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Income Tax-Business Purpose Required for Recognition of Ordinary Losses-Dominant Motivation Test for Business Bad Debts Should Be Applied to Sales of Stock

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RECENT DEVELOPMENTS

Income Tax—Business Purpose Required for Recognition of Ordinary Losses—Dominant Motivation Test for Business Bad Debts Should Be Applied to Sales of Stock

Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971)
United States v. Generes, 405 U.S. 93 (1972)

Corporate stock is normally considered a capital asset, the sale of which gives rise to the recognition of either capital gain or loss.[1] Since the promulgation of the *Corn Products* doctrine by the Supreme Court in 1955,[2] however, taxpayers have been able to deduct losses on

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1 The Internal Revenue Code defines capital asset as follows:

> [T]he term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
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> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
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> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
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> (3) a copyright, a literary, musical, or artistic composition, or similar property, held by—
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> (A) a taxpayer whose personal efforts created such property, or
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> (B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;
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> (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or
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> (5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

Int. Rev. Code of 1954, § 1221 [hereinafter cited as Code]. Corporate stock does not come under any of the listed exceptions and is considered to be a capital asset except in the hands of a dealer who sells to customers. *Id.* § 1221(1); *see* Note, *Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion,* 65 Yale L.J. 401, 406 n.28 (1956).

It is to the taxpayer's advantage to have gains treated as capital and losses treated as non-capital (ordinary). In computing his taxable income, the taxpayer may exclude one half of the excess of his net long term capital gains over his net short term capital losses (Code § 1202); under some circumstances even more favorable treatment may be obtained. *Id.* § 1201. See *id.* § 1222 for definitions of net long term capital gain and net short term capital loss. Capital losses, on the other hand, may not be deducted from gross income except to offset capital gains or, in the case of an individual with no capital gains, to the extent of $1,000 per year. *Id.* § 1211.

2 Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955). The case involved the

sales of stock in full, without regard to the capital loss provisions of the Internal Revenue Code, if the stock was purchased and held in connection with the taxpayer's trade or business.[3] As might be expected, taxpayers who have sustained losses on the sale of stock have attempted to take full advantage of the *Corn Products* doctrine and have sought to fit their transactions within the parameters of the doctrine whenever any connection existed between the stock and the taxpayer's trade or business.[4] Certain recent cases have suggested the possibility

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purchase of corn futures by a taxpayer in the business of manufacturing starch, syrup, sugar, and various other products from corn. Droughts in alternate years caused steep increases in the price of corn purchased for immediate delivery (spot corn), and the taxpayer became unable to purchase corn at a price which would have enabled it to sell its products at prices competitive with those of non-corn substitutes. To protect itself against these high prices and the accompanying possibility of operating losses, the taxpayer instituted a policy of buying corn futures at a favorable price. If the price of spot corn was low and no shortage was imminent, the futures were sold; if unfavorable conditions existed in the spot market, the futures were exercised. The taxpayer realized overall gain on these transactions and attempted to treat the gains as capital gains, since commodity futures, like corporate stock, are normally capital assets. The Supreme Court upheld the determination of the Commissioner of Internal Revenue that the gains were ordinary income, reasoning that the futures dealing was "vitally important to the company's business as a form of insurance against increases in the price of raw corn." *Id.* at 50. The Court determined that the futures transactions were part of the taxpayer's everyday business and, as such, were intended by Congress to give rise to ordinary rather than capital gain or loss. *Id.* at 52.

3 It should be noted that the *Corn Products* rule, although decided in the context of a gain, has in its application to the stock purchase situation exclusively involved losses rather than gains. *See* note 17 *infra.* Shortly before the Supreme Court's decision in *Corn Products,* the Court of Appeals for the Second Circuit ruled that ordinary asset treatment was similarly appropriate for losses realized on the sale of securities purchased as a business necessity. Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (2d Cir. 1944). There the taxpayer was required to post United States government bonds as security for a contract. When the security was no longer needed, the bonds were sold at a loss. Comparing the loss on the bonds to the cost of a surety bond, which would have been fully deductible, the court allowed full deduction of the loss. *Id.* at 946. Together with *Corn Products, Bagley & Sewall* forms the basis for the so-called "*Corn Products* doctrine."

