. CODE OF 1954, § 6511(d) provides for a special seven-year statute of limitations for claims for refund based on a deduction of bad debts, in lieu of the three-year period otherwise provided for in section 6511. For a discussion of worthlessness in relation to bad debt reserves see Hogan, *The Allowance of Bad Debts: A Look Forward and Backward*, 13 TUL. TAX. INST. 369 (1964).

[31]325 F.2d at 852.

alternative significant motivation test would invariably result in a judgment for the taxpayer and is too vague and ambivalent a test.[32]

It seems that the primary and dominant purpose test requires the finder of fact to compare, balance, and select that motive which, more than any other, moved the taxpayer to advance money to the corporation. Under this test, the sole or dominant shareholder in a close corporation who advances money to the corporation would have difficulty in proving his proximate relation. There is usually little doubt that he desires, at least in part, to protect his investment.[33] Unless taxpayer in this situation can get alternative relief through a Subchapter S election,[34] or a Section 1244 stock provision,[35] he will probably not be able to get a deduction for the full amount of his worthless debt.[36]

In contrast to the primary and dominant purpose test, the signifi-

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[32]*Id.* at 853. Also, in *Generes* and *Niblock* the advocates of the primary and dominant purpose test stated that it is the only test that offers certainty without explaining how. Chief Judge Lumbard in *Weddle* stated that there are no scales sufficiently sensitive to be able to ascertain the exact percentage of motivation. Therefore, he concluded that the court must look for the "main and dominant" reason for taxpayer's action. 325 F.2d at 852.

[33]*Id.* at 852 (concurring opinion of Chief Judge Lumbard).

[34]INT. REV. CODE OF 1954, §§ 1371-77. For a discussion of losses under Subchapter S see Chester, *Subchapter S: Operations and Procedure,* 48 TAXES 592 (1970); Lourie, *Subchapter S After Three Years of Operation,* 18 TAX. L. REV. 99, 114-15 (1962). Section 1374 provides that losses to an electing corporation are treated as though they were incurred in a proprietorship, which means the losses would pass through to taxpayer on his individual return. A taxpayer in the *Generes* situation could get relief under this section. *See* REV. RUL. 70-50, 1970 INT. REV. BULL. No. 5, at 9.

[35]INT. REV. CODE OF 1954, § 1244 provides that a loss of section 1244 stock issued to a qualifying individual which would ordinarily be treated as a capital loss is treated as an ordinary loss. *See* Calkins, *How To Use Subchapter S and Section 1244 Without Running Into Trouble,* 15 WEST. RES. L. REV. 349 (1964). *See also* Spillers v. Commissioner, 407 F.2d 530 (5th Cir. 1969).

[36]If allowed a nonbusiness bad debt deduction, the amount of the deduction would be limited by INT. REV. CODE OF 1954, § 1211, under which the most taxpayer could set off against ordinary income would be $1000. However, there is no limit on the number of years available for a carryover of excess net capital loss under section 1212(b). Part of the policy behind limiting the nonbusiness bad debt deduction to a short term capital loss is that investments and transactions entered into for profit fall short of the concept of a trade or business and thus do not warrant as favorable treatment as losses incurred in a trade or business. *See* Whipple v. Commissioner, 373 U.S. 193 (1963); Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963). The distinction between investment and trade or business is often difficult to discern for a shareholder-employee in a close corporation because the motivations of the shareholder-employee cannot be divided easily between investment and business. In cases where both motivations are strong, characterization of a bad debt as investment motivated or business motivated is not accurate. Subchapter S and Section 1244 Stock show an effort by Congress not to saddle small business corporations with classifications and consequences of the large public corporate form. This type of flexibility should be reflected in the bad debt area. Note 56 *infra.*

cant motivation test requires from the taxpayer a lesser burden of proof and gives a deduction to close corporation shareholders where deductions previously have not been available.[37] To be proximately related to taxpayer's trade or business under *Generes,* his debt must be created with the motivation of preserving the taxpayer's trade or business of being a corporate employee.[38] This test seems to disregard whatever other motivations the taxpayer may have had. Yet, it should be noted that in *Generes* there was undisputed evidence that without the taxpayer's guarantee[39] the corporation would have ceased to exist, and the taxpayer would have lost his job.[40] Therefore, the facts bring *Generes* within situations contemplated in *Trent.*[41]

However, in *Stratmore v. United States,*[42] in a situation analogous to that in *Generes,* the taxpayers were guarantors of notes issued by corporations of which they were shareholders and officers. A business bad debt deduction was disallowed because taxpayers failed to meet even the weak significant motivation test. In that case, without the taxpayers' loans for debt securities, the corporation would have become insolvent, terminating the employment of taxpayers. However, despite the employment protection motivation, there was no evidence as to taxpayers' salary[43] to determine proximate relation, and there was no finding by the trial court as to either taxpayers' degree of investment or the amount of stock held by the taxpayers in the corporation.

