NOTES

LOSS DEDUCTIONS FOR QUASI-INVESTORS: 23(e) v. 23(k) v. 117

AN INDIVIDUAL taxpayer [1] wishing to extend financial aid to a business enterprise,[2] in which he has a pecuniary interest,[3] may prefer to lend money to it rather than to invest capital. If the business need is short-term, there is no reason to use a more permanent financing mechanism. Moreover, the loan alternative may prove more attractive because of the enterprise's ability to deduct interest payments from taxable income as a business expense,[4] the preferential treatment of creditors over investors in bankruptcy,[5] and other reasons.[6] Furthermore, if the enterprise should become insolvent, an investor will be entitled to only capital loss deduction.[7] A lender, on the other hand,

1. The problem with which this note deals does not affect the corporate taxpayer; the non-business bad debt provision of the Internal Revenue Code applies only to individual taxpayers. INT. REV. CODE § 23(k) (4).

2. The business enterprise may be a corporation, an association, or a partnership. The "enterprise" may also be an individual in whom the taxpayer has a financial interest. *E.g.*, Fox v. Commissioner, 190 F.2d 101 (2d Cir. 1951) (wife guaranteed husband's open account with stockbroker to protect her previous loan to husband); Shiman v. Commissioner, 60 F.2d 65 (2d Cir. 1932) (taxpayer guaranteed broker's account for brother-in-law to protect taxpayer's own collateral). Also, testamentary trust estates are considered "enterprises." J. B. Book, Jr., 8 T.C.M. 101 (1949) (taxpayer guaranteed notes of trust estate to enhance his remainder interest).

3. The interest may be that of a stockholder or a bondholder; that of a proprietor or a partner; or that of a holder of a mortgage or other evidence of debt. In addition, the interest may exist if the taxpayer's livelihood is derived from the enterprise. George Aftergood, 21 T.C. No. 7 (1953). A taxpayer may also be considered "interested" if he hopes to recoup previous loans or investments by extending additional aid. Fox v. Commissioner, *supra* note 2; Daniel Gimbel, 36 B.T.A. 539 (1937) (guaranty in hope of realizing return on investment in corporate stock).

4. INT. REV. CODE § 23:

> "Deductions From Gross Income.
>
> "In computing net income there shall be allowed as deductions:
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> "(b) Interest.—All interest paid or accrued within the taxable year on indebtedness. . . ."

5. Holders of stock in a corporation and proprietors of a non-corporate enterprise will recover in bankruptcy only after the provable claims of creditors have been satisfied. See 52 STAT. 873 (1938), 11 U.S.C. § 103 (1946).

6. For example, a taxpayer might be able to discount notes with greater facility than he could sell an interest in an unincorporated enterprise.

7. Capital losses are of limited deductibility. They may be applied against capital gains, and any excess losses may wipe out $1,000 of ordinary income. The balance, if any, may be carried forward for five years and may be applied against capital gains and $1,000 of ordinary income per year. See INT. REV. CODE § 117.

Capital losses are of two kinds. If the loss arises "from the sale or exchange of a may receive more favorable treatment,[8] despite the fact that he performs an essentially similar function.[9]

Where a lender to a favored enterprise is not repaid, he can take an ordinary loss deduction [10] under § 23(k) (1) of the Internal Revenue Code only if he can prove that the debt is one "the loss from the worthlessness of which is incurred in [his] trade or business."[11] If he cannot meet this requirement, he will obtain a short-term capital loss deduction for a "non-business bad debt" under § 23(k) (4).[12] While the business bad debt category is far more desirable, even § 23(k) (4) may grant the lender a more advantageous deduction than that obtained by the investor.[13]

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capital asset held for not more than 6 months," it is a short-term capital loss. *Id.* § 117(a) (3). If the loss arises "from the sale or exchange of a capital asset held for more than six months," it is a long-term capital loss. *Id.* § 117(a) (5). For the significance of the distinction, see note 13 *infra.*

8. If the bad debt is determined to be a business bad debt, the lender is entitled to an ordinary loss deduction. See note 10 *infra* and accompanying text. When the debt is held to be of a non-business nature, he receives short-term capital loss treatment. See note 13 *infra.*

9. See note 68 *infra* and accompanying text.

10. This may be fully deducted from gross income in computing net taxable income.

11. INT. REV. CODE § 23:

"Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(k) Bad Debts.—

"(1) General Rule.—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; . . . . This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection. . . .