Technically, there is language in *Corn Products* which would imply that the Corn Products Refining Co., through its transactions, had become a dealer in corn futures. As a dealer, the company would have been entitled to ordinary loss treatment by virtue of CODE § 1221(1), which provides: "[T]he term 'capital asset' . . . does not include—(1) . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . ." Nevertheless, the *Corn Products* and *Bagley & Sewall* decisions have consistently been interpreted as holding that courts are not bound by the exceptions specified in § 1221 in defining non-capital assets, but may additionally exclude certain property. *See, e.g.,* Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied,* 400 U.S. 869 (1970). *See also* Kauffman, *A Second Look at the Corn Products Doctrine,* 41 TAXES 605, 609 (1963).

4 *E.g.,* John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir. 1964) (purchase of stock in restaurant by restaurant chain owner which enabled chain to acquire lease on

of a dual purpose on the part of the taxpayer when the stock is purchased[5]—where, although there may be a legitimate business-related purpose for acquiring the stock, there is also an evident nonbusiness purpose, which, were it the sole motivation for the acquisition, would require treatment of the stock as a capital asset.

Until recently, courts have tended to disregard this possibility, preferring instead to force the fact situation to fit into rigid categories of either business or nonbusiness motivation.[6] Aside from the dis-

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ground under new restaurant); Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963) (purchase of stock for purpose of obtaining exclusive right to sell poultry feed to issuing corporation); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (purchase of stock of paper mill by newspaper publisher to assure itself a supply of newsprint); Ancel Greene & Co., 38 T.C. 125 (1962) (purchase of stock of Federal National Mortgage Association as necessary prerequisite of mortgage sale to the association); Missisquoi Corp., 37 T.C. 791 (1962) (purchase of debentures of paper mill by paperboard manufacturer to assure itself a supply of raw materials); Electrical Fittings Corp., 33 T.C. 1026 (1960) (purchase of foundry stock by electrical parts manufacturer to assure itself a supply of needed castings); Gulftex Drug Co., 29 T.C. 118 (1957) (purchase of distilling company stock by liquor distributor to obtain supply of liquor).

5 *E.g.*, Dearborn Co. v. United States, 444 F.2d 1145 (Ct. Cl. 1971); *see* Steadman v. Commissioner, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970); notes 12-14 and accompanying text *infra*.

6 *See* Steadman v. Commissioner, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970); Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970). In *Waterman*, the taxpayer, a dealer in yarn, purchased $100,000 worth of stock in a wool milling corporation for which the taxpayer then sold wool on commission in connection with the reorganization of the milling corporation. The stock was purchased to enable the taxpayer to become the exclusive sales agent for the milling corporation, whose board chairman was of the opinion that the mill's exclusive sales agent should have a substantial investment interest in the mill. 419 F.2d at 849-50. The taxpayer considered the exclusive agency essential to the continuation of its business, but expected the agency to increase significantly its revenues from the sale of worsted wool yarn. The taxpayer became the exclusive sales agent for the mill, but sales were lower than expected, and, after about two years, the milling corporation terminated the agency. The taxpayer immediately sold its stock and suffered a $75,000 loss, which it deducted in full. The majority of the court found this deduction justified owing to the business, rather than investment, motivation of the transaction. *Id.* at 854-55. A dissenting judge questioned this finding, citing the expected sales increase and the desire of the mill's board chairman that its exclusive agent be an investor as evidence of a dual motivation. *Id.* at 861 (dissenting opinion).

