ORIGINAL

In the

Supreme Court of the United States

UNITED STATES OF AMERICA,

Petitioner,

v. No. 70-28

EDNA GENERES, Wife of, and
ALLEN H. GENERES,

Respondents.

Washington, D. C.
November 8, 1971

Pages 1 thru 48

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Washington, D. C.,

Monday, November 8, 1971.

The above-entitled matter came on for argument at 10:07 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice

APPEARANCES:

MATTHEW J. ZINN, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C. 20530, for the Petitioner.

MAX NATHAN, JR., ESQ., Sessions, Fishman, Rosenson, Snellings and Boisfontaine, 21st Floor, 1010 Common Street, New Orleans, Louisiana 70112, for the Respondents.

C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in No. 28, United States against Edna Generes and Allen Generes.

Mr. Zinn, you may proceed whenever you're ready.

ORAL ARGUMENT OF MATTHEW J. ZINN, ESQ.,

ON BEHALF OF THE PETITIONER

MR. ZINN: Mr. Chief Justice, and may it please the Court:

This federal income tax case is here on writ of certiorari to the Court of Appeals for the Fifth Circuit. It raises a question with which this Court is familiar; whether a shareholder, in a closely held corporation is entitled to business or non-business bad debt deduction if he is unable to collect a debt owed him by his corporation.

The difference between a business and non-business bad debt deduction is critical, since the former is deductible against ordinary income and may be carried back as part of a net operating loss. Whereas the latter is deductible only as a short-term capital loss and may not be carried back to offset the ordinary income of prior years.

This Court's decision in Whipple v. Commissioner, in 1963, settled the question whether merely investing in a corporation is a trade or business. The Court held it is not and consequently a mere investor in a corporation, who is

unable to recover his advances to the corporation, is entitled only to nonbusiness bad debt treatment.

On the other hand, since the rendering of services to a corporation for remuneration constitutes a trade or business, an employee who advances funds to his corporation in order to protect his job and salary and who is unable to collect the debt owed him by his corporation is entitled to a business bad debt deduction.

The problem in this case arises where a taxpayer bears the dual relationship of shareholder and employee to the corporation. If he were merely a shareholder, then, as I have said, he would be entitled only to nonbusiness bad debt treatment. But if he were only an employee who advanced funds to protect his job and salary, he would be entitled to business bad debt treatment.

In the dual status situation which arises here, however, where the taxpayer is motivated both by a desire to protect his job and salary and by a desire to protect his investment, the Internal Revenue Code makes no provision for allocating loss in part to business and in part to nonbusiness. The loss must be characterized in its entirety as business or nonbusiness in nature, even though the shareholder employee was motivated by both business and nonbusiness considerations, to make a loan or guarantee his corporation's debts.

Section 166(d) of the Code is the relevant statute,

and it is set out on page 36 of our brief. It provides that the term "nonbusiness debt" means a debt other than a debt created or acquired in connection with the trade or business of the taxpayer, or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The pertinent regulations are set out on pages 36 and 37 of our brief, and, insofar as they are relevant here, they provide, as explicated in Whipple, that a debt will be considered a business bad debt if the loss resulting from the debts becoming worthless is proximately related to maintaining the taxpayer's trade or business.

The position of the United States in this case is that in a dual status situation the test is satisfied only if the dominant motivation for the taxpayer's undertaking was to protect his business interest as an employee, rather than his nonbusiness interest as a stockholder.

The position of the respondent that a taxpayer is entitled to business bad debt treatment even if his dominant motivation was to protect his investment, so long as he was significantly motivated by his business interest as an employee.

With this background, let me turn to the facts of the case. Mr. Generes, the respondent, and his son-in-law, William Kelly, each owned 44 percent of the sock of the Kelly-Generes Construction Company, a corporation engaged in heavy construction work, principally for governmental authorities.

The remainder of the stock was owned by a son and another son-in-law of Mr. Generes.

The corporation had been formed in 1954 as successor to a partnership in which Mr. Generes and Mr. Kelly had been equal partners. Mr. Kelly was the vice president of the corporation, was in the charge of its day-to-day operations, and received a salary of $15,000 a year for his services. Mr. Generes was president, was principally responsible for obtaining bank financing and securing performance and bid bonds on construction jobs undertaken by the corporation, and was paid a salary of $12,000 a year.

Mr. Generes' principal employment was as president of a savings and loan association, for which he worked full time and received an annual salary of $19,000 a year.

At a pretrial deposition, Mr. Generes testified that he devoted about one hour a week to the affairs of the Kelly-Generes Construction Corporation. At trial he testified that he spent six to eight hours a week on the corporation's affairs.

Mr. Generes' original investment in the corporation was $38,900. In addition, he advanced funds to the corporation from time to time, when it was short of working capital, and also guaranteed the corporation's bank loans to enable the corporation to purchase machinery and equipment.

In 1962, when the corporation was in serious financial difficulty, he advanced it $158,000.

The corporation was required to furnish performance and payment bonds in connection with its construction business, which was largely performed for governmental authorities. Most of these bonds were written by the Maryland Casualty Company. From 1954 to 1958 Casualty, as a matter of course, required Mr. Generes to indemnify it with respect to each bond issued to the corporation. Bonds were issued on an individual job basis.

Late in 1958, to obviate the need for individual bonds on each construction job, Mr. Generes and Mr. Kelly, acting for themselves individually and also for the corporation, signed a blanket indemnity agreement with Maryland Casualty. Under this agreement, Casualty agreed to act as surety for the corporation for up to a million and a half dollars on any one job, and $2 million over-all.

Mr. Generes and Mr. Kelly in turn agreed to indemnify Casualty for any loss it might suffer as surety.

In 1962, the corporation defaulted on two contracts. Maryland Casualty made good on the defaults, and Mr. Generes was called upon to respond under his indemnity agreement. He indemnified Casualty for $162,000, which he was unable to recover from the corporation because of its bankruptcy. He was also unable to collect the $158,000 that he had advanced to the corporation in 1962 in direct loans.