"(4) Non-business debts.—In the case of a taxpayer, other than a corporation, if a non-business 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. The term "non-business debt" means a debt other than a debt evidenced by a security . . . and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

12. See note 11 *supra.*

This assumes that the Commissioner cannot prove that the financial aid was a gift rather than a loan. If a gift, taxpayer would receive no deduction whatever. Deductions are allowed only when authorized by statute, and the Code makes no mention of a deduction for gifts. See 2 P-H 1954 FED. TAX SERV. ¶ 13,351 *et seq.* (1954). Even in an intrafamily context it is very difficult to prove that this aid was not a loan. See *e.g.*, Agnes Fox, 14 T.C. 1160 (1950). It was this very difficulty of proof that prompted enactment of § 23(k) (4) in 1942. This section of the Code was designed to prevent the practice of disguising a gift to a friend or relative as a loan for reasons of tax advantage. H.R. REP. No. 2333, 77th Cong., 2d Sess. 45 (1942).

13. While neither short-term loss nor long-term loss may be fully deducted from gross income, short-term loss is the more favorable of the two classifications for a taxpayer who has both short and long-term capital gains. For short-term losses are first applied to reduce short-term gains, which are taxed like ordinary income. The net short-

In order to fall within § 23(k)(1), the taxpayer, while he need not be in the "trade or business" of money lending, must be more than merely an active investor.[14] Thus the Second Circuit recently held that an entrepreneur with a financial interest in seven enterprises did not meet the test.[15] The indicated criteria are the number and the nature of the enterprises in which the lender is interested.[16] It seems clear that the taxpayer who makes loans

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term loss, if any, is then applied against long-term gains, which are taxed at roughly half the rate applicable to ordinary income. Long-term losses, on the other hand, are first applied against long-term gains, with the net long-term loss, if any, then applied against short-term gains. INT. REV. CODE § 117. The consequences of characterizing the loss as long or short-term in this situation become apparent upon illustration. Assume taxpayer has a $20,000 short-term gain and a $20,000 long-term gain and suffers a $30,000 loss. Categorizing this loss as short-term will enable him to wipe out the short-term gain and reduce the long-term gain to $10,000, of which approximately $5,000 is taxable. If the loss is labelled long-term, then all the long-term gain is wiped out, while $10,000 of the short-term gain remains, all of which is fully taxable.

Where there are no capital gains against which capital losses may be applied the distinction between short and long-term losses is of no importance; either may be deducted from gross income only to the limited extent provided for by § 117. See note 7 *supra.*

14. See Friedman, *Bad Debts: Business or Non-Business?*, 5 TAX L. REV. 412, 424 (1950); 5 C.C.H. 1954 FED. TAX REP. ¶ 10,856 (1954).

Cases on the problem of whether § 23(k)(1) or § 23(k)(4) applies are myriad. See 2 P-H 1954 FED. TAX SERV. ¶ 13,924A (1954); Friedman, *supra.*

One criterion often applied is whether or not petitioner has devoted all his time to the favored enterprise. Washburn v. Commissioner, 51 F.2d 949 (8th Cir. 1931). A majority in A. Kingsley Ferguson, 16 T.C. 1248 (1951), citing *Washburn*, ruled that the "criterion is obviously whether the occupation of the party involved so consists of expenditure of time, money, and effort as to constitute his business life." *Id.* at 1257.

Deductible business debts were held to exist in: Vincent Campbell, 11 T.C. 510 (1948) (petitioner, in the business of organizing and operating retail coal concerns, lost money which he lent to one of twelve corporations in which he was interested); Robert Cluett, 3d, 8 T.C. 1178 (1947) (debt represented partial purchase price of a fractional accretion to an exchange seat sold by an exchange member); T. I. Crane, 17 B.T.A. 720 (1929) (loss on sale of stock by taxpayer involved in financing mining and iron businesses).

Only non-business debt deductions were permitted in: Campbell v. Walker, 208 F.2d 457 (5th Cir. 1953) (widow's attempt to deduct loss on loan made by her investor-husband); Omaha National Bank v. Commissioner, 183 F.2d 899 (8th Cir. 1950) (loan by principal stockholder, a practicing attorney, to restaurant corporation); A. Kingsley Ferguson, 16 T.C. 1248 (1951) (petitioner was an entrepreneur in the building industry but the business to which he made the loan was not considered to be sufficiently connected with his major field of enterprise).