The taxpayer in *Steadman*, a lawyer, was retained as general counsel of a corporation formed by one Richards. Additional capital became necessary approximately one year after formation of the corporation. One of the corporation's creditors offered to purchase stock with the understanding that the creditor would take control of the corporation. The creditor made it clear that once in control it would have the corporation's legal work handled by the creditor's law firm rather than by the taxpayer. In order to keep Richards in control of the corporation and thus assure the retention of his own position, the taxpayer arranged for the purchase of 70,000 shares of newly issued stock, keeping 32,000 for himself at a cost of $80,000. Prior to this time, the taxpayer had acquired 12,000 shares. The additional capital failed to solve the corporation's financial difficulties.

tortions which result, continued avoidance of the problem will lead to unpredictability in the application of the law. Each court will apply a formula to each fact pattern in order to decide which category is more appropriate, while refusing to recognize any dual purpose which might exist. The courts in future cases will be offered no real basis for the application of precedents and the end result will be a mere catalogue of individual fact patterns and their resolutions. This rigidity will merely add to the confusion and promote forum shopping.[7] A uniform standard, on the other hand, would permit explicit consideration of all the facts and give reviewing courts the opportunity to approve or disapprove the test used, thus encouraging consistency among the various tribunals.[8]

I

THE *Dearborn* APPROACH

In *Dearborn Co. v. United States*,[9] the Court of Claims attempted to analyze the problems raised by the presence of a dual purpose. Dur-

About three years later the corporation filed a petition under Chapter XI of the Bankruptcy Act, and the taxpayer's shares became worthless. Both the Tax Court and the Sixth Circuit allowed full deduction of the loss suffered on the 32,000 shares purchased to keep Richards in control, finding a purely business motivation for the purchase. Charles W. Steadman, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970). Again one judge at the trial level dissented, doubting that the evidence justified a finding that Steadman possessed no investment motivation with respect to the 32,000 shares. 50 T.C. at 383-84 (dissenting opinion).

Both cases illustrate the problems and distortions which necessarily follow from a strictly categorical approach. Although the decisions seem intuitively correct, the facts of the cases strongly imply at least some investmeut purpose motivating the purchases. A standard which recognizes this combination of purposes would enable the courts to reach their ultimate determination in a more realistic manner.

7 In the event of a deficiency determination on any federal income tax return, the taxpayer may contest the decision within 90 days upon petition to the Tax Court (CODE § 6213(a)), or he may pay the tax and subsequently sue for a refund in either the Court of Claims (jurisdiction granted in 28 U.S.C. § 1491 (1970)) or in the appropriate federal district court (jurisdiction granted in 28 U.S.C. § 1340 (1970)). Pursuant to 28 U.S.C. § 1346(a)(1) (1970), the district courts are given this original jurisdiction concurrently with the Court of Claims over "[a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected." The adoption of differing standards or tests among the courts would allow the informed taxpayer a significantly greater chance of recovery by a calculated choice of forum.

8 The analogous problem with bad debts provides an appropriate example. Once the courts announce the tests being used, a reviewing court can determine the proper test and establish a rule for the future. Such was the rationale in United States v. Generes, 405 U.S. 93 (1972), in which the Supreme Court decided that the test for the business or nonbusiness nature of a bad debt loss should be dominant rather than merely significant motivation. *See* notes 29-33 and accompanying text *infra*.

9 444 F.2d 1145 (Ct. Cl. 1971).

ing a period when hardwood was in short supply, the taxpayer, a furniture manufacturer, purchased stock in the Munising Wood Products Company which produced, among other things, hardwood and furniture parts which the taxpayer needed to carry on its business. The stock purchases enabled the taxpayer to gain management control of Munising and assure itself an adequate supply of these raw materials. Munising produced other products as well, and by continuing to run the woodworking company as a separate entity, Dearborn was able to receive both dividends and management fees from its operations.[10] About eleven years after the first purchases, the Munising stock was sold at a loss of $151,000, which the taxpayer attempted to deduct in full under the *Corn Products* doctrine, claiming that the purpose for the purchase had been to assure itself a supply of scarce raw materials needed in its business.[11]

The court found that Dearborn's primary reason for purchasing the Munising stock had indeed been to assure itself a ready supply of materials needed for the continuation of Dearborn's furniture business.[12] The court also found the expectation of receiving dividends and management fees to have been significant, thereby concluding that Dearborn had additionally been motivated by "substantial investment purpose and intent."[13] Without citing any prior authority, the court found that the "decided law in this area" precluded full deduction—ordinary loss treatment—where a substantial, although not primary, nonbusiness purpose was present.[14] Accordingly, the taxpayer's claim was not allowed.

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10 *Id.* at 1166.

