Buffalo Law Review

Volume 13 | Number 3 Article 11

4-1-1964

Taxation—Bad Debts: Limitations of the "Promoter Doctrine"

Ronald B. Felman

is not logical to include defendants and not agents, employees, etc., of parties. If a restricted rule is deemed desirable under the inviolability of the person policy, then it should be applicable to plaintiffs alone, since the reason for the strict approach—the sanctity of the body and mind—allows for the examination of plaintiffs alone via the "waiver" theory. The Supreme Court, therefore, should have either accepted the recommendations of the Advisory Committee, or it should have removed defendants from the coverage of the Rule.

PETER H. BICKFORD

TAXATION—BAD DEBTS: LIMITATIONS OF THE "PROMOTER DOCTRINE"

A stockholder will often advance loans to his corporation in order to facilitate its expansion or in order to maintain its operation. Although it is not a very frequent occurrence in the case of large, widely held corporations, such advances are very common among shareholders of closely held corporations. The shareholder-creditor is usually a small entrepreneur, operating his business in the corporate form. As is often the case, ensuing financial difficulties prevent the corporation from paying these loans. Subsequently, the shareholder-creditor will seek a business bad debt deduction from his gross income. He can, however, take an ordinary deduction, as distinguished from a capital loss deduction, only if he can show that his advances to the corporation were genuine loans within the context of section 166(a) of the Code, i.e., that the debt became worthless during the taxable year, and that the debt was incurred in his trade or business.[1] The latter requirement has been the subject of substantial litigation and is the subject now under consideration.

During the ten year period prior to his establishment of the Mission Orange Bottling Co. of Lubbock, Inc., Whipple, the taxpayer in instant case,[2] was instrumental in the organization of numerous partnerships and corporations.[3] In 1951, shortly before he established Mission Orange, Whipple secured

1. Int. Rev. Code of 1954, § 166: Bad Debts.
(a) General Rule.—
(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
. . . .
(d) Nonbusiness Debts.—
(1) General Rule.—In the case of a taxpayer other than a corporation— . . .
(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 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. Whipple v. Commissioner, 373 U.S. 193 (1963).
3. In 1941 Whipple was a member of a series of partnerships engaged in either the

a franchise from the Mission Dry Corporation, entitling him to produce, bottle and distribute a soft drink. The taxpayer then purchased the assets of a bottling business and conducted it pursuant to his franchise as a sole proprietorship for approximately two months. Thereafter, he sold the bottling equipment to Mission Orange. He owned approximately 80 per cent of the outstanding shares of this corporation.[4] During the following year he acquired a tract of land, constructed a bottling plant upon it and leased it to Mission Orange. In that same year, 1952, the taxpayer advanced cash to Mission Orange despite the fact that it still owed him a substantial amount from the purchase of the bottling equipment the year before. Again in 1953, Whipple loaned additional sums to Mission Orange and on December 1, 1953 the total due to him was $79,489.76. Within two weeks another $48,000 was advanced to the corporation, for which he received a transfer of the corporation's assets having a book value of $70,-414.66. After this transfer the corporation was still indebted to Whipple for approximately $57,000. This became worthless in 1953. During the entire existence of the corporation the taxpayer never collected a salary nor interest on the loans. There was, however, some evidence that he was owed rent under the lease. Whipple did receive such income from his other corporations.[5]

Whipple deducted the worthless debt as a business bad debt in his return for 1953, but the Commissioner assessed deficiencies against him on the ground that the debt was a nonbusiness bad debt. This was affirmed through the lower courts.[6] On final determination, the Supreme Court held than an individual taxpayer is not authorized to take an ordinary deduction for a worthless loan to a corporation to which he devotes his full time and energies unless his loan to the corporation can be characterized as incurred in his trade or business.[7]

construction or construction supply business. During 1949 and 1950 he was an original incorporator of seven corporations which he sold later in 1950 along with five others. In 1951 and 1952 he formed eight new corporations, one of which was the Mission Orange Bottling Co. of Lubbock, Inc., bought the stock of a corporation known as Mason Root Beer and acquired and disposed of a restaurant and participated in a related vending machine business. From 1951 to 1953 he also bought and sold land, acquired and disposed of a restaurant and participated in several oil ventures.