In his income tax return for 1962, Mr. Generes

treated the loss on the direct loans as a nonbusiness bad debt, and the Commissioner allowed that loss, and it is not here in dispute. However, he treated his indemnification loss of $162,000 as a business bad debt. The proper treatment of that $162,000, as business or nonbusiness, is the sole issue before this Court.

The case was tried before a jury in New Orleans. The trial lasted one day.

Mr. Generes testified, and I refer now to page 67 of the record, that the only reason he signed the indemnity agreement with Maryland Casualty was to protect his part-time job with the corporation.

In response to the question whether he had given any thought at all to his investment in the corporation, in guaranteeing -- and his investment, I might point out, consisted both of his stock interest and his direct loans to the corporation -- he testified, and I quote: "No, I never once gave it a thought."

And I quote again from page 69 of the record, "To tell you the truth about it, I never gave that a thought; I never gave my investment a thought."

Q Mr. Zinn, incidentally, are his returns in the record?

MR. ZINN: I believe they are, Mr. Justice.

Q Do they show roughly what his gross income was

for the year in question?

MR. ZINN: I think it does, Mr. Justice. The --

Q It must include the two salary items.

MR. ZINN: That's right. And --

Q Anything more, do you know?

MR. ZINN: Yes, he had some dividends, and I think the record shows that his income roughly, with dividends and other income, averaged about $40,000 a year.

Q Which would take him close to 42 to 50 percent --

MR. ZINN: In those days, Mr. Justice, that was before enactment of the Revenue Act of 1962, so the rates were somewhat higher. I would say 40 to 50 percent was probably -- if that's what you're asking --

Q Right.

MR. ZINN: -- was the marginal tax bracket before the enactment of the Revenue Act of '62.

Q Thank you.

Q Mr. Zinn --

MR. ZINN: Yes, sir.

Q -- on the evidence, would you agree that the evidence of this case would have brought this under the dominant motive test?

MR. ZINN: I think that the --

Q To put it another way: If the instruction had been given, as the government requested, on this evidence with

that instruction there would have been no problem; you wouldn't be here, would you?

MR. ZINN: I think the government would have prevailed, Mr. Chief Justice. We wouldn't be here, no. On the dominant --

Q Would it have prevailed if the jury had found in favor of the government on this evidence --

MR. ZINN: If the jury had --

Q -- with the appropriate instruction that you requested?

MR. ZINN: I think we might have been in the Court of Appeals on the grounds that there was insufficient evidence to support the verdict; but we wouldn't be here.

My point was, Mr. Chief Justice, that it's difficult for me to believe that the jury would have found for the taxpayer, under the dominant standard.

Q But then you'd have a very different case here.

MR. ZINN: On the question of whether the jury's finding was clearly erroneous, and we wouldn't be in this Court on that.

Q You're only quarreling with -- really quarreling with the instruction, aren't you?

MR. ZINN: That's correct, sir. Only with the instruction.

After getting the significant motivation instruction, to which the Chief Justice has referred, the jury went out

shortly after five o'clock, at the close of this one-day trial, and it stayed out nearly two hours. It returned shortly after 7:00 p.m., seeking clarification of the significant motivation instruction. And I refer the Court to page 129 of the record, at which the jury put the following question to the trial judge, and I quote:

"Is the question given to us intended for us to decice whether he signed the indemnity agreement solely for the protection of his salary, investment, or could it be both?"

The jury, it seems clear to us, was somewhat confused as to how to apply the so-called significant motivation instruction.

After coming back this first time, at shortly after seven o'clock, the jury went out for another 40 minutes, and it returned again for clarification of the instruction; and I refer the Court now to page 130 of the record, and again, at this point, the jury asked, and I quote:

"Would you please re-read your answer to our question and possibly interpret it further?"

And the trial judge undertook to do that.

The jury went back to deliberate for the third time, and reached a verdict favorable to Mr. Generes. The government's motions for judgment n.o.v. and alternatively for a new trial were denied. And on the government's appeal, the Fifth Circuit, by a divided vote, held that the jury had been properly

instructed.

Q Was the only direct evidence on the issue of what his motivation had been what you've referred us to on pages 67 and 69 of his own testimony?

MR. ZINN: Yes. There is other testimony, Mr. Justice Stewart, that he had some hope of getting dividends, that he was trying to build up an estate for his children, and so forth. But that, I think, is the critical evidence that he did not give his investment a thought.

Q And that he testified that his sole purpose --

MR. ZINN: That's correct.

Q -- in signing this indemnity agreement was to protect his job and his salary from the job?

MR. ZINN: Right. Of course, if the only purpose is that purpose, we wouldn't be here. The whole basis of this case is that there is a duality of purpose. And a single-purpose case we think is fairly clear under this Court's decision in Whipple, where the single purpose is investment purpose, and under the Trent case, which we do not disagree with, where the man is solely an employee, Second Circuit decision, and is required as a condition to his employment to --

Q But your point is that although the only direct evidence was that his sole motivation was to protect his salary as an employee, and to protect his employment itself, is that, nonetheless, the very fact that he was a stockholder --

MR. ZINN: Yes, sir.

Q -- entitled you to give instruction on this?

MR. ZINN: That is correct. And it seems clear enough on this record that the jury had some difficulty in believing that that was his sole purpose, because if it was they wouldn't have had to worry about what the term "significant" meant, as they did worry about it. And for that reason we think that any suggestion in the respondents' brief that the error on this record may have been harmless is not well taken.

Q Just because he was in fact a stockholder.--

MR. ZINN: Yes, and because it --

Q -- in that?

MR. ZINN: -- is obvious that the jury didn't believe that his sole interest was as an employee interest. They could have decided that, here it was five o'clock, they had sat all day. We think it's somewhat unusual that a jury would spend three hours on a case like this one, when it's anxious to get home for dinner.