11 *Id.* at 1147-48. This was the typical "business purpose" rationale used to justify full deduction in earlier cases. *See, e.g.*, Smith & Welton, Inc. v. United States, 164 F. Supp. 605 (E.D. Va. 1958); Electrical Fittings Corp., 33 T.C. 1026 (1960).

12 444 F.2d at 1166.

13 *Id.* at 1168; *see id.* at 1166-68.

14 The court apparently based its decision on the following language from Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962), *quoted in* 444 F.2d at 1147:

> [I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss. If, on the other hand, an investment purpose be found to have motivated the purchase or holding of the securities, any loss realized upon their ultimate disposition must be treated in accord with the capital asset provisions of the Code.

Although this language would seem to support the *Dearborn* court's decision, an examination of the *Booth Newspapers* opinion reveals that there, as in other cases (*see* note 6 *supra*), the court assumed the taxpayers could have only one motivation for purchasing stock. The facts of the two cases were similar. In *Booth Newspaper* it was shown that the taxpayers had purchased the stock of a paper mill in order to assure themselves

By expressly considering the possibility that both business and non-business factors may motivate a stock purchase, the *Dearborn* court took a significant step toward resolving the dual purpose dichotomy. To comply with the rule of *Corn Products*, the test adopted should permit the full deduction if the stock is purchased "as an integral and necessary act in the conduct of [taxpayer's] business."[15] Any test chosen should also deny the taxpayer the option of treating the stock as ordinary or capital property depending on whether its sale produces gain or loss. To allow such an election would permit a taxpayer able to relate his investments to a business purpose to place part of the risk of those investments on the public. Since this result is contrary to the intent of the law,[16] such an election should be discouraged insofar as is possible.[17]

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a supply of newsprint needed in their newspaper publishing business. The mill had previously been in the business of producing other paper products, however, and the taxpayers continued this business to the extent consistent with utilizing the mill as a source of supply for newsprint. Arguably, the taxpayers' eventual goal was to sell the mill at an attractive price. The court did not consider the possibility that this constituted an investment motivation for the acquisition, stating, "The difficulty with [the government's] position is simply that the record will not support a conclusion that [the taxpayers] were investment-minded when they purchased the stock." 303 F.2d at 921.

15 Booth Newspapers, Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962).

16 It may be argued that the law does not intend to prohibit this practice. CODE § 1231 permits deduction in full of losses incurred in the sale of real and depreciable personal property used in a trade or business, while allowing recognition of capital gains if such property is sold at a gain. The property covered by this section, however, does not include corporate stock, and Congress failed to include provision for such stock in an extensive revision of § 1231 included in the Tax Reform Act of 1969 (Pub. L. No. 91-172, 83 Stat. 487). Thus, the rule of the courts—that the transaction will be treated as ordinary or capital depending on its purpose, without regard to whether gain or loss was realized—remains in force.

17 This Note deals only with the legal aspect of the business-related stock purchase problem, that is, the selection of an appropriate test to determine whether a transaction is sufficiently business related to require treatment of the stock as ordinary property. Even with the adoption of a uniform standard, however, the taxpayer may retain, to a certain degree, the choice of treating the stock as ordinary or capital property according to whether a gain or loss is realized upon its sale. Where a loss is realized, the standard may be applied and ordinary or capital loss recognized, depending upon the circumstances of the case. Ordinarily, however, a gain on the sale of stock will be capital gain and it is therefore doubtful whether, in most cases, the Internal Revenue examiner will question a return on which capital gain treatment of stock gains has been claimed. Although *Corn Products* itself involved a contention by the government that the sale of corn futures produced ordinary rather than capital gain, this case may have attracted special attention in the Internal Revenue Service because of its unusual fact situation. In the early years of its trading in corn futures, the Corn Products Refining Co. realized losses, which were deducted in full. In later years, when gains exceeded previous losses, the taxpayer attempted to amend its earlier returns to have all transactions taxed as sales of capital assets. *See* 350 U.S. at 49.