15. Commissioner v. Smith, 203 F.2d 310 (2d Cir.), *cert. denied*, 346 U.S. 816 (1953). There, taxpayer made a loan to an incorporated farm in which he owned twenty percent of the stock. He was also its treasurer and general manager. His additional pecuniary interests included a department store, two cleaning corporations, a bank, a garage, real estate, and a gear works. The decision was based on Judge Disney's dissent in the Tax Court. Weldon D. Smith, 17 T.C. 135, 147 (1951). The Second Circuit held that "(t)he full-time management of one's investments does not constitute a trade or business." Commissioner v. Smith, *supra* at 312. *But cf.* Henry E. Sage, 15 T.C. 299 (1950); Vincent Campbell, 11 T.C. 510 (1948).

16. See Friedman, *supra* note 14, at 415-17.

only to the subsequently insolvent enterprise and perhaps to a few more will be restricted to the less favorable non-business bad debt deduction.

Were the lender able to bring his loss under § 23(e)(2),[17] he would fare better. That provision permits an ordinary loss deduction when a loss is sustained in "any transaction entered into for profit, though not connected with the [taxpayer's] trade or business."[18] However, the Supreme Court has held § 23(e) and § 23(k) mutually exclusive.[19] Hence, § 23(e)(2) can apply only when the loss is not a bad debt.

If, instead of investing or lending directly, the taxpayer guarantees third-party loans to the favored enterprise and subsequently has to make good his guaranty, that payment may fall within § 23(e)(2). Courts are currently divided on this question.

In recent years the Tax Court has refused to sanction § 23(e)(2) treatment for a guarantor of loans to a favored enterprise.[20] Deduction under § 23(e)(2) is allowed only for losses "not compensated for by insurance or otherwise."[21] When the guarantor pays the creditor, he will ordinarily be subrogated to the creditor's claim, thus acquiring the right to collect from

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17. INT. REV. CODE § 23:

> "Deductions From Gross Income.
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> "In computing net income there shall be allowed as deductions:
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> "(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—
> (1) if incurred in trade or business; or (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; . . . ."

A lender will not ordinarily attempt to fall within § 23(e)(1). If he can qualify for this section, he can also obtain an ordinary loss deduction under § 23(k)(1). However, § 23(e)(1) may prove more advantageous where the taxpayer would have difficulty in proving the year of worthlessness if the loss is categorized as a bad debt. 5 C.C.H. 1954 FED. TAX REP. ¶ 10,856 (1954).

18. INT. REV. CODE § 23(e)(2).

19. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934). The fact that specific provisions were made for debts indicates that they were not to be considered as falling within the general provisions. *Id.* at 189. Taxpayer requested a bad debt deduction on a portion of a partially worthless debt. This was denied because the debt was not totally worthless. He then argued that this was a business loss. This elicited the court's ruling of mutual exclusion. At this time there was little tax difference between bad debt and business loss treatment. But the decision has taken on more significance with the advent of the non-business bad debt provision, written into the Code in 1942.

20. *E.g.*, George Aftergood, 21 T.C. No. 7 (1953) (taxpayer guaranteed loans of corporation to which he devoted full time and of which he was managing director); Leo Pollak, 20 T.C. No. 48 (1953), *rev'd*, 209 F.2d 57 (3d Cir. 1954) (taxpayer guaranteed loans of corporation in which he owned stock); Kate Baker Sherman, 18 T.C. 746 (1952) (wife endorsed note for husband-debtor in an enterprise in which she too was involved); Agnes I. Fox, 14 T.C. 1160 (1950), *rev'd*, 190 F.2d 101 (1951) (wife guaranteed husband's brokerage account covering stocks which she had previously lent him). But see notes 28-32 *infra* and accompanying text for the Tax Court's earlier and more liberal treatment of the guarantor.