Q Is there any evidence in the record about the value of his stock interest?

MR. ZINN: About the value, sir? No. We know that his basis in the stock was $38,900. The basis in the stock.

Q And what was the loan that was guaranteed?

MR. ZINN: $162,000 as of 1962. So, as far as we're concerned --

Q And what was his salary?

MR. ZINN: $12,000 a year.

Q Do you make an argument that he really wouldn't guarantee a loan of $160,000 just to protect a $12,000 salary interest?

MR. ZINN: No. I'm sorry. He had -- let me go back and get the figures right. He had made direct loans to the corporation of $158,000.

Q But they're not in issue here.

MR. ZINN: They're not in issue here, but we think they're very relevant because the taxpayer treated these as nonbusiness loans, as an investment. So his investment clearly was at least $158,000, even if the stock was worthless.

Q But if you add the stock to it?

MR. ZINN: If we add the stock, it brings it -- assuming that it had a fair market value equal to its basis, we're talking about an investment of $200,000.

Q Well, would you -- do you make the argument that no one would --

MR. ZINN: We certainly --

Q -- that no one would guarantee a loan of this amount just to protect a $12,000 salary interest?

MR. ZINN: Yes, we do. We're talking about a guarantee here of up to $2 million, Mr. Justice White, and --

Q That's what I wanted to know.

MR. ZINN: Yes. We think that it strains the imagination to think that someone who is solely an employee, solely an employee now, who is making $12,000 a year on a part-time job, who had from 30 to 55 thousand dollars in assets, who is over 70 years old, would -- if you'll pardon the express -- go on the hook for up to $2 million in order to protect this part-time job.

Q On that basis, why would he do it to protect that $150,000?

MR. ZINN: Well, a $200,000 investment, and also he had other motivations, we think. After all, it was his son-in-law who was running this business, and I think another son-in-law was working in the business, the stock was owned by him individually, by two of his sons-in-law and by a son. And so we think he had significant personal motivations here --

Q Yes; right.

MR. ZINN: -- as well as nonbusiness motivations.

Our position that business bad debt treatment should be allowed in a dual status situation, only where the dominant motivation for the undertaking is protection of employment, rests on four considerations.

The first of these arises simply from the fact that we are faced with a situation here where we must characterize a bad debt in its entirety as business or nonbusiness in nature, even though the taxpayer was motivated by two considerations to

guarantee his corporation's debts.

Now, the Internal Revenue Code might have provided in such circumstances that half of the debt should be treated as a business bad debt and half should be treated as a nonbusiness bad debt; but that's not what it does provide. A choice has to be made. Either it's all business or it's all nonbusiness. And we submit that, purely from the standpoint of logic and in the absence of any overriding policy consideration, it is far more logical to have the character of the debt determined by reference to the weight of your consideration rather than by reference to a lessar consideration.

Secondly, we have referred in our brief to several analogous situations, in which the tax consequences are determined by reference to the weight of your consideration, in situations where an all-or-nothing choice must be made, just as here. And the first involves the business bad debt provision itself.

Prior to 1942, as Mr. Justice White pointed out in his opinion in Whipple, there was no such thing as business and nonbusiness bad debts, they were simply bad debts; and whether they were business, nonbusiness, or otherwise, if they went unrepaid, they were deductible against ordinary income.

A substantial loophole developed in the Internal Revenue Code, where loans would be made to family members and go unrepaid and taxpayers would claim an ordinary deduction

against -- for these loans.

So one of the primary purposes of Congress' enactment of the business/nonbusiness dichotomy in 1942 was to close up this loophole. Now, you could have a situation where, instead of -- as we have here for the most part, we're talking about a nonbusiness investment consideration against a business consideration -- where you have primarily a nonbusiness personal consideration against a business consideration.

Now, under the tests that respondent proposes, the significant test, a business bad debt would be allowed even if the weight of your consideration were the personal consideration. And we submit this would be squarely contrary to the congressional intent in 1942.

Similarly, as Mr. Justice Brennan pointed out in the Putnam case, one of the purposes of the 1942 legislation was to put nonbusiness investments in the form of loans, on the footing with nonbusiness investments in the form of stocks. And the courts have held that where corporate stock is purchased, both for business reasons and investment reasons, the dominant motivation is controlling in characterizing that loss.

Again, to put the two on an equal footing, only the dominant standard can be applied.

Finally, we refer to the fact that in the legislative history of Section 166 there are references to applying the same test as is applied under Section 165, in determining whether

an expense is incurred or a loss is incurred in a trade or business, or in a transaction entered into for profit. And under Section 165 it is clear that the dominant standard controls.

And thirdly, a point that I referred to in answering Mr. Justice Stewart, we think the dominant standard is far easier to apply by a jury than the significant standard, and we think it's necessary only to the point, to what happened in this particular case, and the difficulty that the jury encountered.

And lastly, we rely on the opinion in the Whipple case. The gist of the opinion, it seems to us, is that a presumption exists against the allowance of business bad debt treatment to stockholders whose interests are not subordinate to the interests of other stockholders.

And this is just as it should be, because it's a rare case in which an employee with no other interest in a corporation would undertake to advance substantial funds to, or guarantee the debts of this corporation. Application of the significant standard, we believe, would go a long way toward overcoming the presumption in the Whipple case; as can be seen from this case itself, a taxpayer may be able to overcome it simply by testifying that he didn't give his investment a thought.

I should like to retain my remaining time for rebuttal, Mr. Chief Justice.

MR. CHIEF JUSTICE BURGER: Surely.

Q Mr. Zinn, this is of no relevance, but this case of course came up to the district court, didn't it?

MR. ZINN: Yes, it did, sir.

Q Why is the -- why does your Appendix make reference to the United States Tax Court on page 1? I assume this is an error.

MR. ZINN: Of the record, sir?

Q Page 1, at the very top: United States Tax Court.

MR. ZINN: That's an error, yes, sir.

MR. CHIEF JUSTICE BURGER: Mr. Nathan, you may proceed.