As might be expected, all of the reported cases subsequent to *Corn Products* dealing with corporate stock have involved losses, since absent special facts like those of *Corn*

Although the "substantial nonbusiness purpose" test of *Dearborn* represents a step forward from prior decisions, *Dearborn* is still too restrictive in that it does not permit full deduction in *all* cases in which the stock purchase is a necessary business act. A stock purchase may be a business necessity yet concomitantly offer a significant investment opportunity.[18] Application of the *Dearborn* test in such a case would either conflict with the rationale of *Corn Products* or require the courts to distort the facts to reach the correct result. A proper standard should deal with this dual purpose in a more realistic fashion.[19]

II

An Alternative Approach

A situation analogous to the stock purchase problem may arise under section 166 of the Internal Revenue Code. This section allows a taxpayer to deduct the amount of any unsecured debt[20] which becomes worthless during the tax year. Subsection (d) of this section, however, limits the noncorporate taxpayer's treatment of bad debt losses to the amount specified for short term capital losses[21] unless the debt was "created or acquired in connection with" or "the loss from the worthlessness of which is incurred in" the taxpayer's trade or business.[22] Since

Products capital gain claims will not ordinarily be questioned. *But cf.* Hollywood Baseball Ass'n v. Commissioner, 423 F.2d 494 (9th Cir.), *cert. denied*, 400 U.S. 848 (1970), where the government was upheld in requiring a minor league baseball club to treat the gains from sales of its player contracts—essentially the "raw materials" of the business—as ordinary income on the ground that such contracts were held for sale on demand. This administrative problem has been recognized and statutory and regulatory solutions have been suggested. *See* Kauffman, *supra* note 3, at 613; Note, *supra* note 1, at 408-12. Neither Congress nor the Treasury has adopted such a solution, however, and the courts' power is limited to deciding the cases before them. Accordingly, the administrative problem is likely to remain. The discussion herein is consequently focused on the allowance of the ordinary deduction upon realization of a loss only.

18 *See, e.g.*, Waterman, Largen & Co. v. United States, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970). Although the court in *Waterman* found the stock purchase necessary to the taxpayer's business and thus the loss upon sale fully deductible (419 F.2d at 854-55), the mill's owner insisted that its exclusive agent have a "substantial financial interest" in the mill. *Id.* at 849. Additionally, the mill was reopening at a new location and its owners expected to operate the business at a profit. *Id.* at 857 (dissenting opinion). The possibility of at least some investment motive was strongly implied. *See id.* at 861 (dissenting opinion).

19 *See* text accompanying notes 6-8 *supra*.

20 Unsecured debt and debt as used herein refer to a debt which is not evidenced by a bond, note, debenture, certificate, or other evidence of indebtedness. *Cf.* Code §§ 165(g)(2)(C), 166 (e).

21 For treatment of short term capital losses, see *id.* §§ 1211-12.

22 *Id.* § 166(d)(2).

the statute speaks only of "trade or business" and not of profit-making activities in general,[23] the same business-investment question involved in business-related stock purchase cases is present in those cases in which a shareholder-employee of a corporation makes a loan to his employer which later becomes worthless.[24] It has been held that serving an employer constitutes the "business" of an employee for the purposes of section 166;[25] hence, if the debt were created or acquired or became worthless "in connection with" the employment relationship, the debt upon default would be fully deductible as a business bad debt.[26] If the debt merely were related to the shareholder relation, however, only a short term capital loss could be recognized.[27]

Considerably more attention has been given by the courts to the taxpayer's possible dual purpose in the shareholder-employee bad debt situation than in the stock purchase situation. This may be due in part to the requirement contained in the regulations under section 166 that the debt bear a "proximate relationship" to the taxpayer's trade or business in order to be eligible for the full rather than the capital deduction.[28]

The Supreme Court, in *United States v. Generes*,[29] recently considered the problem of formulating a criterion for determining business, as opposed to nonbusiness, bad debts. The Court adopted a test requiring that business considerations be the "dominant and primary motivation" for the debt before full deduction will be allowed in the event that the debt should become worthless.[30] The Court reasoned that

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23 In several other situations, provision is made for special treatment of activities related to the taxpayer's trade or business and other activities undertaken for the production of income. *See, e.g., id.* §§ 162, 212 (deductibility of expenses); *id.* §§ 165(c)(1),(2) (deductibility of losses). Since § 166(d) refers only to trade or business, debts related to other activities undertaken for profit have been held to be nonbusiness-related debts. *See* Whipple v. Commissioner, 373 U.S. 193 (1963).

