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Has the 1976 Tax Reform Act Injected a Gain-Seeking Requirement into Section 166?

By J. CLIFTON FLEMING, JR.

The author describes the impact of the 1976 Tax Reform Act on Section 166. Congress, he says, now intends Section 166 to be read as allowing deduction of a guarantor's or lender's loss only if the guaranty was given or the loan was made in connection with the taxpayer's trade or business or was entered into for profit.

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Section 166(f) was added to federal tax law by the 1954 Code. Its dubious purpose [1] was to permit ordinary deduction for losses sustained by noncorporate taxpayers in performing guaranties of certain debts incurred by other noncorporate taxpayers.[2] This provision was repealed by Section 605(a) of the 1976 Tax Reform Act [3] which states: "Section 166 . . . is amended by striking out subsection (f) and by redesignating subsections (g) and (h) as subsections (f) and (g), respectively." One would be tempted to conclude from this sparse language that deletion of Section

[1] See, e.g., Note, "Section 166(f) of the Internal Revenue Code: Bad Debts and Confusion Guaranteed," 65 *Yale Law Journal* 247, 252-53 (1955); Staff of Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, 157 (Comm. Print 1976) (hereinafter cited as "General Explanation").

[2] SECTION 166. BAD DEBTS.

(f) Guarantor of Certain Noncorporate Obligations.—A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

[3] Statutory citations preceded by "TRA" are to the 1976 Tax Reform Act, P. L. 94-455. All other statutory references are to the Internal Revenue Code of 1954, 26 U. S. C.

166(f) is its only effect. The Committee Reports reveal, however, that Congress designed this modest provision to accomplish additional ends.

Guaranty Losses

The relevant Reports state that TRA Section 605(a) is intended to incorporate into the Code the views of Congress on two matters: (1) the timing of a deduction for loss arising from performance of a guaranty obligation [4] and (2) the question of whether absence of subrogation rights in a losing guarantor permits his deduction to be claimed under Section 165 rather than Section 166.[5] However, to those innocuous matters the Reports add the following:

> Also, in the case of a guaranty agreement which is not entered into as part of the guarantor's trade or business, or as a transaction for profit, no deduction is to be available in the event of a payment under the guarantee.
>
> . . .
>
> In the case of a guaranty agreement, however, it is not always easy to tell whether the transaction has been entered into for profit on the part of the guarantor. It is not uncommon for guaranty agreements to provide for no direct consideration to be paid to the guarantor. Often this may be because the guarantor is receiving indirect consideration in the form of improved business relationships. On the other hand, many other guaranties are given without consideration as a matter of accommodation to friends and relatives.
>
> The committee believes that a bad debt deduction should be available in the case of a guaranty related to the taxpayer's trade or business, or a guaranty transaction entered into for profit. However, no deduction should be available for a "gift" type of situation. *Thus, the committee intends that for years beginning in 1976 and thereafter, the burden of substantiation is to be on the guarantor, and that no deduction is to be available unless the guaranty is entered as part of the guarantor's trade or business, or unless the transaction has been entered into for profit, as evidenced by the fact that the guarantor can demonstrate that he has received reasonable consideration for giving the guaranty.* (Italics added.) For this purpose, consideration could include indirect consideration; thus, where the taxpayer can substantiate that a guaranty was given in accordance with normal business practice, or for *bona-fide* business purposes, the taxpayer would be entitled to his deduction even if he received no direct monetary consideration for giving the guaranty. On the other hand, a father guaranteeing a loan for his son would ordinarily not be entitled to a deduction even if he received nominal consideration for giving the guaranty.[6]

Thus, Congress now intends for Section 166 to be read as allowing deduction of a guarantor's loss only if the guaranty was given in connection with the guarantor's trade or business or was entered into for profit.[7] Apparently a guaranty is not considered profit-motivated unless the guarantor received a reasonable fee for giving the guaranty or unless the guaranty was given to obtain an indirect business benefit. A guaranty motivated by family relationships does not meet this test.

The bland manner in which the foregoing Committee Report quotation articulates this business connection-profit motivation requirement gives the impression that nothing significant has occurred. In creating such an implication, Congress has been disingenuous. Section 166 was never previously

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[4] The Ways and Means Committee Report on the 1976 Tax Reform Act states:

> The committee further wishes to resolve for the future the appropriate timing of the deduction for a payment under a guaranty agreement. If the guaranty agreement (including for this purpose a guaranty, indemnity or endorsement) requires payment by the guarantor upon default by the maker of the note (i. e., the borrower), and the guarantor has a right of subrogation or other right against the maker, no deduction will be allowed to the guarantor until the year in which the right over against the maker becomes worthless (or partially worthless, where the guaranty occurs in connection with the guarantor's trade or business). If the guarantor has no right over against the maker of the obligation, the payment under the guaranty is deductible as a bad debt for the year in which the payment is made.