4. Whipple v. Commissioner, 373 U.S. 193, 196 n.4 (1963): "At the time Mission Orange was organized [Whipple] was issued 88% of the outstanding shares. The charter was amended in December of 1952 to authorize additional capital stock which, when subsequently issued, reduced his interest in the corporation to 77%. Sometime before the end of 1953, [Whipple] increased his holdings to about 79.5% of the outstanding shares."

5. *Id.* at 196 n.5: "He collected interest totaling $1,680.15 in 1951, $2,285.35 in 1952 and $1,747.59 in 1953; rental income of $15,570.78 in 1952 and $12,225.19 in 1953; and salaries totaling $29,400 for 1952 and $33,450 for 1953."

6. The Tax Court, 19 CCH Tax Ct. Mem. 187 (1960), after determining that the taxpayer was not in the business of organizing, promoting, managing or forming corporations, of bottling soft drinks, or of general financing and money lending sustained the deficiencies. The Court of Appeals, 301 F.2d 108 (5th Cir. 1962), by a divided court, affirmed. Certiorari was granted, 371 U.S. 875 (1962), by the Supreme Court upon a claim of conflict.

7. Whipple v. Commissioner, 373 U.S. 193, 203 (1963): "[S]ince . . . there was no intention here of developing the corporations as going businesses for sale to customers in the ordinary course, the case before us inexorably rests upon the claim that one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises is in a trade or business. That argument is untenable . . . and we reject it."

The Court stated that ". . . furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business . . ."[8] for bad debt purposes.[9]

Congress has dealt differently with the taxpayer in his business and nonbusiness capacities. In the latter capacity he is permitted only certain deductions from his gross income. Thus, the individual as a nonbusiness taxpayer is authorized to take deductions for various expenses such as: medical expenses,[10] charitable contributions,[11] interest[12] and taxes.[13] The majority of personal expenses such as food, clothing and shelter are not deductible.[14] In contrast are the expenses incurred by the taxpayer in his trade or business or in his profit seeking activities, where Congress has chosen to allow ordinary treatment for all expenses and business connected bad debt loss.

The statutory framework for allowing the taxpayer deductions for his cost of earning a living consists of three principal provisions. First, he is allowed to deduct all the ordinary and necessary expenses incurred in his trade or business,[15] whereas the nonbusiness taxpayer's deductions are limited to those which are expressly provided for in the Code.[16] Secondly, all the ordinary and necessary expenses incurred for the production of income or for the management, conservation or maintenance of property held for the production of income are deductible against ordinary income.[17] Finally, any business loss not compensated by insurance or otherwise is deductible from ordinary income.[18]

The business-nonbusiness dichotomy has been incorporated within the bad debt section of the Code. Before 1943 all bad debts, personal or otherwise, were deductible from ordinary income[19] but since that time only business bad debts have been allowed ordinary treatment, whereas nonbusiness bad debts are treated as short term capital losses. As a consequence of the more favored treatment of business bad debts the shareholder-creditor has struggled to fit his bad debt losses within that category. The bad debt section defines a business bad debt as a debt created in connection with the taxpayer's trade or business, or a debt, the loss from the worthlessness of which is incurred in the taxpayer's trade or business.[20] Thus, the shareholder-creditor is presented with the task of fitting the activity which resulted in a bad debt into the context of the phrase "trade or business."

8. *Id.* at 203.
9. See Int. Rev. Code of 1954, § 166, reprinted in part at note 1, *supra.*
10. Int. Rev. Code of 1954, § 213.
11. Int. Rev. Code of 1954, § 170.
12. Int. Rev. Code of 1954, § 163.
13. Int. Rev. Code of 1954, § 164.
14. Int. Rev. Code of 1954, § 262.
15. Int. Rev. Code of 1954, § 162.
16. Int. Rev. Code of 1954, §§ 261, 262.
17. Int. Rev. Code of 1954, § 212.
18. Int. Rev. Code of 1954, §§ 165(a) & (c)(1).
19. Revenue Act of 1913, § II B, 38 Stat. 167. The distinction between business and nonbusiness was added by Revenue Act of 1943 as § 23(k)(4), 53 Stat. 821 (1942).
20. Treas. Reg. § 1.166-5 (1963).

