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"any dispute," and the Court had no trouble in finding this included an action in rem. It is submitted that this distinction was made in *Carbon Black* to avoid facing the issue of the enforceability of forum selection clauses.[40] In light of the approval given forum clauses in the instant case, courts should be dissuaded from indulging in hypertechnical analysis of the language used, and enforce the clause whether it reads "any dispute" or merely "any action against the owner." The parties' inclusion of such a clause should indicate an intention to provide an *exclusive* forum for settling their differences, and admiralty courts have realized in other contexts that an action against the ship is an action against the owner.[41]

Harold Watson

THE DOMINANT MOTIVATION STANDARD FOR BUSINESS BAD DEBT DEDUCTIONS

Taxpayer was president of a closely held construction corporation in which he owned 44% of the outstanding stock, representing an original investment of $33,900.[1] He had signed an indemnity agreement required by the bonding company which furnished the necessary performance bonds for construction contracts. After the corporation defaulted in its performance of two contracts, taxpayer indemnified the bonding company to the extent of more than $162,000 for which he was not reimbursed. Taxpayer claimed the indemnification loss as a business bad debt and deducted it from ordinary income on his federal

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tion was retained on the basis suggested above in cases involving a contractual limitation of actions. *See* Loomis v. S.S. Santa Rosa, 447 F.2d 105 (9th Cir. 1971); Silvestri v. Italia Societa Per Azioni Di Navigazione, 388 F.2d 11 (2d Cir. 1968). One district court even went so far as to say that *Carbon Black* stood for the proposition that such a clause *could not* bar an action in rem. Amicale Industries v. S.S. Rantum, 259 F. Supp. 534 (D. S.C. 1966). *Peugeot v. S.S. Honestas, In Admiralty No. 8036 (E.D. Va., Nov. 10, 1959)*, also contains language which might support this proposition.

40. *See* the dissent of Justice Harlan in *Carbon Black*, 359 U.S. at 184.

41. *See, e.g.*, Continental Grain Co. v. The FBL-585, 364 U.S. 19 (1960).

1. Taxpayer also held a full time position as president of a savings and loan association from which he received a salary of $19,000. Taxpayer's services to the construction corporation, to which he devoted no more than six to eight hours per week, included reviewing bids, making cost estimates, obtaining performance bonds and bank financing. The son-in-law of the taxpayer also owned 44% of the corporation's outstanding stock, while the remaining 12% was owned by a son of the taxpayer and by another son-in-law.

income tax return. He later filed a claim for a refund asserting a net loss carryback under § 172 of the Internal Revenue Code for the portion of the unused business bad debt.[2] In the trial of the refund suit, the court held that *significant motivation* satisfies the requirement of a proximate relationship between the debt and the trade or business of the taxpayer.[3] The Court of Appeals for the Fifth Circuit affirmed.[4] The Supreme Court on certiorari *held* that in determining whether a bad debt is proximately related to the taxpayer's trade or business and thus qualifies as a business bad debt, the proper measure is that of *dominant motivation*.[5] *United States v. Generes*, 92 S. Ct. 827 (1972).

Prior to the Revenue Act of 1942, the Internal Revenue Code did not distinguish between business and nonbusiness bad debts. Both were deductible in full against ordinary income.[6] The result was abuse of the deduction for nonbusiness bad debts by taxpayers who made loans they did not expect to be repaid. In response to these abuses,[7] Congress created in the Revenue Act of 1942 a special classification and treatment of nonbusiness bad debts.

The characterization of a debt as a business or nonbusiness bad debt is of importance to the taxpayer because business bad debts may be deducted in full against ordinary income in the

2. INT. REV. CODE of 1954, § 172 allows the taxpayer whose business deductions exceed his business gross income to carry the loss back three years.

3. Generes v. United States, 67-2 U.S. Tax Cas. ¶ 9754 (E.D. La. 1967).

4. United States v. Generes, 427 F.2d 279 (5th Cir. 1970).

5. Certiorari was granted to resolve a conflict among the circuits, 401 U.S. 972 (1971). *Compare* Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963) *and* United States v. Generes, 427 F.2d 279 (5th Cir. 1970), *with* Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969). *See also Oddee Smith*, 55 T.C. 260 (1970), where the United States Tax Court applied the significant motivation test in compliance with the ruling of *Generes* in order to promote efficient judicial administration.