ORAL ARGUMENT OF MAX NATHAN, JR., ESQ.,

ON BEHALF OF THE RESPONDENTS

MR. NATHAN: Mr. Chief Justice, and may it please the Court:

May I say that that is not the only error that the government has made in this case. I submit that they are attempting to mislead this Court, not only as to the basic facts that are involved, but also as to proper interpretation of the statute.

I think it might be best if I started out by pointing out that Mr. Allen Generes was not a mere investor, as that term has been used by this Court and as the government has used it here.

There is no dispute whatsoever that Allen H. Generes had as a trade or business"being a corporate executive for a salary" The government stipulated to that fact with me at the trial of this case, and it's in the record. We stipulated that he had "serving the corporation and receiving a salary" as a trade or business.

Q Where do we find that in the record? I'd like to see the scope of the stipulation.

MR. NATHAN: That's in the pretrial order, Your Honor. The pretrial order that was issued.

Q You can't give me the page on that?

MR. NATHAN: I don't recall it right now.

Q Don't take any off your time.

MR. ZINN: On page 9, I think.

MR. NATHAN: We've also agreed, the government has stipulated with us, that the taxpayer may have more than one trade or business, as Mr. Generes did have. He was the president of Central Savings and Loan Association, for which he also received a salary.

The point here is that he rendered services to this corporation, he received a salary of some $12,000 a year, he was not a majority shareholder, he only owned 44 percent of the stock in the corporation, and no conclusions, I submit, can be drawn from the fact that his brother-in-law -- a son-in-law, I'm sorry, happened to be also an owner of 44 percent of

the stock.

The son-in-law had a separate, different business prior to the early 1940's when these two men formed a partnership together, and when they incorporated they each owned the same amount of stock but they rendered different services, they received different salaries. And Mr. Generes did render services. And the only evidence in the record is that the investment in this corporation was $38,900.

Now, the government --

Q Once again, the question Mr. Justice White asked, is there anything in the record showing the actual value of that investment?

MR. NATHAN: No, there is not, Your Honor.

Q Just the book figure?

MR. NATHAN: The evidence is that Mr. Generes deducted $38,900 in the year that the corporation went under as a capital loss; that was his investment in the corporation. That is the only evidence in the record, and the government had the opportunity to introduce such evidence if it wanted to. This was the --

Q You also had the opportunity to show that it was of less value --

MR. NATHAN: That's correct.

Q -- if you wanted to.

MR. NATHAN: Yes, but we acknowledged that that was

the proper value. We never had any question about that, as a practical matter.

What you really get down to here is that over a number of years this company was in the contracting business, and you're talking about a very unique kind of business. You're talking about a business that was engaged in municipal public works contracts, for which they had to have payment and performance bonds. And I had testimony introduced by the vice president of Maryland Casualty Company, by a local insurance agent, all of them testified: we will not grant payment and performance bonds to small corporations without the personal endorsements of the principal officers of those corporations.

As a result of this, Allen Generas and his son-in-law, William F. Kelly, agreed to indemnify the bonding company for writing bonds for the corporation. It was the only way the corporation could have gotten bonds. It was the only way the corporation could have stayed in business. And consequently, over a number of years this was done.

Finally, in 1958 a blanket indemnity agreement was executed, and this is why you talk about a $2 million exposure. The government is throwing a scarecrow up at you here when they say, "Look, he's endorsing; why would he expose himself to $2 million worth of liability for a salary of $12,000 a year?"

The fact of the matter is that you're not really exposing yourself to anything like $2 million worth of liability. This meant merely that Maryland would bond contracts which aggregated a contract price of $2 million. That meant the corporation had contracts to perform. It meant there would be money paid on these contracts, there would be retainage, there will be stage payments.

Mr. Generes would only be liable to Maryland if the corporation did not perform the contract, and if the amount of retainage that was left in the contract was insufficient to pay Maryland off; and then you had all the assets of the corporation to go against before Mr. Generes would become liable.

Q I can understand that argument being made to the jury, and I assume you argued that proposition to the jury?

MR. NATHAN: I did, Your Honor.

Q And perhaps you would have prevailed with the jury, conceivably, even under the government's instruction.

MR. NATHAN: Your Honor, I submit that we're entitled to prevail under the government's instruction. I contended throughout that this was his dominant motivation.

Q But it wasn't -- the government's requested instruction wasn't given.

MR. NATHAN: The government's was not, because --

Q That's the only issue in this case, isn't it?

MR. NATHAN: That's correct. At the time this case

was tried, you had the Weddle decision from the Second Circuit, in which it said, on a majority opinion, that significant motivation was the proper test. And Judge Alvin Rubin, who is, I think, I submit to this Court, one of the most respected judges in the country in the field of tax laws, believed that the Weddle decision was correct, and so instructed the jury.

In fact, it's very interesting, if you read that complete charge you will find that that charge lasted over one hour, that there are some 4,500 words in it, almost every charge the government submitted to that jury -- most of them unfavorable to the taxpayer -- where used examples and illustrations of business bad debts were given to the jury, taken directly from the government's requested charges, they have picked one word in one paragraph from an hour-long jury charge, and they've seized on that to submit that is reversible error here.

Q But the government also says that when the jury came back three different times, they were only interested in one word in that whole -- how many thousand-word opinion?

MR. NATHAN: 4,500, Mr. Justice Marshall.

Q But they were only interested in one word, according to Mr. Zinn; is that right?

MR. NATHAN: That is his position, Your Honor.

Q What do you think about this "significant"?

MR. NATHAN: I think that significant motivation is

the proper test to apply, and I submit that it is the only workable test under the statute, and that what the government is asking -- what the Solicitor General is asking you to do is to rewrite Section 166 of the Internal Revenue Code, as they wish it had been written instead of as it was written.