The ultimate issue is whether a shareholder-creditor, who actively engages in organizing, managing and financing enterprises, is acting in a trade or business separate and distinct from the business conducted by the corporation when he advances loans to those enterprises. Is the fact that a taxpayer who spends his time promoting enterprises sufficient by itself to establish the existence of a trade or business of promoting corporations which would permit him to take a business, rather than nonbusiness deduction for advances to those corporations when those loans become worthless? Before reaching this question a brief coverage of the circumstances surrounding the 1943 amendments to the bad debt section is in order.

Prior to the Revenue Act of 1943 only expenses incurred in one's trade or business—as distinguished from expenses incurred in one's profit seeking activities—were deductible. Therefore, in 1941, when the *Higgins* case[21] came before the courts it was essential for the taxpayer to show that his expenses were incurred in his trade or business in order to be allowed a deduction. In that case the taxpayer held extensive investments in stocks and bonds, requiring an office and a staff of assistants to aid him in accumulating and shifting his investments. The taxpayer asserted that the salaries and expenses incident to caring for these investments were deductible as expenses incurred in what he considered a trade or business, speculation. The Supreme Court, however, upheld the determination that the phrase "trade or business" was not broad enough to cover the expense of managing one's investments in stocks and bonds. Thus, private investment does not constitute a trade or business.[22]

Congress recognized that the courts had created a new category of activities with fully taxable income but non-deductible expenses. In order to correct this Congress enacted the provision providing for deductibility of expenses incurred in one's profit seeking activities.[23] Concurrent with this enactment, Congress amended the bad debt section, which had previously provided for full deductibility of all bad debts, to provide for short term capital loss treatment for nonbusiness bad debts. Determining whether or not a debt is incurred in a trade or business is a question of fact.[24] The criteria employed to determine this question are substantially the same as those used for determining whether a loss is incurred in a trade or business.[25] Since the loss section distinguishes between losses incurred in one's trade or business and losses incurred in a transaction entered into for profit though not connected with the trade or business,[26] it seems that a somewhat similar distinction was also made in the bad debt section where that section distinguishes between business and non-

21. Higgins v. Commissioner, 312 U.S. 212 (1941), *affirming*, 39 B.T.A. 1005 (1939).
22. *Ibid.*
23. House Ways & Means Comm., H.R. Rep. No. 2333, 77th Cong., 1st Sess. 373 (1942).
24. I Seidman, Legislative History of Federal Income and Excess Profits Tax, Laws 1953-1939, 1353 (1954); H.R. Rep. No. 2333, 77th Cong., 2d Sess. 76 (1942).
25. *Ibid.*
26. *Compare* Int. Rev. Code of 1954, § 165(c)(1), *with* § 165(c)(2).

business bad debts. Debts incurred in transactions entered into for profit but not connected with a trade or business are to be treated as nonbusiness debts, rather than business bad debts. For the purpose of determining whether the debt is or is not incurred in the taxpayer's trade or business

> [t]he character of the debt . . . is not controlled by the circumstances attending its creation . . . but is to be determined rather 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 is not a nonbusiness debt for the purposes of this amendment.[27]

Thus we are brought to the ultimate issue of this paper: under what circumstances are a shareholder-creditor's bad debts afforded the ordinary deduction as a business bad debt and when are they limited to a capital loss deduction as a nonbusiness bad debt?

In the past there have been several theories under which a shareholder-creditor could deduct a bad debt as one incurred in a trade or business. First, and most recently, where an employee-shareholder is required to advance loans to the corporation as a condition of his employment (in order to retain his job) such loans have been held to have been created in connection with his trade or business.[28] By this decision the court equated the term "employment" with the term "trade or business."