24 *See, e.g.*, Stratmore v. United States, 420 F.2d 461 (3d Cir. 1970); Millsap v. Commissioner, 387 F.2d 420 (8th Cir. 1968); Robert E. Gillespie, 54 T.C. 1025 (1970); B.A. Faucher, 29 CCH Tax Ct. Mem. 950 (1970).

25 Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).

26 *See* B.A. Faucher, 29 CCH Tax Ct. Mem. 950 (1970).

27 *See* Whipple v. Commissioner, 373 U.S. 193 (1963).

28 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 relationship 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 [from nonbusiness debts] . . . .

Id.

29 405 U.S. 93 (1972), *rehearing denied*, 405 U.S. 1033 (1972).

30 In so doing, the Supreme Court resolved a conflict between the Second and Fifth Circuits on the one hand and the Seventh Circuit on the other. The Second and Fifth

since Congress had carefully distinguished between business and nonbusiness debts, the test to be applied to determine whether a debt is business related should make the distinction a meaningful one rather than blunting it.[31] The Court also favored the "dominant motivation" test since it would prevent the taxpayer from always obtaining favorable treatment of the debt[32] and would provide a workable guideline for the trier of fact.[33]

Similarities between the stock purchase and bad debt situations provide a cogent argument for the application of the same test to both.[34] In both, the taxpayer provides funds to a corporation in which he has

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Circuits favored a test permitting full deduction for a debt that was "significantly motivated" by business considerations, even if the business considerations provided only a secondary motivation. United States v. Generes, 427 F.2d 279, 283-84 (5th Cir. 1970); Weddle v. Commissioner, 325 F.2d 849, 851 (2d Cir. 1963). The Seventh Circuit propounded the "dominant and primary motivation" test which the Supreme Court ultimately adopted. Niblock v. Commissioner, 417 F.2d 1185, 1187 (7th Cir. 1969).

> [31] The Code itself carefully distinguishes between business and nonbusiness items. . . . [T]his distinction has been a policy of the income tax structure ever since the Revenue Act of 1916, § 5(a), 39 Stat. 759, provided differently for trade or business losses than it did for losses sustained in another transaction entered into for profit. And it has been the specific policy with respect to bad debts since the Revenue Act of 1942 incorporated into § 23(k) of the 1939 Code the distinction between business and nonbusiness bad debts. 56 Stat. 820.
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> The point, however, is that the tax structures have made the distinction, that the Congress therefore intended it to be a meaningful one, and that the distinction is not to be obliterated or blunted by an interpretation that tends to equate the business bad debt with the nonbusiness bad debt. . . . We think that emphasis upon the significant rather than upon the dominant would have a tendency to do just that.

405 U.S. at 103-04.

[32] *Id.* at 104.

[33] *Id.*

[34] The "significant motivation" test, rejected by the Supreme Court in the bad debt situation (*id.* at 103-04; *see* note 30 *supra*), would likewise be unacceptable in the stock purchase case. Under this test, the taxpayer could call a gain capital if the stock's purchase were significantly (though not dominantly) motivated by nonbusiness considerations, or could call a loss ordinary if the purchase were significantly (though not dominantly) motivated by business considerations. Such a result would, under a broad range of circumstances, allow the taxpayer the option of treating his stock as ordinary or capital property depending on whether its sale yielded gain or loss, thus violating one of the criteria previously discussed. *See* note 16 and accompanying text *supra*. The realization that the taxpayer will always win if the significant motivation test were to be applied was one of the Supreme Court's major reasons for rejecting it in *Generes*.

> Application of the significant-motivation standard would also tend to undermine and circumscribe the Court's holding in *Whipple* and the emphasis there that a shareholder's mere activity in a corporation's affairs is not a trade or business. As Chief Judge Lumbard pointed out in his separate and disagreeing concurrence in *Weddle*, . . . both motives—that of protecting the investment and that of protecting the salary—are inevitably involved, and an inquiry whether employee status provides a significant motivation will always produce an affirmative answer and result in a judgment for the taxpayer.