I would submit to the Court that if you look at the statute itself you find that prior to the 1954 Code, you had only one definition of business bad debts, and that was a debt that was incurred in the trade or business. That's the language of the statute. The 1939 Code said the debt must be incurred in the trade or business.

Then, in 1954, you have Section 166 amended, and you have a new section added. The old language, that a debt which is incurred in the taxpayer's trade or business, is kept, and a new test is also given. And that is at page 36 of the Petitioner's brief, where the statute is cited, which says -- and it's a backhanded wording, I submit that as one of the problems. It defines "nonbusiness bad debt" and then says "is any debt other than a debt ... created, or acquired" (as the case may be) in connection with a trade or business of the taxpayer."

Now, I submit to the Court that you've got to look at those words "in connection with a trade or business"; that does not require the direct relationship that a loss incurred in the trade or business would require.

Q But you're -- I guess you're contending that if the Treasury regulations, instead of saying "proximate" had said "primary", that it must be the primary motivation, then the regulation would have been invalid under the statute?

MR. NATHAN: I think so, Your Honor. I submit to you that the Congress of the United States should have said "primarily in connection with a trade or business" --

Q But you're relying on --

MR. NATHAN: -- if that's what they had intended.

Q You're relying on the statute rather than the regulation?

MR. NATHAN: Well, Your Honor, I submit the regulations are correct, because the regulations say that they interpret "in connection with" to mean there must be a proximate relationship.

Q Yes, but the Treasury interprets its own regulations and says that "proximate" means primary.

MR. NATHAN: Well, we do quarrel with that. We have no quarrel with the use of the word "proximate". I think I could not do so. This Court has inferentially approved the test of proximate relationship. I think Your Honor did so in the Whipple case.

Q But it hasn't been -- certainly hasn't settled -- certainly haven't settled -- we haven't settled this case.

MR. NATHAN: Absolutely not. I hope you haven't --

Q In prior opinions.

MR. NATHAN: I think not. No, this case has not been before this Court before; it has been before three circuits, but up to this point it has not been before this Court.

My point here is that "proximate", as this Court has inferentially approved it, I think is perfectly proper. Then the question is: what do you mean by "proximate"?

And I would say that a significant relationship would be proximate. And that's the basis of the argument.

You've got a statute which, if Congress had so intended, it might easily have said "a debt created or acquired primarily in connection with a trade or business." That would have resolved the matter. I could not be here arguing the significant motivation test, if Congress had said that.

What the Solicitor General is attempting to do is to amend the statute by inserting a word that Congress itself did not put in.

Q You think, as a matter of law, "in connection with a trade or business" means that it must be a business bad debt if it's incurred for two reasons: one, a business reason; and one, a nonbusiness reason?

MR. NATHAN: Provided the business reason bears -- is a significant relationship, yes.

Q Well, let's say that they're 50/50.

MR. NATHAN: Then --

Q You think "in connection with" necessarily means that it's a business bad debt?

MR. NATHAN: I do, Your Honor.

Q Even though 50 percent of the reason is that it is not in connection with a business?

MR. NATHAN: That is correct. But I would submit if there is a significant relationship in the business relationship area, then that gives rise to a business bad debt. And if Congress did not intend that result, all Congress had to do was say "primarily in connection with", and that would have ended the matter.

And they have done that in other sections of the Code. This Court has interpreted other sections of the Code as, for example, with capital assets, where you talk about "primarily for sale in the ordinary course of business"; the Court has interpreted the word "primarily", and that would have put an end to the matter here. But when they say "in connection with", the Commissioner of Internal Revenue issued its own regulations and used the word "proximate".

I said that's what is meant here, a proximate relationship; and then, of course, they get annoyed when courts look at the word "proximate" and, as the Second Circuit did, and as the Fifth Circuit did, they see that there is an analogy in the tort law -- they haven't drawn on the tort law; but we know that you may have more than one proximate cause. And all

that you're talking about there is a certain nearness, a certain importance; and I think that the point here is that this will not give rise to baseless deductions. You cannot claim a business bad debt unless there is a significant relationship between the loss or the debt and the employee's trade or business.

And I would submit that that test is just as easy, if not easier, to apply by jury, and I think it's more flexible, it is fairer to the taxpayer, it is fairer to everyone.

Q Mr. Nathan, is there anything in the record to show how many businesses this man was in?

MR. NATHAN: Only, I think, inferentially, Your Honor, because he had,as one trade or business, that of being president of Central Savings and Loan Association. He had, as another trade or business, --

Q Well, I mean I'm just struck with the fact that a man that can take $200,000 out of his watch-pocket couldn't get that from $12,000 a year.

MR. NATHAN: Mr. Justice Marshall, if I may, I guess I would have to depart from the record, but this man had to go out and mortgage everything he owned --

Q Well, I mean, --

MR. NATHAN: -- to come up with this money at the end.

Q -- I'm not interested in going outside the

record, I'm interested in what's in the record. That this man has a $12,000 a year interest, jobwise, and he's willing to put $200,000 up for that.

MR. NATHAN: Your Honor, that may be somewhat misleading, because what happened was that in 1962, at the end of the game, really, this corporation, which had been having millions of dollars of business every year, in 1962 they seriously underbid two major contracts and the corporation became defunct. They defaulted on those contracts, and Maryland stepped in. In order to try to bail out the corporation and to salvage the operation, then in 1962 Mr. Generes made loans to the corporation of a very substantial amount. You're right. He tried to salvage the corporation at a time when it was going under.

And I submit that's a big difference. There you're talking about loans to the corporation, and Mr. Generes deducted those as nonbusiness bad debts, because he loaned them to them in the last year, at a time when the corporation was going under.

What we're talking about in this case is not a loan to the corporation, it never was. And it's misleading if we try to think of it as a loan to the corporation. This was an agreement to a bonding company to personally indemnify that bonding company if the bonding company would write bonds for the corporation.