H. Rept. 94-658, 94th Cong., 1st Sess., 177-78 (1975) [hereinafter cited as "House Report"]. See also Conf. Rep. on the 1976 Tax Reform Bill, 94th Cong., 2d Sess. 440 (1976) and General Explanation 158.

[5] The Ways and Means Committee Report on the 1976 Tax Reform Act states:

> The committee also wishes to make it clear that in the case of a guarantor of a corporation obligation, any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business.

House Report 177. See also Conf. Rep. on the 1976 Tax Reform Bill, 94th Cong., 2d Sess. 440 (1976) and General Explanation 158.

[6] Id.

[7] If the guarantor is an individual, this rule will apparently also apply even where the debt is evidenced by a Sec. 165(g)(2) "security." See Secs. 166(e) and 165(c) and General Explanation 157.

understood as imposing any such requirement on guarantors.

Prior to the 1976 Tax Reform Act, relevant case law held a payment discharging a guaranty of a worthless debt to be deductible as a Section 166 bad debt loss unless the guaranty was intended as a gift or contribution to capital.[8] The courts traditionally resolved this issue by examining all pertinent facts. Among the circumstances considered germane to this inquiry was the likelihood of any economic benefit to the guarantor from giving the guaranty. The fact that a guaranty had been entered into with an expectation of such benefit was some evidence that the guarantor did not intend a gift or contribution to capital.[9] The absence of economic benefit was not determinative,[10] however, and there was no requirement that the guarantor prove a business connection or profit motivation as a precondition to deducting his loss under Section 166.[11]

A leading case in which a guarantor was allowed a deduction for payment of a worthless debt even though the guaranty was neither profit-motivated nor business connected is *Alice DuPont Ortiz*.[12] There, the taxpayer guaranteed her husband's stock brokerage accounts. The husband had previously been a successful investor. Taxpayer was assured, erroneously as it turned out, by her financial adviser and her husband that market conditions would improve and that she would suffer no loss from the guaranty. When ultimately required to perform her guaranty, she collected reimbursement from her husband to the extent of his available assets. From these facts, the Board of Tax Appeals concluded that the guaranty was not intended as a gift. Taxpayer's loss was, accordingly, allowed as a bad debt deduction even though no evidence was introduced to show that taxpayer received any fee or other economic benefit from giving the guaranty or that the guaranty was connected with a business carried on by the taxpayer. Similar opinions exist.[13]

Since the Commissioner did not raise and litigate the issue of whether the absence of business connection and profit motivation would bar deduction of a guaranty loss in *Ortiz* and similar cases, those opinions are not definitive authority for the proposition that guaranty losses can be deducted under Section 166 without meeting a business connection-profit motivation requirement. However, failure of the Commissioner and the courts to raise this issue in *Ortiz* or any other reported decision does indicate long-standing acceptance of the idea that Section 166 contained no such requirement prior to the 1976 Tax Reform Act. Therefore, the above-quoted Committee Report language compelling a guarantor to meet a business connection-profit motivation test before any deduction is allowable under Section 166 is clearly a newly imposed qualification.

It is possible that the Committee Report language from which this conclusion is drawn is nothing more than an inartful restatement of the established rule that a loss on a guaranty intended as a gift is not deductible under Section 166 and that the note of alarm sounded herein is not well founded. Support for this view appears in the following Committee Report quotation: "The Committee believes that a bad debt deduction should be available in the case of a guaranty related to the taxpayer's trade or business, or a guaranty transaction entered into for profit. However, no deduction should be available for a 'gift' type of situation." [14] Nevertheless, the forcefulness and specificity with which the Committee Report articulates a business connection-profit motivation requirement [15] makes this position seem unreliable. Congress seems to view all guaranties as involving a "gift type of situation" unless the business connection-profit motivation test is met. Absent future judicial or administrative authority to the contrary, a guarantor should assume for planning purposes that his loss will be nondeductible unless the guaranty was connected with his business or was entered into for profit. The business connection-profit motivation rule is a threshold provision addressed

[8] Compare *Shiman v. Commissioner*, 3 USTC ¶ 976, 60 F. 2d 65 (CA-2 1932) with *Hoyt v. Commissioner*, 44-2 USTC ¶ 9517, 145 F. 2d 634 (CA-2) and *Charles J. Matthews*, CCH Dec. 15,861, 8 TC 1313 (1947).

[9] *Kate Baker Sherman*, CCH Dec. 19,109, 18 TC 746 (1952); *D. W. Pierce*, CCH Dec. 11,119, 41 BTA 1261, 1265 (1940), acq. 1940-2 CB 6.

[10] See cases cited in footnotes 12 and 13.

[11] See House Report 176 and General Explanation 156.

