Non-Business Guaranty Loss: Ordinary or Capital Deduction

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NOTES

NONBUSINESS GUARANTY LOSS: ORDINARY OR CAPITAL DEDUCTION?

INTRODUCTION

Primary objectives of almost every taxpayer are that his gains be taxed as capital gains and his losses deducted as ordinary losses.¹ These objectives retain their significance when the taxpayer is also a stockholder. There are three basic methods that the stockholder-taxpayer can employ to inject funds into his corporation:² stock purchase, direct loan, or guaranty of the corporation's debt. In each, his primary profit motive is the potential gain in value of his present stock holdings, a capital gain. If he suffers a loss, he can look for an ordinary loss deduction if he is a guarantor; however, his loss will be a capital deduction if he lent money directly or purchased more stock, unless he is in the trade or business of making loans or selling stock.³ Thus, the guaranty offers certain advantages to a stockholder.

However, at the present time, the treatment of a guarantor's loss as an ordinary loss is not a certain proposition. Congress, by failing to specify the treatment to be given losses arising from individual guaranties of corporate debt, and the courts, by not consistently defining guidelines, have left this area in a confused state. Presently, the best

¹. Taxpayers of course desire to reap the benefits of the capital gain sections (Irv. Rev. Code of 1954, §§ 1201-02) and avoid the limitations on capital losses (Id. at § 1211). Ordinary loss treatment is still clearly preferable for most taxpayers despite the 1964 change in section 1212 allowing an indefinite capital loss carryover for individuals.

². Few individuals, other than stockholders, guarantee loans except for purely personal or purely business reasons. These two categories are the extremes and will be mentioned briefly in the text. If the guarantor is a corporation, there is little problem concerning the treatment of a loss; it is usually a business deduction. If the debtor is an individual, the guaranty is usually covered by a special provision [Id. at § 166(f)]. Thus, the discussion will center around the individual (stockholder) guaranty of a corporate obligation.

³. Under the Irv. Rev. Code of 1954, trade or business expenses (§ 162), losses (§ 165), and bad debts (§ 166) are deductible. See the text, infra, for further discussion of this subject.
such a guarantor can anticipate is that he can get an ordinary loss deduction at the cost of litigation.\(^4\)

Preferably, Congress should make special provision for all losses in conjunction with guaranteed debts—whether it should give such losses capital or ordinary loss treatment is a matter for Congress to decide. In the meantime, the Supreme Court should affirm the technical rules which seem to have found favor with most of the courts.

**Legislative Background**

Prior to 1942, all bad debts were deductible in full and, apparently, guaranty losses were so deductible as bad debts.\(^5\) Of course, the taxpayer had no objection to this treatment. Since almost all losses were likewise deductible in full, the Commissioner had little interest in the matter.

For various reasons,\(^6\) Congress added section 23 (k)(4) [now section 166 (d)(1)]\(^7\) to the Internal Revenue Code in 1942. It limited the loss on a nonbusiness bad debt to a short term capital loss deduction. This change triggered a tremendous problem—whether a bad debt loss is a business or nonbusiness loss.\(^8\) Naturally, a guarantor’s “bad debt” loss could be business or nonbusiness depending on the facts.\(^9\)

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6. H.R. REI. No. 2333, 77th Cong., 2d Sess. 45 (1942) gave, as an example, the abuse of the previous statutes by making “loans” to friends and relatives with no expectation of recovery. Such “loans” resulted in bad debts which were deductible as ordinary losses. Taxpayers have tried without much success to say that the intent of Congress was to limit nonbusiness bad debts to this one instance. See, e.g., 5 J. MERTENS, LAW OF FEDERAL TAXATION § 28.70, at 321 (1963 rev., Supp. 1968); Lewis, Deductibility of Losses Arising from Business Ventures, U. So. CAL. 1966 TAX INST. 625, 626-29.
8. A nonbusiness debt is defined as a debt not created or the loss from which was not incurred in the taxpayer's trade or business. Int. Rev. Code of 1954, § 166(d).
9. The answers to this problem remain somewhat vague; however, the Supreme Court in Whipple v. Commissioner, 373 U.S. 193 (1963), has made it clear that it will be difficult for a lender or guarantor to meet the business test. Basically, one cannot meet the business bad debt test unless his potential gain will be ordinary income and will be different from that of an investor. For example, an individual would have to promote businesses for a fee or commission or for sale in the ordinary course of business to qualify for the “promoter” business. Most cases decided in this area have involved direct loans to corporations; however, if it can be established that a guaranty loss is a bad debt, then those cases would apply equally to guaranty losses. See Rev. Rul. 60-48, 1960-1 CUM. BULL. 112. For detailed discussion concerning business and nonbusiness treatment of losses on loans and guaranties, see, e.g., Cohen, Hazy Position
Section 23 (e)(2) of the 1939 Code [now section 165 (c)(2)] allowed a full deduction for a “loss” incurred in a transaction entered into for profit. Thus, a guarantor who could not establish a business bad debt suddenly acquired an interest in showing that his loss was a loss, and not a bad debt. In this manner the real issue of whether a guarantor’s loss was a bad debt or a loss arose.