21. INT. REV. CODE § 23(e).

the principal debtor.[22] His loss on payment of the guaranty is then "compensated for" by acquisition of the debt,[23] a highly speculative asset.[24] And where the debt subsequently proves uncollectible, the guarantor receives bad debt treatment.[25] This brings him under § 23(k) (4), assuming that the debt did not arise in the taxpayer's trade or business.[26]

But other courts have granted more favorable treatment to the guarantor, allowing him an ordinary loss deduction under § 23(e) (2).[27] They have relied on *Greenspon*, an earlier Tax Court decision.[28] There a taxpayer who had guaranteed loans to a corporation in which he had a financial interest [29] fulfilled the guarantee when the debtor corporation was both insolvent and completely liquidated.[30] Since the principal debtor no longer existed, no recovery from it was possible. Therefore, the guarantor acquired "no debt" to offset his payment, and was left with an uncompensated-for loss.[31] And because this was a "transaction entered into for profit," the requirements of § 23(e) (2) were met.[32]

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22. Leo Pollak, 20 T.C. No. 48, at 3 (1953), *rev'd*, 209 F.2d 57 (3d Cir. 1954); Kate Baker Sherman, 18 T.C. 746, 751 (1952). See also ARANT, SURETYSHIP § 79 (1931); BRANDT, SURETYSHIP AND GUARANTY § 324 (1905). One court expresses this concept by saying that "the law implies a promise on the part of a principal debtor to reimburse his guarantor where the guarantor is forced to pay his debt. . . ." Agnes I. Fox, 14 T.C. 1160, 1164 (1950).

23. Presumably a person who guarantees performance of a contract and who must make good under the guaranty is entitled to an action for damages against the defaulting principal. Although such a chose in action is not a technical "debt," it would help to "compensate" the guarantor for his loss.

24. The value of the indebtedness held by the guarantor or lender is determined not only by the present worth of the debtor enterprise, but also by its future business prospects. See 5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 30.30 (1953).

In some instances the guarantor may pay the creditor where the debtor is solvent; the debtor may be *temporarily* unable to pay, as where the assets of the enterprise are not liquid. Here the chances of eventual recovery may be good. *E.g.*, Daniel Gimbel, 36 B.T.A. 539 (1937).

25. See cases cited in note 20 *supra*.

26. If the debt arose in taxpayer's trade or business, he receives § 23(k) (1) treatment. See text at notes 14-16 *supra*.

27. Pollak v. Commissioner, 209 F.2d 57 (3d Cir. 1954); Fox v. Commissioner, 190 F.2d 101 (2d Cir. 1951); Allen v. Edwards, 114 F. Supp. 672 (M.D. Ga. 1953).

28. Abraham Greenspon, 8 T.C. 431 (1947).

29. He was vice-president of the corporation and owned 35 percent of its stock. *Id.* at 432.

30. *Id.* at 434-5. Petitioner Greenspon and his brother orally guaranteed loans totaling $31,833.34 made in 1928, 1930 and 1931 by one creditor and a loan of $4,500 made by another in 1931. From 1941 to 1945 Greenspon paid $1,575 plus interest to one creditor and $350 monthly to the other creditor after 1942. He expended a total of $4,585 in 1942, and $3,855.25 in 1943. *Id.* at 432-3.

31. *Id.* at 435.

32. *Ibid.* See also Frank Ingersoll, 7 T.C. 34 (1946). The Tax Court granted a business loss deduction where the taxpayer had guaranteed a note of the family corporation in which he was financially interested. The court ruled that no debt was ever owed petitioner, because payment was subsequent to corporation reorganization. Therefore tax-

In the *Fox* case,[33] the Second Circuit, on very similar facts,[34] adopted *Greenspon's* "no debt" rationale to reverse a Tax Court decision denying a § 23(e)(2) deduction.[35] The sole distinction between the cases is that this defunct debtor was not a corporation but was the guarantor's deceased husband, whose insolvent estate had been closed for several years.[36] The court held that payment on the guarantee could not be "compensated for" by acquisition of a debt "where recourse to the original debtor's estate was now obviously out of the question."[37]

In *Allen v. Edwards*,[38] a district court allowed a guarantor a § 23(e)(2) deduction where the debtor corporation was hopelessly insolvent but still in existence.[39] The court found that the debt acquired by the guarantor was totally worthless when the guaranty was paid.[40] Therefore a bad debt deduction was precluded, because § 23(k) applies only to debts which once had value and "become worthless [in the taxpayer's hands] within the taxable year."[41] Admitting confusion,[42] the court rebuffed the Collector's realistic

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payer was not subrogated to any rights against it. The court then found a business loss. In J. B. Book, Jr., 8 T.C.M. 101 (1949), the remainderman of a testamentary trust estate fulfilled his personal guaranty of notes issued by the estate. Since the trust estate had ceased to exist at the time of payment, the court used the same rationale as in *Ingersoll*, citing it and *Greenspon*. *Id.* at 104.

