Harlan v. United States

34 A.F.T.R. 2d 5837

Findings of Fact and Conclusions of Law

Findings of Fact

MAHON, District Judge: 1. This is a civil refund suit for the recovery of $6,550.25 plus statutory interest thereon representing income taxes and deficiency interest upon such taxes assessed and collected by the Defendant from Mary Jane and W. Larry Harlan for the 1967.

2. Plaintiff is the widow and independent executrix of W. Larry Harlan and resides at 9963 Rockbrook Drive, Dallas, Texas. For the year 1967, Mary Jane Harlan and W. Larry Harlan filed separate income tax returns. All questions [*2] of law and fact in this case are identical for Mary Jane Harlan and the estate of W. Larry Harlan and arise out of the business activities of W. Larry Harlan. Plaintiff Mary Jane Harlan individually is involved solely by reason of the community property effect of such activities.

3. For the year 1967, Mary Jane and W. Larry Harlan filed timely separate federal income tax returns. On or about October 3, 1970, taxpayers filed claims for refunds which were denied by the Director of the Internal Revenue Service Center, Austin, Texas, on March 8, 1971.

4. Mr. Harlan since 1949 was the Manager of the Credit Life Insurance Division of American National Insurance Company under a contract which provided, among other things, that his compensation would be based upon a percentage of the premium income produced for American National Insurance Company under his direction. Thus Mr. Harlan's income was directly tied to the productivity of his organization. In connection with this business, Mr. Harlan developed an organization based in Dallas consisting of employees of American National Insurance Company, employees of his own and some individuals whose salaries were paid both by American [*3] National and by Mr. Harlan.

5. During the years 1963 through 1970, Mr. Harlan made thirty-two loans to members of his organization. These loans are described on Exhibit F to the Partial Stipulation of Facts filed in this case. This Exhibit sets forth the name of the person to whom the loan was made, the principal sum, the date of the loan, the interst rate, current status as paid or unpaid, whether default occurred, and whether a deduction was claimed.

6. In 1965, an employee of Mr. Harlan, Charles M. Holman, borrowed $23,582.99 from the First National Bank in Dallas, and asked Mr. Harlan to guarantee his loan. Mr. Harlan did guarantee the loan. No charge was made by Mr. Harlan for acting as guarantor of this loan, and it is the only instance in which Mr. Harlan acted as guarantor of a loan to one of his employees. These funds were used for Mr. Holman's private investments and not used in his individual trade or business. By late 1966, this indebtedness had been reduced to $16,089.48, for which amount Mr. Holman issued a new note. Early in 1967, Mr. Holman was adjudged bankrupt in Case Number 3-728 in the United States District Court for the Northern District of Texas. [*4] On

June 2, 1967, the First National Bank in Dallas, called on Mr. Harlan to pay $16,611.94 which amount included the principal of Mr. Holman's note of $16,089.48, and interest in the amount of $522.46. Upon this payment, the Bank endorsed the note to Mr. Harlan and assigned to Mr. Harlan the Bank's bankruptcy claim. A dividend to creditors of 8.555 per cent was paid before the end of 1967, and that bankruptcy proceeding was closed December 15, 1967. Mr. Harlan received the amount of $1,382.68 on his claim. This dividend reduced the amount of Mr. Harlan's loss to $15,229.26, which amount became totally worthless during 1967. Mr. Harlan deducted this loss as an ordinary loss in computing his 1967 income tax liability. The Internal Revenue Service treated this loss as a short term capital loss. This difference in treatment gives rise to these proceedings.

7. Mr. Harlan's guaranty of Charles Holman's note was part of a pattern of loaning money and credit to his employees. This activity was a factor in developing and maintaining employee loyalty and dedication which maintained employee productivity and enhanced Mr. Harlan's income which was directly tied to the volume of business [*5] his organization produced. I find that Mr. Harlan's activity of loaning money and credit in general, and his action in guaranteeing the note of Charles Holman in particular, were appropriate and useful actions in furtherance of his business as an insurance producer and that the relationship of these actions to his business was proximate. I find that Mr. Harlan's guaranty of the note of Charles Holman was made in connection with his business as an insurance producer.

8. The Court adopts the Partial Stipulation of Facts agreed to by the parties and filed among the papers of this cause.

Conclusions of Law

From the foregoing facts, the Court concludes:

1. The Court has jurisdiction over this action by virtue of the provisions of *Section 1346(a) (1) of Title 28 United States Code*.Venue is correctly placed under *28 U.S.C. Section 1402(a) (1)*. This action is properly brought within the time prescribed by *Section 6532 of the Internal Revenue Code of 1954*, as amended.