**Judicial History**

Under the rationale of *Spring City Foundry Co. v. Commissioner*, sections 165 and 166 are mutually exclusive; if a loss is proved to be a bad debt, then it cannot be deducted as a loss. However, taxpayers have been allowed to plead and argue in the alternative. If the taxpayer can prove that he has a loss and not a bad debt, then he must show that he had a profit motive or he might lose the deduction altogether.

1942 to Putnam

Generally, the Tax Court took the view that the guarantor had a bad debt, based on the ancient guaranty theory of subrogation. Upon payment of his obligation, the guarantor was seen as stepping into the...
shoes of the creditor and acquiring the debt running from the debtor.\textsuperscript{16} For example, in \textit{Peter Stamos}\textsuperscript{17} the debtor corporation was insolvent but, because it was still in existence, the Tax Court found a debt running to the guarantor when he honored his obligation. The court held that the guarantor had a nonbusiness bad debt deductible only as a short term capital loss.

The taxpayers countered with the argument that section 23 (now section 166) required that a debt become worthless within the taxable year. The Supreme Court in \textit{Eckert v. Burnet}\textsuperscript{18} had implied, at least, that there could be no deduction for a debt which was worthless when acquired, that the debt must become worthless in the taxpayer's hands.\textsuperscript{19} In the usual situation, the corporate debtor was either insolvent (as in \textit{Stamos}) or, possibly, dissolved when the guarantor was called upon to honor his obligation. Thus, the guarantor contended that he acquired nothing—that the "debt" was worthless when acquired. He argued that he simply had a loss (incurred in a transaction entered into for profit, of course) resulting from his guaranty obligation.\textsuperscript{20}

Greenspon, 8 T.C. 431 (1947) (earlier, more liberal view). At very least, subrogation "compensated" for the section 23(e)(2) [now section 165(c)(2)] loss, thereby disallowing any deduction under that section and forcing the taxpayer to claim a bad debt. See Note, \textit{Loss Deduction for Quasi-Investors}, 63 \textit{Yale L.J.} 862, 865-66 (1954).

16. Most courts view a debtor-creditor relationship developing in this manner. See, \textit{e.g.}, \textit{Putnam v. Commissioner}, 352 U.S. 82 (1956). Some courts suggest a debt on the basis of an implied promise running from the debtor to the guarantor. See \textit{Howell v. Commissioner}, 69 F.2d 449 (8th Cir.), \textit{cert. denied}, 292 U.S. 654 (1934); \textit{Estate of Barret L. Rosset}, P-H Tax Ct. Mem. \$54,346 (1954); \textit{Alice duPont Ortiz}, 42 B.T.A. 173 (1940), \textit{rev'd on other grounds sub nom.}, Wilmington Trust Co. v. Helvering, 124 F.2d 156 (3d Cir. 1941), \textit{aff'd on other grounds}, 316 U.S. 164 (1942). Although state statutes may provide differently, the common law and prevailing American view is that a debt does arise when the guarantor honors his obligation and meets the statutory requirements.

17. 22 T.C. 885 (1954).

18. 283 U.S. 140 (1913).

19. \textit{Id.} at 141. Judge Learned Hand in \textit{Shiman v. Commissioner}, 60 F.2d 65 (2d Cir. 1932) and the \textit{Putnam} Court in \textit{Putnam v. Commissioner}, 352 U.S. 82 (1956), have discredited this interpretation for the most part.