Secondly is the "lender doctrine," where in order to qualify for business bad debt treatment the lender is required to show that he is in the business of lending money.[29] However, it has been held by the Tax Court

> on numerous occasions that the right to deduct bad debts as business losses is applicable only to the exceptional situations where the taxpayer's activities in making loans have been regarded as so extensive and continuous as to elevate that activity to the status of a separate business.[30]

It has not yet been held that a taxpayer becomes engaged in the business of lending money when he makes a single loan for the purpose of realizing interest. Some cases, however, indicate that other factors in addition to the frequency of loans may be important in determining this question.[31]

Thirdly is the "separate business entity doctrine." A shareholder's loans to his corporation are given business bad debt treatment when found to be essential to the operation of the taxpayer's separate business or made in con-

27. I Seidman, *op. cit. supra* note 24.
28. Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961), *reversing* 34 T.C. 910 (1960).
29. Estate of Morris H. Cone, P.H. 1954 T.C. Mem. Dec. ¶ 54162; *accord*, Commissioner v. Smith, 203 F.2d 313 (2d Cir. 1953).
30. Stuart M. Sales, 37 T.C. 576, 580 (1961).
31. *E.g.*, Lloyd E. Mangrum, 29 P-H Tax Ct. Mem. 778 (1960). (Here the court considered the taxpayer's motive in determining whether the loans were incident to his trade or business.)

nection with it.[32] In the leading case on this doctrine, the Court held that a corporation and its shareholders are usually regarded "as separate entities [and] only under exceptional circumstances . . . can the difference be disregarded."[33] In that case, the Court found that the taxpayer, in the management of the corporation's business, was managing a business which was not his own; the business which the taxpayer managed was that of the corporation. Thus the Court treated the managers of a corporation and the corporation's shareholders as separate entities. Therefore, a loan made with the intent to benefit one's own business is to be distinguished from one which is made to protect the taxpayer's investment in the corporation to which he is loaning. In the latter situation business bad debt treatment is denied.[34]

Finally, in the "promoter doctrine,"[35] the courts directed their inquiry to whether or not the taxpayer was in the trade or business of promoting business enterprises, not whether he was in the trade or business of lending money. Promoting business ventures has been held to be a trade or business in the

> exceptional situations where the taxpayer's activities in promoting, financing, managing, and making loans to a number of corporations have been regarded as so extensive as to constitute a business separate and distinct from the business carried on by the corporations themselves.[36]

Thus it appears that the frequency test, described above in relation to the "lender doctrine," has had equal importance in connection with the "promoter doctrine." However, it also appears that the test would operate differently in connection with the "promoter doctrine." Despite the fact that in order to qualify as being in the business of promoting enterprises, the taxpayer had to involve his time, effort and money in more than one corporation,[37] it seems that it would be sufficient for even a single loan to one of these enterprises to be recognized as incident to the taxpayer's business of promoting. Therefore under the "promoter doctrine," even a single loan incident to the

32. Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949); Cowden v. Commissioner, 34 T.C. 819 (1960) (the loans in these cases were proximately related to the taxpayer's own business); Levine v. Commissioner, 31 T.C. 1121 (1959); Martin v. Commissioner, 25 T.C. 94 (1955).

33. Burnet v. Clark, 287 U.S. 410, 415 (1932), *reversing*, 19 B.T.A. 859 (1930); *accord*, Dalton v. Bowers, 287 U.S. 404 (1932), *affirming*, 56 F.2d 16 (2d Cir. 1932). (Here the court stated that holding all the corporate stock was not the "special circumstances.")

34. See Gulledge v. Commissioner, 249 F.2d 225 (4th Cir. 1957), *cert. denied*, 356 U.S. 959 (1958).

35. The "Promoter Doctrine" appears to have been used first in relation to trade or business *losses* (Washburn v. Commissioner, 51 F.2d 949 (8th Cir. 1931)), and again with respect to trade or business *expenses* (Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935)). In these cases the courts inquired whether the activities of the taxpayers, who actively participated in the management of the corporations in which they had controlling interests, could be recognized as a trade or business; they held in the affirmative.

36. Berwind v. Commissioner, 20 T.C. 808, 815 (1953), *aff'd per curiam*, 211 F.2d 575 (3d Cir. 1954).

37. *Compare* Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) (12 corporations in 20 years held sufficient), *with* J. Terry Huffstutler, 23 P-H Tax Ct. Mem. ¶ 54000 (1953) (4 corporations in 5 years held insufficient). Therefore it is difficult to determine that lowest rate necessary to meet the frequency test.

business of promoting corporations could be a business loan even though the taxpayer was not engaged in the trade or business of lending.