2. Any findings of fact heretofore made which are deemed to be conclusions of law are incorporated by reference in these Conclusions of Law as if fully set forth herein.

3. The loss suffered by the Plaintiff [*6] is deductible under *Section 166(a) of the Internal Revenue Code* and is a business bad debt because it was incurred in connection with the trade or business of Mr. Harlan as an insurance producer. *Welch v. Helvering, 290 U.S. 111 (1933)*; *Stuart Bart v. Commr., 21 T.C. 880 (1954)*; *Estate of Martha Byers v. Commr., 57 T.C. 568 (1972)*.

4. Assuming, arguendo, that the "dominant and primary motivation" test adhered to in *United States v. Generes, 405 U.S. 93, 31 L. Ed. 2d 62, 92 S. Ct. 827 (1972)* is applicable to the circumstances at bar, the guaranty in question satisfies the requirements thereof, and it is so held both as a matter of law and as a matter of fact.

The Court believes that support for this conclusion is found in the evidence as well as in the arguments and authorities advanced by Plaintiff. In addition, the Court further observes that the distinction between business and nonbusiness bad debts was established by amendment of the tax statutes in 1942. Those amendments sought to "prevent taxpayers from lending money to friends or relatives who they knew would not repay it and then deducting against ordinary income a loss in the amount of the loan." [1] A transaction in [*7] which there was reflected a

merely gratuitous act of that nature would not be entitled to the treatment accorded a business bad debt.

1 *United States v. Generes, 405 U.S. 93, 109-110 (1972)* (Marshall, J., concurring opinion).

While it would seem that conceptually there could be considerable overlapping, the motivations behind intrafamily loans and the motivations underlying a loan by an employer to an employee would not be inherently the same. It is noted that debts incurred for which there was no legal obligation but which were undertaken in an effort to avoid "impairment" of the attitudes of salesmen and for the "purpose of preserving the loyalty of employees" have been recognized as an "ordinary and necessary" expense of carrying on a business. [2] Attention is also directed to *Champion Spark Plug Co. v. Commissioner of Internal Revenue, 30 T.C. 295 (1958)*, aff'd, *266 F.2d 346 (6th Cir. 1959)*. There the contention was made by the Commissioner that the death benefits paid by Champion to the widow of one of its deceased employees was unnecessary since the company was under no legal duty to make the payment. In holding that the payment was an ordinary and necessary expense [*8] as that term is contemplated by the tax laws, the Tax Court wrote:

"In modern times a large corporation often makes some expenditures having a connection with the employer and employee relationship, such as sickness, recreational, or welfare items, which the employer, for business reasons or good employee relationship, desires to either pay or obligate itself to pay. This is not a situation of an obligation to make a gratuitous expenditure having no connection with petitioner's trade or business for respondent concedes the deductibility of payment. It is sufficient here that the petitioner desired to obligate itself to make the payments that have a connection with its employer-employee relationship. It translated its desire into an unconditional obligation to make the payments. The expenditure, which we feel was ordinary and necessary in the conduct of its business, was properly accruable in the year 1953 when the obligation to pay was made fixed and definite by the resolution." *30 T.C. at 298*.

2 *Dunn & McCarthy v. Commissioner of Internal Revenue, 139 F.2d 242 (2d Cir. 1943)*, cited with approval *Lutz v. Commissioner of Internal Revenue, 282 F.2d 614, 620 (5th Cir. 1960)*.

[*9] Further, it is perhaps appropriate to recognize that the circumstances in the cause sub judice are distinguishable from those in cases similar to Generes wherein loans have been made by a shareholder-employee of a corporation to his employer. In many of these instances an individual has contributed resources to a venture, which, if successful, would have resulted in income subject to capital gains treatment, while, upon its lack of success, he has attempted to claim a deduction against ordinary income. It has been said that activities which may "generate capital gains ought not, without express Congressional approval, give rise to ordinary loss if unsuccessful." [3] Such circumstances are not present herein. Unlike the Court in Generes, we are not faced with a taxpayer who occupies a "dual status relative to the corporation" and who is attempting to recognize benefits in two ways.

3 Cannon, Characterization of Shareholder-Creditor Bad Debt: United States v. Generes Sounds the Knell for Deductions from Ordinary Income, 26 Vand. L. Rev. 105, 112 (1973).

I do not believe the debt in question to be in the nature of those to which the nonbusiness provisions of the Code were [*10] intended to be applied. To the contrary, the dominant motivation for the guaranty related to the taxpayer's business to which it was proximately related.

5. Plaintiff is entitled to judgment of $6,550.25 plus interest at the rate of 6% per annum as provided by law.