In other words, you started back years earlier, in order to stay in business and in order to have a going business, you needed bonds as a fact of life in the construction business. Kelly-Generes Construction Company could not get jobs if it couldn't get payment and performance bonds. And it couldn't get payment and performance bonds without the personal endorsements of Allen H. Generes and William F. Kelly; and, as a result, Generes and Kelly both agreed to Maryland, we'll personally indemnify. That is not a loan to the corporation.

And the issue in the case was in executing the agreement to indemnify the bonding company, what was Generes' motivation?

Now, the trial judge charged this jury that there are a number of facts, that they should consider, and only one was the motivation. But the test, as now boiled down and gotten to this Court is: when he executed that indemnity agreement agreeing to indemnify Maryland so that the corporation could get bonds and go as a going concern, he was significantly motivated by the desire to protect his trade or business as a salaried officer.

Q What is the rule with -- assume this business had been a partnership; there wouldn't have been any question about it?

MR. NATHAN: There never would have been a necessity for him to sign indemnity agreements with Maryland, because

than he, as a partner, would have been personally liable.

Q Yes. But, say, he had to guarantee a bank loan, would there have been any question about it being a business --

MR. NATHAN: As a partner or in a corporation, Your Honor?

Q As a partnership.

MR. NATHAN: No, I think, again, he would have been personally liable. As a partnership there would have been no necessity. He can bind the partnership and he, as a partner, would have been bound.

That raises some very sticky points, and I apologize for this, but the case arises from Louisiana, and we have the civil law system and not the common law, which does create some problems that I would rather not -- I would be happy to discuss the partnership law in Louisiana. But we make distinctions that are not made in the other States.

Q Mr. Nathan, I'm a little intrigued by comparative values here. As I read these briefs, there is a good bit of talk about the value of the investment on the one hand and the salary on the other. And always the latter is referred to as $12,000.

The difficult I have is that the investment consists of taxpaid dollars; the salary consists of pretax dollars. And hence my inquiry of Mr. Zinn as to trying to get some feel for the tax bracket in which this man was.

Actually he's not protecting the $12,000 net salary, he's protecting the $12,000 gross salary on your approach, which I assume, in actual dollars, means something far less than that to him; maybe $7,000 or so. Would you agree?

MR. NATHAN: I think that that's correct, Your Honor. But, again, we don't have all of Mr. Generes's tax returns in the record. His salary -- his total income aggregated about $40,000 per year. The man had formed Central Savings and Loan Association in the 1930's and had always been the president and general manager, and he always had a good salary from that.

He had been in the contracting business long before he ever set up Kelly-Generes Construction Company. He started out in the contracting business. He had many years of experience in it. Then he formed a partnership with his son-in-law in the 1940's, during World War II, and then only in 1954 did they actually incorporate. And at that point did he become the owner of 44 percent, at that stage of the game the investment in the corporation was $38,900.

And I think in order to find out what the value of that investment was, eight years later, you would have to look at all of the corporate returns and see what income the corporation had generated and so forth; it would require a massive amount of work, which we have not gotten into at this point.

Q Well, my inquiry is directed to the other side of the scale, and I think what I'm saying is that the $12,000

salary, if one argues that this is what he was trying to protect in the way of cold dollars in his pocket, this is a little misleading; it's something far less than that.

Am I not correct?

MR. NATHAN: In the sense that he would have to take into consideration that he would pay ordinary income tax on his salary, I think that is correct.

Q So I think the balance, if there is one, is the investment, on the one hand, against maybe $7,000 pre-State income taxes on the other; do you have an income tax in Louisiana?

MR. NATHAN: Yes, sir. Yes, we do, Your Honor.

Q So it's even less than my figures.

MR. NATHAN: But it's a very nominal income tax; it's about 2 percent or 4 percent.

Q I suppose if we take that approach, Mr. Nathan, well, we'd have to figure this on what would be the cost of a single premium annuity that would produce $7,000 a year at the given age of this man. You said he was around, or someone said he was around 70.

MR. NATHAN: He was 82 at the time of the trial.

So you would find it a very high premium, I submit, Your Honor.

Q Yes, well --

MR. NATHAN: But the main point is that the initial

investment was only $38,900 --

Q I suggest to the contrary, Mr. Nathan; it would be quite a low premium for an annuity. A high premium for life insurance; but a low premium for an annuity.

Q That's correct.

MR. NATHAN: There's actually no way of knowing the exact amount of the investment as of 1962, but the point is that you've got a continuing indemnity agreement. I might submit that that would cast some light on this, that, starting at the outset in 1954, at the time the initial investment was made, the bonding companies were then requiring personal endorsements. And that what happened was that every time Kelly-Generes got a bond, a bid on a job, and they had a job available to it and they needed a bond, Allen Generes and Bill Kelly went to Maryland Casualty and got a bond, and they personally agreed to indemnify Maryland Casualty Company.

It was found that that was very inconvenient, and,as a result, in 1958 a blanket indemnity agreement was executed, so that you didn't have to keep going to Maryland with each job that was bid.

But the corporation did have assets, we can't deny it, there is testimony in the record that would give some indication there that there were some substantial assets, but that these were mortgaged up to the hilt.

Q Does this record show, Mr. Nathan, the comparative

yield to this gentleman out of the corporation by way of dividends and salary?

MR. NATHAN: It does. There were no dividends paid. This corporation never paid a dividend in its history.

Q So that his only stake, in that sense, was the continued existence of the corporation, to continue the salary.

MR. NATHAN: That's correct. It was a closely held corporation, he did have his son-in-law, then there were other sons-in-law who had about 12 percent, I think it is, of the stock of the corporation; but throughout its history the corporation never paid a dividend.

But it did pay his salary, and it paid the salary every year, and there were some years when the tax -- the record does show that there were some years when the corporation operated at a deficit. They had, I think, over a $40,000 deficit one year. But yet it continued to pay these salaries.

Q Well, what about a profit, though? A lot of corporations make money and don't pay it out.