Although the instant case does not focus its attention on the first three theories above, it appears to have serious consequences for the future of the "promoter doctrine" as a basis for treating one's bad debts as incurred in a trade or business. In an attempt to illustrate the significance of *Whipple* and in order to understand its impact upon shareholder-creditors it is essential to examine the major cases prior to this recent Supreme Court decision. The first cases in which the forerunner to the present bad debt section was invoked by the Commissioner in an attempt to limit the bad debts to a capital loss resulted in his defeat.[38] *Cluett* serves as a convenient place at which to begin.[39] In that case the taxpayer owned a seat on the New York Stock Exchange, which he held in addition to his activities as a partner for several brokerage firms. In his partnership capacity, and due to his ownership of the seat on the Exchange, he bought and sold securities for these partnerships. Following the Exchange's increase in membership he sold his share of a newly acquired membership for which he received a promissory note in partial satisfaction for the transfer. The balance of the note became worthless following his receipt of approximately one-sixth of its value. Although his sale might not have been proximately related to the brokerage firms' business, the Tax Court reasoned that it was related to his own business of owning and using a membership on the Stock Exchange for the production of income. Therefore, the court held that the debt arose from and the loss was incurred in the course of that business.

Although *Cluett* was not concerned with a stockholder's loan to his corporation, it is worth noting in the light of subsequent decisions where stockholders did advance loans to their corporations. It gave recognition to the notion that a taxpayer's own activities could qualify as a business, even though those very same activities were also connected to a business which might not qualify as the taxpayer's within the meaning of the nonbusiness bad debt section.[40] In a later case which did involve advances by the sole shareholder to his corporation this same logic was applied.[41] The taxpayer in that case leased property to the corporation. About two-thirds of his time was spent as a corporate officer; the remainder of his time was spent in performing services of a landlord. The lease obligated the taxpayer to provide the corporate finances. These facts led the court to conclude that the taxpayer's loss was incurred in his own business of acquiring, owning, expanding and leasing and not in connection with the business of the corporation. In the case of *Vincent C. Campbell*[42] the taxpayer

38. Cluett v. Commissioner, 8 T.C. 1178 (1947); Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949), *affirming*, 47-2 USTC ¶ 9347 (1947).
39. Cluett v. Commissioner, *supra* note 38.
40. See Holland, *Tax Effect of Stockholder Loans to Corporations*, in 9th Annual N.Y.U. Institute on Federal Taxation 1083, 1105 (1951).
41. Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949).
42. 11 T.C. 510 (1948).

organized, owned and operated retail coal corporations for approximately fifteen years. It was found to be a part of the business of the taxpayer to advance money to his corporations. Therefore, a business bad debt deduction was allowed with respect to the advances he made to one of his twelve corporations. The court held that the loss was a direct result of and incurred in the taxpayers business of organizing and operating corporations in the retail coal business. Within twelve years of *Campbell* another case was decided which involved a taxpayer who invested in a variety of ventures over a lengthy period.[43] Most of them were unprofitable. When the taxpayer sought to deduct a loan to one of these corporations as a business bad debt he was allowed a full deduction for its worthlessness. The court reasoned that the taxpayer's investments, varied as they were, were so frequent and regular that they amounted to his own business. In yet another case, the taxpayer was allowed a business bad debt deduction for a loan he made to a close corporation which became worthless, because the court found that the taxpayer's business was that of exploiting patents.[44] Such finding was grounded on the basis of the taxpayer's many investments in and management of corporations formed for the purpose of patent exploitation. Cases such as these increased the shareholder-creditor's optimism in seeking business bad debt deductions for worthless loans to corporations on the basis of being in the business or organizing, managing and financing coporations, i.e. the "promoter doctrine."