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[37] *See* Note, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code,* 75 HARV. L. REV. 589 (1962); note 16 *supra.*

[38] The *Generes* court, relying on *Trent,* stated:

> ...if...the jury could have reasonably concluded that the taxpayer's endorsement was motivated by a desire to preserve his business of being a corporate employee the jury could have properly determined that the bad debt was proximately connected with taxpayer's trade or business.

427 F.2d at 283.

[39] Cases cited notes 7 and 16 *supra.*

[40] This would amount to a "constructive firing" under the *Trent* doctrine. Note 16 *supra.*

[41] 291 F.2d 669 (2d Cir. 1961). *Weddle v. Commissioner,* 325 F.2d 849, 851 (2d Cir. 1963) stated that the fact that Mrs. Weddle, unlike Trent, did not have to fear being fired by a superior was not at all conclusive as to what she was trying to protect; she would have been fired soon enough if the corporation ceased operation. The Fifth Circuit in *Kelly v. Patterson,* 331 F.2d 753, 756 (5th Cir. 1964), pointed out that the taxpayer in *Trent* was a minority shareholder seeking to save his job, but that *Weddle* extended *Trent* to majority shareholders where job protection motivation could be shown to be significant.

[42] 420 F.2d 461 (3d Cir. 1970).

[43] 420 F.2d at 463-64. Taxpayers did not provide any evidence as to the amounts of their salaries, which the Court said made it impossible to evaluate the importance of salary maintenance and increase. However, the facts were stipulated that without the loans guaranteed by taxpayers, taxpayers' salaries as well as the corporation would have ceased to exist.

The *Stratmore* court refused to adopt either motivation test,[44] but implied it would prefer to balance taxpayers' salaries against taxpayers' proprietary interests in the corporation in order to determine their motives.[45] However, the entire court in *Weddle* rejected this balancing approach as inconclusive, particularly in light of the many considerations involved in setting an officer's salary in a close corporation.[46] If a balancing comparison is appropriate at all, it would seem more appropriate in a primary and dominant purpose test where motives are also compared and weighed against each other.

The effect of *Generes,* if followed, will be to lessen the burden of proof for taxpayers who are shareholder-creditors in a close corporation, and who cannot use Subchapter S or the Section 1244 provisions to deduct their losses.[47] The holding of the case appears to require only that taxpayer must show that he was motivated by a desire to protect his corporate employment. However, taxpayers who wish to rely on *Generes* run the risk of having their bad debt deduction distinguished on the facts, because evidence was offered that taxpayer had to guarantee the bonds to keep the corporation in business.[48] It is not clear how far *Trent* and *Weddle* have been extended by *Generes,* but the holding in the principal case shows an effort on the part of the Fifth

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[44]420 F.2d at 463.

[45]The Court did not say the comparison would be conclusive but:

> Certainly, where both proprietary and employee motivation are admittedly present, the extent of the proprietary motivation is most relevant in determining whether there was a "significant" employee motivation.

Id. at 463.

The dissent in *Stratmore* agreed that the comparison of proprietary and employee motivation is important. Taxpayer must produce evidence negating the possibility that investment considerations were so important that the transaction would have been undertaken even without business considerations. *Id.* at 469.

[46]325 F.2d at 851, 853.

[47]Notes 34 and 35 *supra.*

[48]427 F.2d at 284. In *Weddle* the deduction was not allowed at least partly because the money from the loan had been used to purchase taxpayer's daughter's stock in the corporation.

The Supreme Court in *Whipple* effectively overruled the line of cases represented by *Maytag v. United States.* 289 F.2d 647 (Ct. Cl. 1961), and *Mays v. Commissioner,* 272 F.2d 788 (6th Cir. 1959), wherein taxpayers were allowed business bad debt deductions, when they were active in carrying out jobs with the corporations and looking to future improved salary by their advances. See Note, *Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code,* 75 HARV. L. REV. 589 (1962) for discussion of *Mays* and *Maytag.* It seems that *Stratmore* would more suitably fall under this line of cases because the stipulated facts stated taxpayer was looking to future salary when the loan was made.

Circuit to make it easier for a taxpayer to take a business bad debt deduction.[49]

The controversy over the proximate relation test has evolved from a dispute as to whether a shareholder-employee could be in a trade or business, as in *Trent,* to a dispute as to how much weight should be given to taxpayer's investment interests when he is a corporate employee. Even so, there is one underlying characteristic that is common to the different approaches to proximate relation—the debt was necessary to keep the trade or business functioning.[50]