[12] 1940 CCH ¶ 7427, 42 BTA 173, acq. on this point 1940-2 CB 6, nonacq. on other issues 1940-2 CB 13, rev'd on other grounds, 41-2 USTC ¶ 9666, 124 F. 2d 156 (CA-3 1941), aff'd on other grounds 42-1 USTC ¶ 9441, 316 U. S. 164.

[13] *H. Rodney Sharp*, CCH Dec. 10,100, 38 BTA 166, 171-73, 176-77 (1938), acq. 1938-2 CB 29; *George Aftergood*, CCH Dec. 19,936, 21 TC 60 (1953), acq. 1954-1 CB 3.

[14] House Report 177. See also General Explanation 157-58.

[15] ". . . [I]n the case of a guaranty agreement which is not entered into as part of the guarantor's trade or business, or as a transaction for profit, no deduction is to be available in the event of a payment under the guarantee. "[T]he Committee intends that for years beginning in 1976 and thereafter, . . . no deduction is to be available unless the guaranty is entered as part of the guarantor's trade or business, or unless the transaction has been entered into for profit. . . ." House Report 177. See also General Explanation 157-58.

to the question of whether any deduction at all, capital or ordinary, is available to a losing guarantor. It is unrelated to, and must be satisfied before reaching, the more familiar question of business v. nonbusiness bad debt characterization.

Losses on Direct Loans

Unfortunately, the Committee Report mischief does not end at this point; the following is also included:

> . . . when a taxpayer has a loss arising from the guaranty of a loan, he is to receive the same treatment as where he has a loss from a loan which he makes directly.[16]

Congress seems to be saying that a taxpayer's loss consequences are to be identical under Section 166 whether he is a guarantor or a direct lender—a proposition for which there is some support in the Supreme Court's *Putnam* decision.[17] Since we must now assume the imposition of a business connection-profit motivation requirement on guarantors for reasons given above, logic compels the further assumption that direct lenders must also meet this requirement before any deduction is allowable under Section 166. As in the case of guaranty losses, this requirement is a threshold qualification that must be satisfied before the familiar question of business-nonbusiness characterization of the debt is even reached.[18]

This new rule for direct lenders constitutes a substantial departure from present law. It has long been accepted that a principal distinction between the treatment of losses of individuals under Sections 165 and 166 is that the latter provision does not have a business connection-profit motivation requirement. One recent commentator flatly stated that "the bad debt deduction merely requires the existence of a bona fide debtor-creditor relationship." [19] Other writers are in agreement.[20] Thus, the imposition by Committee Report of a business connection-profit motivation requirement on lenders who suffer bad debt losses represents as great a change in prior law as does imposition of the same requirement on guarantors.[21]

Conclusion

The 1976 Tax Reform Act has increased the degree of consistency between Sections 165 and 166 by injecting into the latter a business connection-profit motivation requirement substantially identical to that found in Section 165(c)(1) and (2). Presumably individuals who make loans and give guaranties in connection with a trade or business and corporations which guarantee and lend [22] will encounter no difficulty in meeting the new requirement for deduction under Section 166.[23] However, an individual who makes a loan or gives a guaranty unconnected with his business should charge a greater than nominal rate of interest on the loan [24] and should charge a reasonable fee for the guaranty or be prepared to demonstrate some economic benefit accruing to

[16] Id. at 176. See also Conf. Rep. on the 1976 Tax Reform Bill, 94th Cong., 2d Sess. 440 and General Explanation 157.

[17] *Putnam v. Commissioner,* 57-1 USTC ¶ 9200, 352 U. S. 82 (1956) states the following at 92-93:

> There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same, and are accomplished by § 23(k)(4) [now section 166(d)].

See also *Bert W. Martin,* CCH Dec. 29,550, 52 TC 140, 144-46 (1969), aff'd per curiam, 70-1 USTC ¶ 9421, 424 F. 2d 1368 (CA-9), cert. denied 400 U. S. 902 (1970).

[18] A business connection-profit motivation requirement has previously been applicable to losses of individuals on debts represented by Sec. 165(g)(2) securities. See Secs. 166(e) and 165(c) and Treas. Reg. Sec. 1.165-5 (b) and (c).

[19] Young, "Income Tax Consequences of Investment Losses of Individuals," 27 *Tax Law Review* 1, 5 (1971).

[20] Griswold and Graetz, *Federal Income Taxation* 406 (1976); Chommie, *Federal Income Taxation* 161 (2d ed. 1973); 1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation* 387 (1972); Bersch and Neil, "Getting the Most from Bad Debt Deductions—A Classification Problem," 52 TAXES—*The Tax Magazine* 530, September 1974. See also *Griffin Andrew.* CCH Dec. 29,956, 54 TC 239, 244-45 (1970), acq. 1970-2 CB xviii.