In 1954, however, *Commissioner v. Smith* was decided.[45] Its holding was contrary to this line of decisions. Smith invested in several enterprises, investigated the possibility of investing in several others, purchased shares in and loaned money to several small corporations and participated in the management of several others. He claimed that a business bad debt resulted from his advances to a cattle raising corporation of which he owned 20 per cent. The worthless debt was limited by the Second Circuit to short term capital loss treatment. Although the court recognized that the taxpayer was directly interested in a number of enterprises as an investor, manager and creditor, it said:

> . . . since each of these activities separately [did] not constitute a business, . . . [the court could not] see how a combination of them spread over various businesses [could] alter the result. . . . [I]f [Smith] were regularly engaged in lending money to business enterprises, bad debt losses resulting therefrom would be incurred in his business.[46]

In that statement it is clear that the Second Circuit was voicing its disapproval of the "promoter doctrine" of trade or business, while on the other hand it reaffirmed the existence of the "lender doctrine" of trade or business. The

43. Henry E. Sage, 15 T.C. 299 (1950).
44. Commissioner v. Stokes, 200 F.2d 637 (3d Cir. 1953).
45. Commissioner v. Smith, 203 F.2d 310 (2d Cir. 1953).
46. *Id.* at 312.

pre-*Smith* doctrine, however, continued to show vitality in decisions subsequent to it.[47] Therefore, when *Whipple* came before the courts there was a direct conflict in the circuit courts as to the appropriateness of the promoter test for determining the existence of a trade or business.[48] As a result of this conflict the Supreme Court granted certiorari.[49]

In *Whipple* the Court distinguished between a trade or business and activities pursued for profit. It noted that this distinction is not isolated to the bad debt section. On the contrary, it has been used in other Code provisions.[50] Further, the Court pointed out that in the past, where Congress discovered inequities due to the Court's interpretation of the phrase "trade or business," the inequity was resolved not by disrupting the settled usage of that phrase, but by "[enlarging] the category of income with reference to which . . ." deductions were allowable.[51]

In both the Tax Court and the Court of Appeals *Whipple* contended that he was engaged in the business of lending money, of financing corporations and of bottling soft drinks independent from the business of the corporation. All these contentions were answered in the negative by both lower courts, and the Supreme Court was unwilling to upset these determinations because it could not conclude that they were clearly erroneous. Further, the Supreme Court did not consider the question of whether Whipple could have been in the trade or business of working as a corporate executive for a salary because he did not assert it in the lower courts. The Court, however, did state that the argument would have been futile because it was not shown that he ever collected salary from Mission Orange nor was it shown that he was owed one. Moreover, no proof was submitted ". . . that the loan was necessary to keep his job or otherwise proximately related to maintaining his trade or business as an employee."[52]

The most significant aspect of the instant case is its impact upon the future of the "promoter doctrine" as a basis of showing an independent trade or business of the taxpayer. In answer to the question of whether an independent trade or business is shown where the taxpayer furnishes regular services to one or many corporations the Court answered in the negative. The Court stated:

Devoting one's time and energies to the affairs of a corporation is

47. Giblin v. Commissioner, 227 F.2d 692, 698 (5th Cir. 1955), where the court stated that to hold that a bad debt of a dealer in enterprises "was not suffered in the course of his engaging in a trade or business, would be to apply a sterile and rigid approach that is not contemplated by the statute."

48. *Compare* Commissioner v. Stokes, 200 F.2d 637 (3d Cir. 1953), *and* Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935), *and* Henry E. Sage, 15 T.C. 299 (1950), *and* Campbell v. Commissioner, 11 T.C. 510 (1948), *and* Cluett v. Commissioner, 8 T.C. 1178 (1947), *with* Commissioner v. Smith, 203 F.2d 310 (2d Cir. 1953).

49. 371 U.S. 875 (1962).

50. *E.g.*, Int. Rev. Code of 1954, § 162 (ordinary and necessary expenses), § 165 (losses), § 167 (depreciation), § 172 (net operating loss deduction).

51. Whipple v. Commissioner, 373 U.S. 193, 200 (1963).

52. *Id.* at 204.

> not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.[53]

Using this reasoning as a basis, the Court concluded that since devoting one's full time to the affairs of a single enterprise would not, by itself, amount to a trade or business, ". . . it is difficult to understand how the same services to many corporations would suffice."[54] Further, the Court noted that where a taxpayer regularly promotes corporations for a commission or a fee or for a profit on their sales there is compensation other than the return received by the ordinary investor. The promoter in the future will have to receive income directly for his own services, independent from the corporation, rather than as a result of his investments, in order to be said to be in the trade or business of promoting enterprises. Whipple did not contend that his purpose was to organize and develop the corporations as going businesses for future sales of these corporations in the ordinary course of business. Therefore, the taxpayer's contention was based on the theory that "one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises is in a trade or business."[55] The Court stated that this was an untenable argument and held that merely ". . . furnishing management and other services to corporations for a reward no different than that flowing to an investor in those corporations . . ."[56] cannot be characterized as a trade or business for the purpose of the bad debt section.

