Keating v. Commissioner, 89 T. C. 1071 (1987)

Nonbusiness bad debts are treated as investment expenses only to the extent they are currently deductible for purposes of calculating investment interest limitations.

Summary

In Keating v. Commissioner, the taxpayers reported a nonbusiness bad debt of $567,424 on their 1978 tax return, deductible only to the extent of $116,800 due to capital loss limitations. The issue was whether the full amount of the bad debt should be treated as an investment expense under IRC §163(d), reducing their net investment income, or only the deductible portion. The Tax Court held that only the amount currently deductible ($116,800) should be considered an investment expense, reasoning that the term “allowable” in the statute limits the expense to the current year’s deduction. This decision impacts how nonbusiness bad debts are calculated for investment interest deductions, affecting tax planning and legal practice in this area.

Facts

Charles and Mary Elaine Keating invested in Provident Travel Service, Inc. , with Mrs. Keating owning stock and Mr. Keating providing cash advances. In 1975, Mrs. Keating sold her stock to Harrington Enterprises, Inc. , receiving a promissory note secured by the stock. Mr. Keating’s advances were evidenced by an unsecured note. By 1978, both notes were deemed worthless, leading to a reported nonbusiness bad debt of $567,424 on the Keatings’ tax return, deductible only up to $116,800 against their short-term capital gain.

Procedural History

The Commissioner issued a deficiency notice for the years 1978-1980, asserting that the entire nonbusiness bad debt should be treated as an investment expense, reducing net investment income and disallowing further investment interest deductions. The Keatings petitioned the U. S. Tax Court, which ruled in their favor, holding that only the currently deductible portion of the nonbusiness bad debt should be considered an investment expense.

Issue(s)

1. Whether the full amount of a nonbusiness bad debt should be treated as an investment expense under IRC §163(d)(3)(C) for calculating investment interest limitations, or only the portion currently deductible.

Holding

1. No, because the term “allowable” in IRC §163(d)(3)(C) limits the amount of nonbusiness bad debts treated as investment expenses to the portion currently

deductible under IRC §166(d).

Court's Reasoning

The court interpreted IRC §163(d)(3)(C) to mean that only the currently deductible portion of nonbusiness bad debts should be considered investment expenses. The court reasoned that the term "allowable" in the statute implies that only deductions allowed in the current year should be treated as investment expenses. The court also noted that this interpretation aligns with the policy of IRC §163(d) to limit deductions of investment-related expenses against non-investment income. The court rejected the Commissioner's argument that the full amount of the bad debt should be treated as an investment expense, as it would lead to an anomalous result compared to the treatment of capital losses. The court's decision was supported by legislative history indicating that non-allowed deductions should not be considered investment expenses.

Practical Implications

This decision clarifies that for tax years prior to the Tax Reform Act of 1986, only the currently deductible portion of nonbusiness bad debts should be treated as investment expenses when calculating investment interest limitations. Taxpayers and practitioners must consider this when planning and calculating investment interest deductions. The ruling impacts how nonbusiness bad debts are reported and deducted, potentially affecting tax liabilities and planning strategies. Subsequent cases and IRS guidance have applied this principle, ensuring consistency in tax treatment of nonbusiness bad debts as investment expenses.