20. Some authorities mentioned another reason for allowing an ordinary deduction—section 23(f) [\textit{Int. Rev. Code of 1939}, ch. 1, \$23(f), 53 Stat. 13; \textit{now Int. Rev. Code of 1954}, \$165(a)] which allowed a deduction for losses "not compensated for by insurance or otherwise." Since the subrogation claim was worthless, the loss was not compensated for and was thus fully deductible. This argument is completely without foundation unless the \textit{Spring City Foundry} doctrine is completely ignored. That case, of course, requires an initial inquiry as to whether a debt exists; if it does, no deduction can be taken under the "loss" section. Some guarantors contended that the \textit{Spring City Foundry} rule of "mutual exclusiveness" should not apply, but they met with little
The circuit courts, for a while, accepted this argument. They recognized that subrogation rights existed, but did not find a debtor-creditor relationship. These courts stressed the fact that the purpose of honoring a guaranty obligation was not to acquire a worthless debt, but to satisfy a contractual duty. In Fox v. Commissioner,21 the Second Circuit Court of Appeals held that a worthless subrogation claim against the insolvent and settled estate of the taxpayer's long deceased husband22 was not a bad debt. The court reversed the Tax Court, saying that the decision in the latter was "unrealistic" and "strained." The fifth circuit came to much the same result in Edwards v. Allen,23 where a corporation, though still in existence, was hopelessly insolvent when the guaranty obligation was honored. The court said that the taxpayer received nothing, that the subrogation claim was worthless at its inception. In Pollak v. Commissioner,24 the third circuit went even further than Edwards.25 Here the corporation was not only still in existence, but the taxpayer received a small part (3.59%) of his subrogation claim. The court simply said that the balance of the "debt" was worthless when acquired, that there was no possibility or expectation of repayment. The Sixth Circuit Court of Appeals came to substantially the same conclusion in Cudlip v. Commissioner26 and even the Tax Court agreed in some cases similar to Fox where the debtor no longer existed.27

In 1955 the Eighth Circuit Court of Appeals decided Putnam v. Commissioner28 contrary to the general trend in the circuit courts. The corporation's affairs had been wound up and its assets liquidated in July, 1947. In December, 1948, almost eighteen months later, the taxpayer was required to honor his guaranty obligations on bank notes of the corporation. The circuit court limited the taxpayer to a section 23 (k)(4) [now section 166 (d) (1)] bad debt-capital loss deduction.

22. Prior to enactment of section 166(f) of the Int. Rev. Code of 1954 (see text accompanying notes 42-44 infra), there was no reason to differentiate between corporate and non-corporate debtors.
23. 216 F.2d 794 (5th Cir. 1954).
25. See also Ansley v. Commissioner, 217 F.2d 252 (3d Cir. 1954).
27. E.g., Abraham Greenspon, 8 T.C. 431 (1947); Frank B. Ingersoll, 7 T.C. 34 (1946).
28. 224 F.2d 947 (8th Cir. 1955). The decision was highly criticized at that time. See, e.g., Plowman, Guaranteed Loans (Still Best Method of Getting Business Bad Debt, Despite Putnam), 4 J. Taxation 150 (1956).
The Supreme Court and Putnam

Because the Putnam decision appeared to conflict with the view of the other circuit courts, the Supreme Court granted certiorari, and, in an eight-to-one decision, affirmed the circuit court.29 The taxpayer relied heavily on the Edwards case, claiming that a new obligation arose and that it was outside the scope of section 23 (k) [now section 166 (d)] because it was worthless when acquired. The Court said:

The familiar rule is that, instanter upon the payment by the guarantor of the debt, the debtor’s obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor’s shoes.30

Thus, this old debt, which had value in the hands of the creditor because of the guaranty, became worthless in the hands of the guarantor.31 It also said that even if the “new debt” premise were true, there would be no deduction under section 23 (e) [now section 165 (c)] because of the Spring City Foundry doctrine.32 The majority opinion stated that Pollack, Edwards, and Cudlip turned upon erroneous premises.33 The Court cited Spring City Foundry, and said:

[T]he statutory scheme is to be understood as meaning that a loss attributable to the worthlessness of a debt shall be regarded as a bad debt loss, deductible as such or not at all.34

The Court further distinguished Eckert v. Burnet,35 saying that the latter did not hold that an obligation worthless when acquired could not be a bad debt.36

In dictum, the majority suggested that even the Fox case was not on

30. Id. at 85. See also id. at 88.
31. Id. at 89. See id. at 94-95 (dissenting opinion). This is definitely a poor argument where the debtor is insolvent at the time of payment of the guaranty obligation because the debt running from the debtor has become worthless in the creditor’s hands. The creditor’s value is based on a separate debt—one owed to him by the guarantor. See Shlens & Brighton, New Cases on Tax Matters of Guarantors, 41 Taxes 124 (1963).
33. Id. at 88.
34. Id.
35. 283 U.S. 140 (1931).
sound ground.\textsuperscript{37} The Court said that there is no real or economic difference between a direct or an indirect loan.\textsuperscript{38} On this basis, no distinction should be made where the debtor no longer exists, and the Court suggested that the result in such a case should be the same.\textsuperscript{39}