It is fair to conclude from this decision that the Supreme Court still approves of the "lender doctrine," the "separate business entity doctrine" and the "shareholder employee theory." At the very least, the Court did not voice disapproval of these narrowly defined concepts of trade or business. *Whipple* has a definite negative impact, however, on the "promoter doctrine."[57] It ap-

53. *Id.* at 202.
54. *Ibid.*
55. Whipple v. Commissioner, 373 U.S. 193, 203 (1963).
56. *Ibid.*
57. Whipple v. Commissioner, 373 U.S. 193, 203 n.10 (1963). To the extent that the following cases hold or contain statements to the contrary of the instant case's holding that one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises is not in a trade or business, they are disapproved by the Supreme Court: Maytag v. United States, 289 F.2d 647 (Ct. Cl. 1961); Mays v. Commissioner, 272 F.2d 788 (6th Cir. 1959); Commissioner v. Stokes' Estate, 200 F.2d 637 (3d Cir. 1953); Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935); Washburn v. Commissioner, 51 F.2d 949 (8th Cir. 1931); Sage v. Commissioner, 15 T.C. 299 (1950); Campbell v. Commissioner, 11 T.C. 510 (1948); Cluett v. Commissioner, 8 T.C. 1178 (1947).

pears certain that the "promoter doctrine" has lost its vitality for the shareholder-creditor except under carefully defined circumstances. In order to utilize whatever is left of the "promoter doctrine" the taxpayer must plan carefully. In the future only those individuals who receive a fee or commission as their return for regularly developing corporations or those who regularly develop corporations as going businesses for profitable sale to customers in the ordinary course of business will qualify as being in the trade or business of a promoter. Such a course would not serve taxpayers such as Whipple. A taxpayer in his position must be careful to qualify as being in one of the trades or businesses as recognized by this Court.

The Court left the "separate business entity doctrine" as a possible answer to Whipple himself. Evidence was presented with respect to Whipple's activities as owner and lessor of the property upon which the corporation conducted its business. Although Whipple did not actually receive payments of rent from the corporation, rent was owed to him under the lease agreement.[58] The Court could not conclude that the lower courts properly disposed of the possibility that Whipple's advances to the corporation were proximately related to his trade or business of dealing in real estate.[59] It was not contended by the government that he was not engaged in the business of dealing in real estate. It directed its argument entirely to the issue of proximate relation. The Supreme Court took no position on the merits. Rather it remanded the proceedings to the Tax Court for further determination on that issue.[60]

It is clear that *Whipple* has a severe impact on the taxpayer who devotes his full time and energies to the organization, development and financing of corporations. Without a showing of more than mere entrepreneural activities, the future shareholder-creditor will be limited to the short term capital loss deduction for bad debts even though they are incurred proximate to those activities. This is so because the courts refuse to expand their concept of trade or business to include all commercial activities in the bad debt area. Certainly, nobody could argue that Whipple-type activities are not commercial or businesslike in nature. Nevertheless, a future Whipple-type taxpayer will be limited to the short term capital loss deduction as a nonbusiness taxpayer even though he would seem to be more acurately characterized as a business taxpayer under the business-nonbusiness dichotomy. There is no questioning the fact that the courts have created another area of fully taxable income for which only a partial loss deduction is alloted.

This result seems to follow the reasoning of the *Putnam*[61] decision, where the Supreme Court stated that the amendment in the bad debt section, distinguishing between business and nonbusiness bad debts was intended to accomplish far more than to deny full deductibility to the worthless debts of friends.

58. Whipple v. Commissioner, 373 U.S. 193, 204 n.13 (1963).
59. *Cf.* Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949).
60. The issue was scheduled to be argued on remand in April 1964.
61. Putnam v. Commissioner, 352 U.S. 82, 90-92 (1956).