MR. NATHAN: That's correct, but none of those -- none of those tax returns are in the record, Your Honor. And it was only incorporated in 1954. We don't know what it --

Q But the fact that it's not paying dividends is not --

MR. NATHAN: No.

Q -- not really very significant.

MR. NATHAN: No, but there was no -- the main point is that there was no return here to this man that is the kind of return that is peculiar to an investment.

Q Well, the net worth of his investment was increasing every year, rather that's -- at a rather substantial rate?

MR. NATHAN: Well, it would be, and yet he was receiving a salary every year, and this is what he testified was what primarily motivated him. As a matter of fact, he testified that was his sole motivation that he did it. And there was testimony by other parties that would support that.

I would submit, though, in concluding, Your Honor, that even under a dominant motivation test, as the government argues, that Allen H. Generes was predominantly motivated to protect the salary that he was receiving of $12,000 a year. But I think that the important question --

Q Well, we wouldn't decide that question.

MR. NATHAN: That's correct, Your Honor. But I would submit that the important point for this Court is the interpretation of Section 166 of the Internal Revenue Code, and there is where you get down to the question of whether the significant motivation is the proper test or whether the dominant motivation is the proper test, and, for the reasons set forth in our brief, primarily because Congress itself did not say "primarily in connection with a trade or business" but simply "in connection

with a trade or business, which the Commissioner says, and which this Court has inferentially approved, there must only be a proximate relationship. And I submit that, just as there may be more than one cause, a man may have more than one motive. You will not necessarily find that it is going to be easier for juries to sit down and weigh a man's motivations and decide which is the dominant and which is the less dominant motivation any more so; it may be much easier to look at one motive and decide: is it significant or is it not significant?

And you're not going to be opening the doors to baseless deductions by simply saying the "in connection with" requirement means that there must be a significant relationship. Juries don't have that much problem with the meaning of the word "significant", I would submit, it means important; and they would know that. I think it would be just as easy to determine between significant and insignificant motivations as it may be to try to weigh on a scale the difference between a dominant motive and a less dominant motive.

For those reasons, I submit to this Court that the trial judge's charge to the jury was eminently fair and was eminently appropriate, and that the decision of the Court of Appeals was proper; and I urge the affirmance of the Court of Appeals decision.

Q Until this case, the leading case in this field has been Weddle, the Weddle case opinion written by Judge

Friendly?

MR. NATHAN: That is correct, Your Honor.

Q The Court of Appeals for the Second Circuit?

MR. NATHAN: Out of -- yes. And it's very interesting, the government made the point that if you adopt the significant motivation test, the government's going to lose every one of its cases, and everybody will get a business bad debt deduction, and in the very case that is cited, the Weddle case, the taxpayer lost because the taxpayer could not prove a significant motivation to protect their business.

Q Well, didn't the Seventh Circuit decide the contrary?

MR. NATHAN: The Seventh Circuit --

Q In Niblock, two years after Weddle?

MR. NATHAN: That's correct. The Seventh Circuit -- and subsequent to the refusing of --

Q The trial courts do accept the Second Circuit test?

Q Yes.

MR. NATHAN: That's correct, yes.

There've been any number of other cases. In fact, I might say to this Court that the Generes case, which we are now arguing to you, has been noted in three law reviews, since it was -- since it has been decided. Those have just come out since our briefs were written.

Q And besides --

MR. NATHAN: I'd be happy to submit memos on that, if the Court wants.

Q And besides it really wasn't critical in Weddle to decide the standard, was it?

MR. NATHAN: I don't think so.

Q It was just dicta --

MR. NATHAN: They said that under either theory the taxpayer could not win, and that of course may very well happen if this Court approves the significant motivation test. That even under significant, if you can't prove the significant relationship, then the taxpayer cannot prevail. But then it would not matter.

Q Then the Court of Appeals didn't need to reach the standard question in Weddle, right?

MR. NATHAN: I did not argue the Weddle case, Your Honor, and I was not --

Q Well, all right, that's --

MR. NATHAN: -- privy to all that transpired in the case, so I would not want to take that position. But I would submit that the reasoning of the majority opinion in the Weddle case is very persuasive and I think is absolutely correct.

Q I'd be interested in those law review citations, if you have them at your fingertips. Otherwise, you can just submit --

MR. NATHAN: I do. I happen to have them right here with me, Your Honor, if you want them. One is in Texas Tech University Law Review, at Volume No. 2, beginning at page 318. The other is in the University of Florida Law Review, and I'm sorry, this does not have the -- this does not have the Law Review page.

Q Well, perhaps you should submit it -- submit them to the Clerk.

MR. NATHAN: I will be happy to submit them to the Court, Your Honor.

I might say that they have split the same way the circuits have; but, again, they've gone 2 to 1, saying that the Generes case was properly decided by the courts below.

Q Mr. Nathan, I noticed you've used several times the phrase "in connection with", and perhaps I'm looking at the wrong paragraph. Were you paraphrasing -- oh, I see, Mr. Justice Brennan has just pointed it out "in connection with"; "in the course of" is the paragraph I was looking at.

Do you see a difference between the language "in connection with" and "in the course of"?

MR. NATHAN: Oh, yes, I think there would be -- I would say there would be a significant difference between the two. "In the course of", I think shows a directness that "in connection with" does not have. Just as here in Section 166 you have an (a) and a (b). The (b) says "a debt ... which is

incurred in". When you have an "incurred in", there is a directness that I think is not the same as when you say "a debt created or acquired in connection with a trade or business". I submit that that -- that by doing that, Congress is saying it does not have to be directly incurred in the business. The relationship, as the Commissioner interpreted that, must be proximate.

And then the question is, the Commissioner did not define "proximate", and we have to come along and define it. That's basically what the trial judge charged the jury on, that there must be a proximate relationship. And I would submit that, just as in tort law, where there may be more than one proximate cause, here there may be more than one motivation. And what you're looking at is the significant motivation, I think, and if the business relationship between the taxpayer's act, the debt and the loss, if there is a significant relationship between that debt and the trade or business of the taxpayer, then I submit that under 166, as written, the taxpayer is entitled to a business bad debt deduction.