[21] If, as stated in the text at footnote 14, the troublesome Committee Report language is merely an awkward attempt to reaffirm the familiar rule that losses which are truly gifts are not deductible under Sec. 166, then this conclusion is incorrect. For the reasons given above, however, it seems clear that Congress intended to impose a new requirement rather than restate an old one.

[22] The Committee Reports neither expressly exempt corporate taxpayers from the new business connection-profit motivation requirement nor imply any dichotomy of treatment between individuals and corporations. Consequently, the reasoning of *International Trading Company v. Commissioner,* 73-2 USTC ¶ 9582, 484 F. 2d 707 (CA-7), seems inapplicable to the Sec. 166 business connection-profit motivation requirement. However, most loans and guaranties by corporations will be made in connection with the corporation's business and will satisfy the requirement.

[23] "[W]hen a taxpayer has a loss arising from the guaranty of a loan, he is to receive the same treatment as where he has a loss from a loan which he makes directly. Thus, if the guaranty agreement arose out of the guarantor's trade or business, the guarantor would still be permitted to deduct the loss resulting from the transaction against ordinary income. If the guaranty agreement was a transaction entered into for profit by the guarantor (but not as part of his trade or business), he would be able to deduct the resulting loss as a nonbusiness debt." House Report 176-77.

[24] "Generally, in the case of a direct loan, the transaction is entered into for profit by the lender, who hopes to realize interest on the loan." Id. at 177.

him from the guaranty.[25] Failure to observe these precautions would seem to foreclose any deduction for subsequent loss on the loan or guaranty.[26] However, as noted above,[27] there is a limited possibility that these conclusions are incorrect and that a business connection-profit motivation requirement has not been imposed on Section 166. Therefore, a lawyer confronted with a client who failed to heed the foregoing guidelines and suffered loss, but who had no donative intent, would seem justified in advising the client to claim a Section 166 deduction and prepare to fight.[28] ●

[25] "[N]o deduction is to be available unless the guaranty is entered as part of the guarantor's trade or business, or unless the transaction has been entered into for profit, as evidenced by the fact that the guarantor can demonstrate that he has received reasonable consideration for giving the guaranty. For this purpose, consideration could include indirect consideration; thus, where the taxpayer can substantiate that a guaranty was given in accordance with normal business practice, or for bona fide business purposes, the taxpayer would be entitled to his deduction even if he received no direct monetary consideration for giving the guaranty. On the other hand, a father guaranteeing a loan for his son would ordinarily not be entitled to a deduction even if he received nominal consideration for giving the guarantee." Ibid.

[26] Of course, the transactional formalities and behavior of the parties must be consistent with a bona fide loan or guaranty, particularly where family relationships are present. Treas. Reg. Sec. 1.166-1(c).

[27] See footnote 21 and text at footnote 14.

[28] Rowen, "When May a Lawyer Advise a Client That He May Take a Position on His Tax Return?" 29 *Tax Lawyer* 237, 239-44, 250-60 (1976).

State taxes

Louisiana Increases Income Taxes

Applicable to taxable periods beginning after December 31, 1976, the Louisiana corporate income tax is no longer levied at the flat rate of 4%. The tax, which is levied on Louisiana net income, is now imposed at the following graduated rates: 4% of net income of $25,000 or less; 5% of net income above $25,000 but not in excess of $50,000; 6% of net income above $50,000 but not in excess of $100,000; 7% of net income above $100,000 but not in excess of $200,000; and 8% of net income in excess of $200,000.

Installment payments of corporate estimated income tax due October 15, 1977 through November 15, 1978 must be based on the amount estimated to be due, less credits, at the rate of tax applicable to the tax periods for which the declaration is filed. H. B. 1, 1st Spec. Sess., approved August 17, 1977.

Property Tax System Revised in Montana

Montana property tax assessment and classification provisions have been repealed and reenacted to adopt 18 new tax classifications in place of the 11 property tax classifications formerly provided. Also, the law establishes market value as the basis for most property taxation. All taxable property is now assessed at 100% of market value, book value, annual net or annual gross proceeds or productive capacity. These changes are effective July 1, 1977. Ch. 566 (H. B. 70).

Solar Energy Tax Incentives

With the growing concern over the energy crisis and growing interest in the utilization of alternative sources of energy, many state legislators have been busy working on an assortment of energy related measures, most of which deal with solar energy. Significant energy related measures have been enacted thus far in 1977 by 19 states: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Indiana, Montana, Nevada, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Texas, Virginia, and Washington.

New York City Tax Package Enacted

New York City enacted the following local laws designed to encourage businesses to remain or to relocate in New York City:

Corporate tax rate lowered—credit for sales taxes paid.—L. L. No. 64.

Commercial occupancy tax rates reduced.—L. L. No. 63.