33. Fox v. Commissioner, 190 F.2d 101 (2d Cir. 1951).

34. Mrs. Fox executed a guaranty to her husband's stock brokers as collateral for his open account. She had previously lent him some securities and thus had a "financial interest," as well as a wifely one, in his success. That interest made her guaranty more than a mere moral obligation. *Id.* at 103.

35. The Second Circuit agreed with the Tax Court's dissenting opinion by Arundell, J., who also wrote the Greenspon opinion. The dissent stated that the ruling in Greenspon "does not appear to me to be satisfactorily distinguished by the majority opinion. . . ." Agnes I. Fox, 14 T.C. 1160, 1167 (1950). The Tax Court's dissenting judge in *Aftergood* also cited *Greenspon* and the Second Circuit's decision in *Fox* as precedent for his position. George Aftergood, 21 T.C. No. 7 at 5 (1953).

36. At his death, Fox's net debt to his broker was $141,266.14. "Fox's estate was insolvent and his executors were discharged by the surrogate's court on July 31, 1940." Fox v. Commissioner, 190 F.2d 101, 103 (2d Cir. 1951).

37. *Id.* at 105.

"Nor could payment ten years later create a debt out of something less than even the proverbial stone. It is utterly unrealistic to consider the payment as one made in any expectation of recovery. . . ." *Id.* at 104.

38. Allen v. Edwards, 114 F. Supp. 672 (M.D. Ga. 1953). The Solicitor General has authorized appeal. 4 P-H 1954 FED. TAX SERV. ¶ 71,065 (1954).

39. "The venture was disastrously unsuccessful. By December 1, 1947, . . . [it] . . . was hopelessly insolvent." On December 8, 1947, one creditor called upon the guarantor to pay. He did so between 1947 and 1949. *Id.* at 673.

40. *Id.* at 674-5.

41. INT. REV. CODE § 23(k)(1).

The court cited Eckert v. Burnet, 283 U.S. 140 (1931), as precedent for the holding that a debt which is worthless when acquired cannot be deducted at all as a bad debt because it does not become worthless in taxpayer's hand within the taxable year. Allen v. Edwards, 114 F. Supp. 672, 674-5 (M.D. Ga. 1953). But Judge Learned Hand, author of the Second Circuit opinion affirmed in *Eckert*, has stated that this point in *Eckert* was argument equating a guaranty to a loan.[43] The judge maintained that a guaranty is treated as a liability while a loan is a capital asset.[44] Here the taxpayer had satisfied his obligation on the guaranty [45] and received nothing in return but a theoretical right of subrogation.[46] The court hinged allowance of the § 23(e)(2) deduction on the total worthlessness of the debt, refusing to differentiate between defunct and dying debtor corporations.[47]

A distinction based upon whether the principal debtor is dead or dying when the guaranty is paid would put a premium on the use of manipulative techniques of tax avoidance [48] and would exalt the intricacies of the law of guaranty. Under the *Fox* rule, § 23(e)(2) applied only if the guarantor had suffered a formal deprivation of subrogation.[49] It would be a comparatively easy matter to avoid subrogation by engineering liquidation of a totally insolvent close corporation before the taxpayer satisfies the guaranty.[50] Moreover, subrogation does not occur until the creditor's claim has been paid in full.[51] Where there is no such payment, bad debt coverage would presumably be precluded; and under the "no-debt" theory, § 23(e) treatment would result.[52] Courts have held bad debt provisions inapplicable both where the taxpayer was an indemnitor rather than a guarantor [53] and where the taxpayer paid all but a small fraction of his obligation under the guaranty.[54] The same conclusion has been reached where payment was made for release from

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not the deciding factor, "contrary to what was suggested" by the Supreme Court. The critical factor in that decision was that the taxpayer had merely substituted his note for the note of the corporation. Thus, he changed only the form of his obligation and sustained no real loss. *See* Shiman v. Commissioner, 60 F.2d 65, 67 (2d Cir. 1932).

42. Allen v. Edwards, 114 F. Supp. 672, 675 (M.D. Ga. 1953).

43. *Id.* at 675-6.

44. *Id.* at 676.