405 U.S. at 104 (citation omitted).

both a business and an investment interest. In both, the criterion which governs the allowance of a loss in full or treatment as a capital loss is the extent of the business and investment motivations of the taxpayer in engaging the transaction.[35] The results of the two types of transactions are the same: the taxpayer provides capital for the use of the recipient corporation and thereby increases his financial interest in that corporation. Therefore, to apply a different test to the transaction depending on whether it takes the form of a stock purchase or a loan would be to recognize form over substance, a situation which the courts have normally tried to avoid in tax litigation.[36] In order to provide similar treatment in these two equivalent situations the "dominant motivation" test—the law in bad debt situations—should also be applied in stock purchase cases.[37]

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35 Although it is generally true that the motivation at the time of purchase determines the nature of gain or loss (*see* Steadman v. Commissioner, 424 F.2d 1, 5 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970)), one noteworthy exception exists. The taxpayer may continue to hold stock originally purchased as a business necessity after the business reason for the purchase ceases to exist. In that case, the stock, although eligible for ordinary treatment had it been sold upon termination of the business need, becomes a capital asset yielding capital gain or loss. *See* Missisquoi Corp., 37 T.C. 791, 797 (1962); Gulftex Drug Co., 29 T.C. 118, 121 (1957). This exception should not bar the use of the dominant motivation test, however. In such cases the holding of the stock beyond that period for which it satisfies a business need should be evidence that the dominant purpose for the purchase was to make an investment. The stock, therefore, should be treated as a capital asset.

36 *See generally* Higgins v. Smith, 308 U.S. 473, 476 (1940); Gregory v. Helvering, 293 U.S. 465, 468-70 (1935).

37 There are three differences between the stock purchase and the bad debt situations: (*1*) the bad debt deduction is controlled by statute while the ordinary deduction in the stock purchase situation is a creature of the courts; (2) the stock transaction offers the possibility of direct gain; and (*3*) the bad debt provision limits only nonbusiness loans made by noncorporate taxpayers to capital loss treatment. CODE § 166(d)(1)(B). None of these differences renders adoption of a uniform standard inappropriate. In both situations the intent of the law is to require ordinary treatment of gains or losses on business-related transactions; the bad debt provision and decisions thereunder provide a model for the court-made law in the stock transaction situation. In view of holdings which allow the ordinary loss deduction only when the stock transaction is entirely business related, regardless of the corporateness or noncorporateness of the taxpayer (*e.g.*, Missisquoi Corp., 37 T.C. 791 (1962); Gulftex Drug Co., 29 T.C. 118 (1957)), the nonapplication of the business/nonbusiness distinction to the corporate taxpayer in the bad debt situation should be seen as a statutory exception to the general rule.

The basic similarity between investment in the form of a loan and investment in the form of a stock purchase was acknowledged by Mr. Justice Marshall in *Generes*:

> A related congressional purpose in enacting the predecessor to § 166 was "to put nonbusiness investments in the form of loans on a footing with other nonbusiness investments." *Putnam v. Commissioner*, 352 U.S. 82, 92 (1956). Congress recognized that there often is only a minor difference, if any, between the investment in the form of a stock purchase and one in the form of a loan to a corporation.

405 U.S. at 110 (concurring opinion).

CONCLUSION

The "dominant motivation" standard recently adopted by the Supreme Court for application in determining the business or nonbusiness nature of a loan made by a shareholder-employee to his corporation is also the most appropriate standard for determining the eligibility of stock losses for full deduction under the *Corn Products* doctrine. Use of this test will result in the allowance of the full deduction when the stock purchase is necessary to the taxpayer's business but will limit the deduction to the appropriate capital loss deduction in the case of a mere investment which incidentally benefits the taxpayer's business, thus carrying out the intent of the Supreme Court as expressed in *Corn Products*.[38] The "dominant motivation" test will also equalize treatment of stock purchases and loans and prevent mere differences in transaction form from leading to different methods of taxation.

Robert A. Warwick

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38 Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 52 (1955).