6. Int. Rev. Code of 1939, ch. 1, § 23(k), 53 Stat. 13.

7. H.R. REP. No. 2333, 77th Cong., 2d Sess. 45 (1942): "C. NONBUSINESS BAD DEBTS. The present law gives the same tax treatment to bad debts incurred in nonbusiness transactions as it allows to business bad debts. An example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for nonbusiness bad debts had suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. . . . This situation has presented serious administrative difficulties because of the requirement of proof." *See also* Putnam v. Commissioner, 352 U.S. 82 (1956), where the Supreme Court extended the purpose of § 166 to include the placing of nonbusiness investments in the form of loans on a footing with other nonbusiness investments.

year they arise and deductions are allowed for either total or partial worthlessness of such debts.[8] On the other hand, nonbusiness bad debts are treated as short term capital losses and are deductible only when totally worthless.[9]

To establish the existence of a business bad debt, the taxpayer must prove that there is a true indebtedness,[10] that the debt became worthless in the taxable year,[11] and that the debt was acquired in connection with the trade or business of the taxpayer.[12] Thus, the taxpayer must establish first that he is engaged in a trade or business and, second, that there is a connection between that business and the debt.[13] The Treasury Regulations specify that a debt is to be characterized as a business bad debt only if there is a *proximate* relationship between the loss resulting from the debt becoming worthless and the

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8. INT. REV. CODE of 1954, § 166(a).

9. *Id.* § 166(d). As a result, deductions are allowed only to the extent of gains from the sale or exchange of capital assets plus the taxable income for the year or $1,000, whichever is smaller.

10. Treas. Reg. § 1.166-1(c) (1969), specifies that only a bona fide debt qualifies for purposes of § 166, defining a bona fide debt as one which arises from a debtor-creditor relationship based on a valid obligation to pay a fixed sum of money. In the situation where a stockholder employee makes a loan to his closely held corporation, the loan may be held to represent a contribution to capital under which the loss is considered to result from the worthlessness of stock and is treated as a loss from the sale or exchange of such stock in the last day of the taxable year in which the worthlessness occurs. INT. REV. CODE of 1954, § 165(g)(1).

11. Treas. Reg. § 1.166-2(a) (1959).

12. INT. REV. CODE of 1954, § 166(d)(2) provides that a nonbusiness debt is one 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." In *Putnam v. Commissioner*, 352 U.S. 82, 85 (1956), the Supreme Court ruled 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."

13. In *Whipple v. Commissioner*, 373 U.S. 193 (1963), the Supreme Court enunciated the well-established rule that where loans are incurred merely in connection with or for the purpose of protecting an investment in a corporation, they may not be regarded as business loans. Earlier cases allowed taxpayer to qualify for ordinary loss deductions if the loan arose in the taxpayer's business of promoting, organizing, financing and selling corporate enterprises. Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957); Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955); Commissioner v. Stokes' Estate, 200 F.2d 637 (3d Cir. 1953); Omaha Nat'l Bank v. Commissioner, 183 F.2d 899 (8th Cir. 1950); Henry E. Sage, 15 T.C. 299 (1950); Vincent C. Campbell, 11 T.C. 510 (1948).

In *Trent v. Commissioner*, 291 F.2d 669 (2d Cir. 1961), the court held that being an employee may be considered as being in a trade or business for purposes of a business bad debt deduction under INT. REV. CODE of 1954, § 166, just as it is for purposes of § 162(a) (business expenses) and § 172(d)(4) (net operating loss deductions).

trade or business of the taxpayer.[14] The question of whether a debt is a nonbusiness debt is a question of fact in each case[15] and the burden of proof as to the business or nonbusiness character of a debt is upon the taxpayer.[16]

Because the taxpayer who claims a business bad debt deduction must prove motivation to protect his employment[17] rather than his investment in a corporation, the dual status of the taxpayer who is both a shareholder *and* employee of a corporation increases the difficulty of establishing the requisite proximate relationship between the taxpayer's trade or business and his advances to the corporation.[18] Evidence of the taxpayer's protection and management of his investment is set off against evidence of job protection. Thus the problem arises as to the degree of motivation which can be attributed to investment

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14. Treas. Reg. § 1.166-5(b)(2) (1959): "[T]he 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."

The Supreme Court, in *Whipple v. Commissioner*, 373 U.S. 193, 201 (1963), indicated its approval of the Treasury Regulations when it noted that the purpose of the amendment which distinguished between business and nonbusiness bad debts was to "make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls short of reaching every income or profit making activity."