45. Petitioners made guarantee payments over a three-year period on a $160,000 indebtedness owed to one creditor, and they paid $15,000 to another creditor. *Id.* at 673-4.

46. *Id.* at 676.

47. *Id.* at 675.

48. *Ibid.*

49. Fox v. Commissioner, 190 F.2d 101, 105 (2d Cir. 1953).

50. A guarantor who is either an owner or major executive of the enterprise may convince his associates to liquidate before he meets his obligation. Thus when he acquires the notes from the lender, dissolution will already have occurred. Subrogation will not result, since no debtor exists. See cases cited notes 28, 32, 33 *supra*.

51. ARANT, SURETYSHIP § 79 (1931).

52. See text at note 31 *supra*.

53. While guarantors are considered automatically entitled to the right of subrogation, indemnitors will not be subrogated absent a specific agreement to that effect. ARANT, SURETYSHIP § 17 (1931).

In Howell v. Commissioner, 69 F.2d 447 (8th Cir. 1934), the court refused to allow the taxpayer a bad debt deduction because as an indemnitor he was not subrogated to the creditor's claims. Since no other deduction provisions were then available, taxpayer was denied relief.

54. Where the guaranty is not paid in full the principal creditor does not relinquish the notes to the guarantor; therefore subrogation does not result. W. H. Hughes, 11 T.C.M. 797, 801-2 (1952).

a guaranty agreement.[55] And still other situations exist where advice of astute counsel would produce a substantial tax advantage for the guarantor.[56]

In *Pollak v. Commissioner*,[57] the Third Circuit went further than *Allen* in extending the *Fox* rule.[58] Here, as in *Allen*, the debtor corporation was still in existence when the guaranty was paid. But, unlike the guarantor in *Allen*, taxpayer Pollak through subrogation had recovered a small percentage of his guaranty payment from the principal debtor in an approximately contemporaneous bankruptcy reorganization.[59] Nevertheless the court held that the guarantor's loss was not compensated for, and it allowed him a deduction under § 23(e)(2). The fact that he recovered a small percentage in reorganization did not mean that he had acquired "an equivalent asset, a collectible debt."[60] That portion of the debt which was worthless when acquired represented a loss to taxpayer. And since it had not become worthless in the taxpayer's hands, § 23(k)(4) could not apply.[61] Presumably *Pollak* is precedent not only where the debtor corporation is reorganized, but also where it is liquidated.

Pollak represents a logical extension of the *Allen* decision. The only difference between the two cases is that Pollak diminished part of his loss by collecting in reorganization. When any portion of a debt is uncollectible, that portion should be treated in the same manner as a totally uncollectible debt.

55. When the guarantor pays a certain amount for release under the guaranty agreement (a type of accord and satisfaction), he is not paying off the guaranty. Consequently he acquires neither the notes of the debtor nor a right of subrogation. John P. Dillon, 9 B.T.A. 177 (1927). There the Commissioner's contention that the guarantor's payment was a capital investment was rejected; petitioner received a deductible loss for the amount claimed.

56. For example, a surety may be liable for only part of the creditor's claim. Even though he has paid his part of the obligation, he is not entitled to sue the principal debtor until the claim is fully paid. ARANT, SURETYSHIP § 79 (1931).

57. 209 F.2d 57 (3d Cir. 1954). The Solicitor General has decided not to ask for certiorari. 4 P-H 1954 FED. TAX SERV. ¶ 71,062 (1954).

58. "It is true that in [the *Fox*] case the principal debtor was deceased, his estate was insolvent and his executors had been discharged before the guarantor made her payments, while here the principal debtor was in existence, even though almost totally insolvent, when the payments were made. We see no legal significance in this difference. . . . [I]n each case the debt arising under the doctrine of subrogation was substantially uncollectible from the time it arose." Pollak v. Commissioner, 209 F.2d 57, 59 (3d Cir. 1954).

59. Petitioner was a stockholder, officer, and employee of the corporation. With another stockholder, he guaranteed bank loans to the corporation on January 12, 1949. The corporation filed a petition for reorganization under the Bankruptcy Act on April 6, 1949. Pollak paid $100,000 under his guaranty from March 14, 1949 to June 23, 1949. Pursuant to the reorganization petitioner received 3.59% of the total amount due him as a general creditor, on or about December 15, 1949.