Generes is significant in the evolution of the proximate relation test because it reinforces the trend away from the older criteria of establishing either that taxpayer was in the business of buying and selling corporations under the promoter doctrine or that taxpayer was in the business of making loans. Instead, *Generes* tends toward a more flexible view of debts made in connection with taxpayer's trade or business. However, in *Whipple v. Commissioner,*[51] the Supreme Court indicated a limit to the liberal development of the proximate relation test by effectively overruling such cases as *Mays v. Commissioner.*[52] There the taxpayer invested in a number of business ventures incident to his own trade or business for the purpose of creating future income, and was allowed a business bad debt deduction for losses incurred through these loans. The Supreme Court in *Whipple,* however, did approve business bad debt deductions such as that allowed in *J. T. Dorminey,*[53] where taxpayer lent money to an importer in which he held stock, to ensure his wholesale produce business a source of bananas. Without taxpayer's loans there would have been no source of bananas available to taxpayer. Thus, *Whipple* approved of business bad debt deductions where taxpayer is protecting existing income but not where taxpayer is seeking future income.[54]

An alternative solution to the *Generes* business bad debt problem would be to apportion the debt. As the law now stands, the entire amount of the debt put in issue is either allowed as a business bad debt deduction or disallowed as a nonbusiness bad debt deduction. It appears

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[49]The court in *Generes* interpreted *Whipple* as precluding imposition on the taxpayer of proof of dominant motivation. *But see* Niblock v. Commissioner, 417 F.2d 1185, 1187 (7th Cir. 1969).

[50]In *Trent,* taxpayer was fired. In *J. T. Dorminey,* 26 T.C. 940 (1956), taxpayer would have lost his supply of produce. In *Weddle* it was pointed out that Mrs. Weddle would have lost her job. In *Generes* taxpayer would have suffered a "constructive firing."

[51]373 U.S. 193 (1963).

[52]272 F.2d 788 (6th Cir. 1959).

[53]26 T.C. 940 (1956).

[54]373 U.S. at 203.

possible to apportion the debt between the amount required to meet the corporate operating expenses and the amount attributable to capital improvements or increase in equity.[55] This apportionment can be implemented by judicial construction of section 166 of the Internal Revenue Code of 1954, holding that section 166(d)(1) and section 166(d)(2) are mutually exclusive only to the extent that portions of a debt attributable to one section are not attributable to the other.[56] Apportioning indebtedness in this manner would require looking to the application of the proceeds of the loan,[57] and would tend to make the proximate relation test totally objective[58] by shifting the emphasis from an examination of motives to an examination of surrounding facts.

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[55]The Supreme Court in *Whipple* refused to consider cases such as *Trent*, but this has been interpreted to mean approval of situations as in *Trent*. *See* United States v. Generes, 427 F.2d 279 (5th Cir. 1970). It appears, then, that most courts would allow a business bad debt deduction in the *Trent* situation and disallow a deduction in the *Weddle* situation. Thus, for example, if a taxpayer made two loans in two different years to the same corporation, one under *Trent* circumstances, the second under *Weddle* circumstances, the first bad debt would probably be allowed as a business bad debt deduction and the second disallowed.

It seems that in a case like *Generes* where there is only one loan, divisible by motivation into two categories, the loan can be apportioned. Under INT. REV. CODE OF 1954, § 274(a)(1)(B), an entertainment facility used primarily in furtherance of taxpayer's trade or business is deductible to the extent it is related to the trade or business under section 162, if it first qualifies under section 162. Here is an effort to apportion an expense between business and personal use. This is an easier problem because time can be the yardstick to measure the use for business aside from motivation and other evidence such as extravagance. *Cf.* TREAS. REG. § 1.274-1 (1954), T.D. 6659, 1963-2 CUM. BULL. 113.

Also, in the analogous case of an office in the home of taxpayer that is used partially for business and partially for pleasure, the deduction is limited by apportioning the use devoted to business and that devoted to personal purposes. *See generally* 2 P-H 1970 FED. TAXES ¶ 11,519.

[56]The effect of this holding would be to treat an indebtedness created by a shareholder-employee as two separate debts. INT. REV. CODE OF 1954, § 166(d) speaks in terms of "a debt." This language does not prohibit apportionment of indebtedness because the substance of a transaction is determinative for tax purposes and not form. *See, e.g., Tomlinson v. 1661 Corp.*, 377 F.2d 291, 296 (5th Cir. 1967). If the form of the transaction were ignored, examination of the substance of the transaction would result in recognition of two debts, one created by an investor, the other created by a corporate employee. If this type of apportionment were adopted it would have to be applied in all cases involving shareholder-employees except where taxpayer or the government could show one interest to be so insignificant as to be indeterminable. The practical application of this apportionment theory would require taxpayer to show significant motivation to protect his job before he would be entitled to apportionment.

[57]Treas. Reg. § 1.166-5(b)(2), T.D. 6728 (1964) states that the use to which the proceeds of the loans are put is of no consequence in determining the "proximate relation." *But see* note 28 *supra*.

[58]In *Generes* much of the refusal of the circuit court to upset the district court's finding was based on self-serving testimony of the taxpayer. 427 F.2d at 283-84. *But see* Imbesi v. Commissioner, 361 F.2d 640, 644-45 (3d Cir. 1966).