It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax law recognizes as a trade or business, a concept which falls far short of reaching every income or profit making activity. Since the Whipple-type taxpayer receives no return other than that of an investor, he is relegated to the position of an investor. Such a person is not in a trade or business, no matter how extensive are his investments.[62] This causes the resulting limitation of the bad debts incurred while in the pursuit of such activities to short term capital loss treatment as nonbusiness bad debts.

Although the argument has validity in the present state of the case and statutory law, the result should be changed because of its inequitable consequences. As indicated in the instant case, the method by which this inequity could be remedied would be to amend the Code to include an ordinary deduction for this category of activities. After *Higgins* was decided, Congress responded to the inequities confronting Higgins-type taxpayers by adding the profit seeking activities section as an additional means by which investors could deduct the expenses incurred in such activities. At the same time Higgins' inequity was remedied, however, Congress created the present one by amending the bad debt section. It seems that this result was not intended by Congress because the only explicit statement for the amendment was for the purpose of thwarting the fraudulent practice of disguising intra-family gifts as bad debts. Therefore, in order to satisfy its original intent Congress seems to have unwittingly created a different inequity in the treatment of taxpayers engaged in profit seeking activities. It is submitted that Congress should follow a similar path for the relief of Whipple-type taxpayers as it did to relieve Higgins-type taxpayers. Congress should now amend the bad debt section to include full deductibility for bad debts incurred in one's profit seeking activities.

Although the present state of the Code affords Whipple-type activities unfavorable treatment, one engaged in such activities can partially protect himself from such treatment through another Code section.[63] Since 1958, too late for Whipple, a new theory consisting of equity investment, rather than loans, has been provided for those persons engaged in activities similar to Whipple. It provides a different loss treatment on small business stock. An individual taxpayer may deduct as an ordinary loss any loss incurred from the sale or exchange or from the worthlessness of stock which is issued by a small business corporation.[64] This is to be distinguished from the capital loss treatment given to losses incurred from the sale or exchange or from the worthlessness of ordinary stocks. In order to avail oneself of this new provision the stock must be issued to the taxpayer or his partnership under a special plan and the maximum ordinary loss deduction in a single year is $25,000 or $50,000 where the taxpayer and his wife file a joint return. The total amount of stock which

62. Higgins v. Commissioner, 312 U.S. 212 (1941).
63. Int. Rev. Code of 1954, § 1244.
64. Int. Rev. Code of 1954, § 1244(c)(2), (defines small business corporation).

the corporation may issue under the program plus any moneys or property it receives for stock as a contribution to capital and as paid-in surplus cannot exceed $500,000. Further, the stock which is offered under the program plus the equity capital of the corporation cannot exceed $1,000,000 at the time when the program is adopted. The loss on this stock which is allowed ordinary loss treatment is a trade or business loss for the purpose of determining a net operating loss deduction.[65]

A taxpayer engaging in activities similar to Whipple may want to avail himself of this new revision. Instead of advancing cash to his corporation in the form of a loan, however, the shareholder should make an additional investment in the equity of the small business corporation after adopting the plan pursuant to this section. If the taxpayer should suffer a loss on stock issued under this plan, the loss will be allowed ordinary treatment.

Thus, part of the distinction made in *Whipple* is made moot by this new provision. *Whipple* distinguished between investment activities and trade or business activities. The former generates a return to the taxpayer through the enterprise itself, whereas the return arising from the latter legally arises from the taxpayer's own service.[66] This distinction is continued in the Court's conclusion that investment activities are not a trade or business for the purpose of those Code provisions which distinguish between nonbusiness and trade or business activities. If a taxpayer plans carefully and avails himself of this new provision, he can avoid the distinction made in *Whipple* and receive the preferred tax treatment provided for by this section even though the loss arises from an investment.

Although it does not provide a complete solution to the problem, it does provide a useful remedy for the future use of Whipple-type taxpayers under the present state of the Code. It is submitted that an amendment should be made to this provision whereby loans to small business corporations would be afforded the same treatment now given to equity investments.

RONALD B. FELMAN

65. See 1964 Standard Federal Tax Reporter ¶ 14770; 1964 CCH U.S. Master Tax Guide ¶ 810.
66. Whipple v. Commissioner, 373 U.S. 193, 202 (1963).