So that if the Commissioner of Internal Revenue approves of that, he wants them to have the predominant test or the dominant motivation, then they should go to Congress and get Congress to amend Section 166 and say "a debt created or acquired (as the case may be) primarily in connection with a trade or business". That would have resolved the point, and

I would not have the nerve to argue a significant motivation test to the Court if Congress had put in the word "primarily", as they have in many other sections of the Code. But they didn't put it in, and the Solicitor General wants you to put it in for them.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Nathan.

MR. NATHAN: Thank you very much, Your Honor, it's been a pleasure and a privilege for me to appear before the Court.

MR. CHIEF JUSTICE BURGER: Glad to hear you, Mr. Nathan.

Mr. Zinn, you have six minutes left.

REBUTTAL ARGUMENT OF MATTHEW J. ZINN, ESQ.,

ON BEHALF OF THE PETITIONER

MR. ZINN: Thank you, Mr. Chief Justice.

I should like to respond first to the principal argument which respondent makes here. It was the principal argument in his brief, which focuses on subsection(A)of Section 166(d)(2), the "in connection with" language.

There is -- as I understand the argument of respondent, he conceives that subsection (B) would not be sufficiently broad to allow a significant motivation standard.

Now, first of all, let me point out to the Court that the term "proximate", as it appears in the regulations that we have quoted on page 37, applies only to subsection (B).

That regulation was there long before the Code was amended in 1954, to add subsection (A).

Now, we have pointed out, on page 15 of our brief in footnote 7, what Congress' purpose was in enacting subsection (A) and it's really quite simple.

Under the law as it existed before 1954, a taxpayer, who acquired a debt when he was in a trade or business and then went out of a trade or business before a final determination was made as to the worthlessness of the debt, was entitled only to a nonbusiness bad debt.

The sole purpose of subsection (A), as we have stated in footnote 7, was to make it clear that if a taxpayer went out of business after having acquired a debt in the course of a trade or business and then the debt became worthless, he would get a business bad debt.

For this Court to read into that addition of subsection (A) all that respondent urges, it seems to us, would be making an awful lot out of a little. And I urge the Court to read the legislative history of subsection (A). It is very short. And that is the sole purpose of the addition.

As far as the absence of the word "primarily", I would make two points: First, it seems to us that just as we're trying to read the word "primarily" into the statute, the respondent is trying to read the word "significantly" into the statute. We think there's a gap there that this Court has to

fill, and it's not a one-sided gap, it has to be filled one way or the other. Congress simply didn't contemplate this dual status case when it enacted this statute.

Q Would you agree, then, Mr. Zinn, that if Congress had put the word "primarily" before the words "in connection with", the whole task would be a great deal simplified?

MR. ZINN: I don't think we'd be here, Mr. Chief Justice. But I think if they had put the word "significantly" in, we wouldn't be here either.

There's a gap there, and this Court --

Q They have used this term "primarily" in many, many other contexts, haven't they?

MR. ZINN: Yes, they have, but under Section 165(c)(2), which appears on page 35 of our brief, it's referred to there as whether a loss is incurred in the transaction entered into for profit. And the very same Second Circuit, which held adversely to the government in Weddle, has held that loss incurred in a transaction entered into for profit, you have to look for the primary motivation of the taxpayer.

We have cited the Austin case in our brief to that effect. The taxpayer there purchased a residence, both for personal purposes and to make a profit. It was found that the primary purpose was personal, and that was the end of the case. And the word "primarily" doesn't appear in Section 165(c)(2),

as well as in Section 166(d).

As far as the word "proximate", we would only note again that so far as the tort law is concerned, the considerations are entirely different. You can hold more than one tort-feasor liable. Here we have to go back to the fact that a choice has to be made. That simply isn't the case in the tort law. You can hold two or three or a greater number of tort-feasors liable for a single tort.

And I guess I needn't point out, except in passing, that the considerations that have expanded notions of proximate cause are wholly different from those that this Court has to take into account in deciding this case.

One final point. Mr. Nathan would have this Court draw a severe distinction between loans and guarantees. But we don't think that's permissible under the decision of this Court in the Putnam case. Mr. Justice Brennan, there writing for the Court, held loans and guarantees are to be considered the same, for purposes of interpretation of the bad debt provision of the Code.

For these reasons, then, we urge reversal of the judgment below.

Q Could I ask you: It is accepted on both sides that a loss from a debt incurred just to protect an investment isn't a business debt, isn't a business loss?

MR. ZINN: Well, that wouldn't be -- we, of course,

agree with that. I assume that --

Q Well, I know, but that's --

Q Just common ground.

MR. ZINN: Just common ground, I believe --

Q -- just common ground --

MR. ZINN: And we agree, Mr. Justice White, that the Trent case was correctly decided. That is, where the person is solely an employee and is required as a condition of continuing employment to make a loan or guarantee his corporation's debts, we would agree that that is incurred in a trade or business.

Q And a loss of the kind I was asking you about, wouldn't be a deductible loss either, would it? I mean, if you -- just the loss of an investment is not a deductible loss?

MR. ZINN: It is deductible as a capital loss, --

Q Yes.

MR. ZINN: -- but not as an ordinary loss.

Q Even -- and it's not a transaction entered into for profit?

MR. ZINN: It is a transaction, but -- are you talking about a stock investment?

Q I'm talking about 165.

MR. ZINN: An investment loss?

Q Yes.

MR. ZINN: Is deductible --

Q I mean, I guess a loss from a transaction entered into for profit is a deductible loss?

MR. ZINN: Yes, it is.

Q But an investment isn't such a thing?

MR. ZINN: That's right, because it's subject to the capital asset limitations.

Q Thank you.

MR. ZINN: Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Zinn. Thank you, Mr. Nathan.

The case is submitted.

[Whereupon, at 11:05 a.m., the case was submitted.]