The Tax Court held that the bad debt provisions prevailed because petitioner either expected to be repaid by the corporation or to have the rights of a creditor against it. The court pointed out that he did, in fact, receive a dividend on his claim. Leo Pollak, 20 T.C. No. 48 (1953).

60. Pollak v. Commissioner, 209 F.2d 57, 59 (3d Cir. 1954).

61. *Ibid.*

To hold otherwise would be to penalize the taxpayer for his good fortune in recovering part of his guarantee payment from the principal debtor.

These decisions favoring the guarantor leave an important issue unresolved. In *Pollak,* reorganization of the debtor corporation occurred roughly at the time when the taxpayer fulfilled his guaranty.[62] The court seemed to rely on the fact that the amount of taxpayer's loss was thus ascertained when subrogation occurred.[63] Cases may arise in which payment of the guaranty, and hence subrogation, takes place substantially before liquidation or reorganization. Then courts might be tempted to hold that upon subrogation the guarantor holds a debt which may still be collectible, since the amount of any loss has not been ascertained. This could lead them to grant the guarantor only a § 23(k)(4) deduction when reorganization or liquidation later proves that a portion of the debt has "become worthless" in the taxpayer's hands. But such a rationale would misplace emphasis on the *time* of reorganization or liquidation, which is subject to manipulation.[64] The guarantor is no better off because the amount of his loss is not ascertained when he makes payment on the guaranty; it may then be apparent that he will never collect the debt in full. If *Pollak, Allen,* and *Fox* are to stand, courts should meet this situation on like terms. They should allow the guarantor a § 23(e)(2) deduction for the estimated amount of an unascertained loss incurred when the guaranty is paid. The taxpayer's income can be adjusted in a subsequent tax year if reorganization or liquidation of the debtor corporation then shows that the estimate was inaccurate.[65]

Even if *Pollak* were thus extended to assure that all guarantors of loans to favored enterprises receive similar treatment, there is little reason to grant the guarantor a tax advantage denied the lender. The cases culminating in *Pollak* rely on the fact that a guaranty is a transaction entered into for profit,[66] a rationale equally applicable to loans. Both lender and guarantor expect to benefit from the infusion of money into the enterprise in which they are interested.[67] Technically, one is risking capital directly while the other is risking it contingently. But such a distinction presents no rational basis for differential tax treatment, since both entrepreneurs take the same risk and perform the same function in the economy.

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62. *Id.* at 57, 58.

63. *Id.* at 58, 59.

64. Purposeful timing of death of the debtor is less likely than manipulation of dissolution of the business unit. However, the debtor's death at a propitious moment might aid the guarantor considerably.

65. This would be similar to the deduction for bad debt reserves, which the Commissioner may allow in his discretion. INT. REV. CODE § 23(k)(1); U.S. Treas. Reg. 118, § 39.23(k)-5(a) (1943).

66. Pollak v. Commissioner, 209 F.2d 57, 58 (3d Cir. 1954); Fox v. Commissioner, 190 F.2d 101, 104 (2d Cir. 1951).

67. Both have interests in the enterprise other than the particular loan extended or guaranteed. Hence both will have their interests similarly appreciated.

Sound policy requires not only that lenders and guarantors of loans to enterprises in which they have a financial stake be treated alike but that both be treated as investors. The taxpayer, either lender or guarantor, actually performs the function of an investor. Because of his pre-existing monetary interest in the enterprise, he appreciates his equity or sustains a loss in a way in which an uninterested lender cannot.[68] For reasons previously indicated,[69] he has simply chosen to clothe his investment in another guise. Yet, by allowing him a short-term capital loss deduction under § 23(k)(4) or an ordinary loss deduction under § 23(e)(2), courts accord the lender or guarantor treatment different from that which the ordinary investor receives. Both alternatives seem inconsistent with the legislative intent to treat investors' losses differently from other losses.[70] The capital gain and loss provisions of the Internal Revenue Code should be held to apply to all investors, whether they purchase stocks or bonds or make or guarantee loans to enterprises in which they already have a financial interest.

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68. Since the taxpayer already has an interest in the enterprise, its future earning prospects affect him directly. Should an enterprise do well, both the interested and uninterested lender will be repaid; but the former will also have increased his capital value. Conversely, should the enterprise fail, both will lose the amount loaned; but the interested lender will have the value of his investment decreased, as well.

69. See text at notes 4-7 *supra*.

70. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.02 (1953).