S. D. Ferguson v. Commissioner, 28 T.C. 432 (1957)

A stockholder’s loan to a corporation is not a business bad debt unless the taxpayer’s activities in financing businesses are so extensive as to constitute a separate trade or business.

<p>Summary</p>
<p>S.D. Ferguson, the petitioner, claimed a business bad debt deduction for losses incurred from loans and endorsements related to several corporations, primarily those involved in cinder block manufacturing, where he and his son owned all the stock. The IRS disallowed the deduction, treating the debt as a nonbusiness bad debt, resulting in a short-term capital loss. The Tax Court held that Ferguson's activities did not constitute a separate trade or business of promoting, organizing, and financing businesses. Therefore, the debt was not proximately related to a trade or business, denying the business bad debt deduction and affirming the IRS's assessment.</p>

<p>Facts</p>
<p>S.D. Ferguson, born in 1863, engaged in various business ventures including financing small enterprises, and organized numerous corporations. From 1938, he and his son were substantially the sole stockholders in three cinder block manufacturing companies. Ferguson made loans and guaranteed notes for these companies. In 1951, one of the companies, Cinder Block, Inc. (CB), became insolvent. Ferguson paid a $100,000 note under his endorsement liability, and his remaining assets were applied against the liability owing to the petitioner, which includes the $100,000 paid by the petitioner on his endorser's liability, leaving an unpaid balance due the petitioner of $118,503.10.</p>

<p>Procedural History</p>
<p>The IRS determined a deficiency in Ferguson's 1951 income tax, disallowing his claimed business bad debt deduction. The Tax Court considered the case and ultimately sided with the Commissioner, denying the deduction.</p>

<p>Issue(s)</p>
<p>1. Whether the debt of $118,503.10 was a business bad debt deductible under Section 23(k)(1) of the Internal Revenue Code of 1939.</p>
<p>2. If the debt was not a business bad debt, whether the $100,000 payment on the note was deductible under Section 23(e)(2) as a loss incurred in a transaction entered into for profit.</p>

<p>Holding</p>
<p>1. No, because Ferguson's activities in financing businesses were not extensive enough to constitute a separate trade or business.</p>
<p>2. No, because the Supreme Court's decision in Putnam v. Commissioner treated the guaranty loss as a loss from a bad debt, which is

not deductible under Section 23(e)(2).</p>

<p>Court's Reasoning</p>
<p>The court examined whether the debt's worthlessness was proximately related to a trade or business in which Ferguson was engaged in 1951. The court noted that Ferguson had a long history of investments and involvement in various businesses, but the key was whether these activities constituted a current trade or business. The court cited cases emphasizing that a stockholder's loans may qualify as business bad debts if the stockholder is engaged in the trade or business of promoting and financing businesses.</p>
<p>The court differentiated between the activities of a business and the activities of the stockholder: "The business of the corporation is not considered to be the business of the stockholders." The court found that Ferguson's activities in 1951 and the immediately preceding years were not extensive enough to be considered the conduct of a business of promoting, organizing, managing, financing, and making loans to businesses. Regarding the endorsement liability, the court cited Putnam v. Commissioner to establish that guaranty losses are treated as bad debts, which are not deductible under a different provision.</p>

<p>Practical Implications</p>
<p>This case clarifies the requirements for a business bad debt deduction when a shareholder loans money to or guarantees debts of a corporation. Attorneys and tax professionals must ascertain if the taxpayer's financial activities are sufficiently extensive and continuous to be considered a separate trade or business. The frequency and magnitude of the taxpayer's financial activities will determine whether a loss from the worthlessness of a debt is deductible as a business bad debt. The case underscores the importance of meticulous record-keeping to demonstrate that a taxpayer's activities are more than mere investment or management of one's own portfolio. Attorneys should advise their clients on the significance of showing a pattern of activity separate from the operation of the business itself. Furthermore, this case provides a strong precedent for applying Putnam to deny a loss deduction under Section 23(e)(2) for payment of endorsement liability.</p>