The interpretative regulations of the Commissioner of Internal Revenue are not controlling on the courts which may construe and apply the statutory provisions of the revenue laws independent of the Regulations. Nevertheless, the courts accord substantial weight to Regulations which are reasonable and consistent with the revenue statutes. For an excellent analysis of the communications issued by the Internal Revenue Service, see "The Four R's: Regulations, Rulings, Reliance and Retroactivity—A View from Within," an address presented by Mitchell Rogovin, former chief Counsel of the Internal Revenue Service, at the 18th Tax Conference of the University of Chicago Law School, 6 CCH 1972 STAND. FED. TAX REP. ¶ 5980A.015.

15. Treas. Reg. § 1.166-5(b)(2) (1959).

16. Spillers v. Commissioner, 407 F.2d 530 (5th Cir. 1969); Kelly v. Patterson, 331 F.2d 753 (5th Cir. 1964); United States v. Byck, 325 F.2d 551 (5th Cir. 1963).

17. In *Trent v. Commissioner*, 291 F.2d 669 (2d Cir. 1961), the court held that being an employee may be considered as being in a trade or business for purposes of a business bad debt deduction under INT. REV. CODE of 1954, § 166(d)(2)(A).

18. In *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963), the Supreme Court cautioned that "[e]ven if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of corporate business."

protection before the taxpayer will be disqualified from bad debt deduction.

Two conflicting tests arose in the courts of appeal as to the degree of motivation necessary to qualify the loss from a debt as being proximately related to the taxpayer's trade or business. The Seventh Circuit took the views that the test must be that of dominant motivation, requiring that the taxpayer seeking to obtain a deduction for a business bad debt prove that his corporate employment furnished the dominant and primary motivation for making advances and guarantees to the corporation.[19] On the other hand, the Second Circuit adopted a test of significant motivation in *Weddle v. Commissioner*,[20] basing its choice upon a tort analysis of the word "proximate" used in the Regulations to describe the requisite degree of relationship. The court reasoned that "[i]n the law of torts where the notion of 'proximate' causation is most frequently encountered, a cause contributing to a harm may be found 'proximate' despite the fact that it might have been secondary to another contributing cause."[21] The Fifth Circuit in *Generes* adopted the reasoning of the majority in *Weddle*, allowing the taxpayer to recover upon a showing of significant motivation.[22]

The Supreme Court resolved this conflict by holding in *Generes* that the proper test of a proximate relationship is that of dominant motivation. The majority opinion noted that prior decisions distinguishing between business and nonbusiness bad debts have taken a "cautious and not a free-wheeling approach to

19. Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969).

20. Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963).

21. *Id.* at 851. In a concurring opinion, Chief Judge Lumbard disagreed with the court's choice of a significant motivation standard and urged that the taxpayer be required to prove that he was primarily motivated by a desire to protect his employment. He rejected the tort notion of proximate cause as being of little value due to the inapplicability of such factors as time, space, foreseeability and causation in fact to a problem requiring an analysis of different motivations directed at a similar objective. Also he reasoned that the application of the significant motivation test to a stockholder-employee who has made loans to the corporation would inevitably result in a judgment for the taxpayer who will always be motivated by a desire to protect both his employment and his investment. *Id.* at 852.

22. United States v. Generes, 427 F.2d 279 (5th Cir. 1967). *See also Oddee Smith*, 55 T.C. 260 (1970), where the United States Tax Court applied the significant motivation test approved by the Fifth Circuit because the case arose in that circuit although it was the opinion of the court that the test of primary and dominant motivation should apply to the creation of a business bad debt. *See also* Walton M. Dallas, 30 CCH Tax Ct. Mem. 1071 (1971).

the business bad debt."[23] Rejecting the tort theory of proximate cause as inappropriate to the consideration of motivation in income tax law, the Court listed several reasons for its adoption of the dominant motivation standard. First, it relied on the different treatment of business and nonbusiness items in the Code[24] as indicative of a specific policy to distinguish clearly between business and nonbusiness items. The Court noted that this policy distinction would be blunted by the use of the significant motivation test. The Court also pointed to the judicial interpretation of loss provisions of the Code[25] in which the deductibility of a loss has been held to depend on the primary motive of the taxpayer in entering into the transaction.[26] Emphasis was placed on the conclusion of the court in *Whipple v. Commissioner*[27] that a shareholder's activity in the affairs of the corporation is not a trade or business. Finally, the majority rested its conclusion on the workability of the dominant motivation standard, indicating that it provides a "guideline of certainty for the trier of fact."[28]

In remanding the *Generes* case with the direction that a judgment be entered for the United States, the Court seems to establish the principle that a taxpayer cannot prove dominant motivation to protect his salary where his annual after tax salary is substantially smaller than the amount of his original investment in the corporation. The Court suggested that in applying the standard of dominant motivation the trier of fact may "compare the risk against the potential reward and thereby

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23. United States v. Generes, 92 S. Ct. 827, 833 (1972).

24. More specifically, the Court cites § 162 of the INT. REV. CODE of 1954, on expenses, § 165 on losses and § 166 on bad debts as examples of distinctions between business and nonbusiness items.

25. INT. REV. CODE of 1954, § 165(c)(1) which limits deductions of individual losses to those occurring in a trade or business.

26. Imbesi v. Commissioner, 361 F.2d 640 (3d Cir. 1966); Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962); Arata v. Commissioner, 277 F.2d 576 (2d Cir. 1960); Ewing v. Commissioner, 213 F.2d 438 (2d Cir. 1954).

27. 373 U.S. 193 (1963).

28. United States v. Generes, 92 S. Ct. 827, 833 (1972). The concurring opinion of Justice Marshall outlined the legislative history of § 166 of the Internal Revenue Code in support of the Court's adoption of the dominant motivation standard. Noting that the aim of Congress in distinguishing between business and nonbusiness bad debts was to prevent the possibility that closely held family businesses might gain unwarranted deductions against ordinary income, Justice Marshall concluded that the instant case is a perfect example of how the significant motivation test undercuts this intended effect by allowing the type of intra-family loan to the corporation that Congress intended to prevent.

give proper emphasis to the objective rather than to the subjective."[29] Referring to the fact that the taxpayer's stock investment made with after tax dollars was more than five times his net salary, the Court concluded that a reasonable man could not attribute to the taxpayer a dominant motivation of preserving his salary.

It is submitted that a mechanical comparison of the amount of the taxpayer's investment in the corporation with the amount of his net salary should not serve as the single qualifying method of establishing dominant motivation because of the potential for abuse, particularly in closely held corporations where there is often a unilateral determination of salary made by the stockholder-employee. For example, the salary of the taxpayer may include not only compensation for his services but may be formulated so as to include a return on his investment.[30] While a comparison of the value of the taxpayer's salary with his investment in the corporation will serve to indicate his motivation in advancing funds to the corporation, it should be weighed against the background of the taxpayer's total financial situation. Other aspects of taxpayer's financial situation were closely scrutinized by the Court and it is likely that these factors also influenced the Court in its conclusion that a reasonable man could not ascribe to the taxpayer a dominant motivation to protect his salary. One factor considered by the Court was the employability of the taxpayer, as the Court noted that he held a full time job as president of a savings and loan corporation.[31] The Court also took cognizance of the fact that the taxpayer's income from the debtor corporation was only one-half

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29. *Id.*

30. In such a situation the taxpayer would bear the burden of proving that the compensation received from the corporation was reasonable. For an extensive discussion of reasonable compensation cases, see 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 25.68-25.81 (1966).

31. United States v. Generes, 92 S. Ct. 827, 830 (1972). In *Isidore Jaffe*, 26 CCH Tax Ct. Mem. 1063 (1967), the court assessed the potential employability of the taxpayers in finding a dominant motivation to protect their employment where one taxpayer was of an advanced age and the personality of the second made it difficult to work for an enterprise not subject to his control. In *Niblock v. Commissioner*, 417 F.2d 1185 (7th Cir. 1969), the taxpayer was held not to be primarily motivated by a desire to protect his employment where there were no extraordinary circumstances indicating that his personality would make future employment difficult.

that of his income from the savings and loan association.[32] Emphasis was placed on the intra-family nature of the loan, the Court noting that the taxpayer had a personal interest in the integrity of the corporation as a source of living for his son and son-in-law.[33] A consideration of these factors along with others such as the demands of creditors, the past history of financial dealings of the taxpayer, corporate activities of shareholders and the number of shareholders will provide flexibility in the determination of the taxpayer's motivation and thereby lighten the heavy burden of proof resting on the employee-stockholder whose dual status necessitates a showing of a dominant motivation to protect his employment.

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32. 92 S. Ct. 827, 830 (1972). In *B.A. Faucher*, 29 CCH Tax Ct. Mem. 950 (1970), the court found that taxpayer's primary purpose in advancing money to the corporation was to protect his employment where the employment was his only source of income. Also, in *Niblock v. Commissioner*, 417 F.2d 1185 (7th Cir. 1969), the court concluded that the taxpayer was not primarily motivated by a desire to protect his salary, noting the fact that taxpayer received twice the salary from another company by whom he was employed.

33. Justice Marshall, in his concurring opinion, noted that if the taxpayer had simply lent the money to his son-in-law, he could not have deducted the loss as a business bad debt. 92 S. Ct. at 837.