Some writers felt that \textit{Putnam} settled the question of guarantor's losses.\textsuperscript{40} However, the case seems to have resolved only one narrow question—whether the loss resulting from the payment of the debt of an insolvent but existent corporation will be limited to capital loss treatment as a bad debt. The Court answered that question in the affirmative, holding that the same result would follow any time the guarantor obtained subrogation rights.

\textbf{The Effect of Legislative Changes}

The 1954 Code adopted, essentially without change, sections 23(k)(4) and 23(e)(2) of the 1939 Code [sections 166(d)(1) and 165(c)(2), respectively, of the 1954 Code]. Therefore, decisions under the old Code are substantially unaffected by the new one.\textsuperscript{41}

A new section [166(f)] was added to the 1954 Code. It provides for an ordinary deduction in the case of an individual guaranty of a noncorporate obligation if the proceeds are used in the trade or business of the borrower. The \textit{Putnam} Court cited this new section in support of its decision;\textsuperscript{42} the dissent reasoned that it would better support an opposite result.\textsuperscript{43} It does not appear to have had a decisive effect on the \textit{Putnam} decision or to have greatly influenced other decisions.\textsuperscript{44}

\textsuperscript{37} The Tax Court has held that \textit{Fox} is no longer sound. Robert M. Dinkel, P-H Tax Ct. Mem. ¶60,079 (1960); Albert Gersten, 28 T.C. 756 (1957), rev'd on other grounds, 267 F.2d 195 (9th Cir. 1959).
\textsuperscript{38} Putnam v. Commissioner, 352 U.S. 82, 92 (1956).
\textsuperscript{39} Id. at 93 and see text accompanying note 21, \textit{supra}.
\textsuperscript{40} Cohen, \textit{supra} note 9, at 16; Note, \textit{The Supreme Court, 1956 Term}, 71 Harv. L. Rev. 84, 192-94 (1957). \textit{See also} Ferguson v. Commissioner, 253 F.2d 403, 407 (4th Cir. 1958).
\textsuperscript{41} \textit{Putnam} and other cases for a while after 1954 were decided under the 1939 Code, but referred to the 1954 Code on occasion.
\textsuperscript{42} \textit{See} Putnam v. Commissioner, 352 U.S. 82, 86 (1956). Support arises from the fact that the section declares that a discharge of an obligation as guarantor, endorser or indemnitor "... shall be treated as a debt becoming worthless ..." Of course, this language applies only under the circumstances specified in the statute.
\textsuperscript{43} Id. at 102 (dissenting opinion). The primary reasons for this approach are that Congress had no reason to discriminate against guaranties of corporate debt and because the language referred to in note 42, \textit{supra}, cannot be extended beyond the specific situation covered by the statute. \textit{See also} Plowman, \textit{supra} note 28, at 150.
\textsuperscript{44} \textit{See}, e.g., 5 J. MERTENS, \textit{supra} note 6, at n. 57; Note, \textit{supra} note 40. \textit{But see} Plowman, \textit{supra} note 28, at 150.
Post Putnam

Since the Supreme Court clarified what results should follow when guarantors acquire subrogation rights, the taxpayers have been trying frantically to avoid such rights. The common law doctrine of subrogation is somewhat technical, and state statutes on the subject also tend in that direction; therefore, taxpayers often have been successful in avoiding subrogation rights.

The determination of whether a right of subrogation exists may require a close analysis of the facts and local law. It may be implied from the instrument or the circumstances.

First, the regulations group the losses of guarantors, endorsers, and indemnitors together; this is patently misleading. It is almost universally recognized that indemnitors acquire no subrogation rights. No bad debt exists because no principal obligor becomes indebted to the indemnitor by reason of his payment. It is an original undertaking with primary liability. The courts have recognized this proposition and have allowed ordinary loss deductions where such a situation exists.

Next, cases dating back to Fox have held that no subrogation rights and, thus, no debt exists where the debtor is not in existence when the guarantor honors his obligation. Of course, the Supreme Court (in

45. The taxpayer must bear in mind that a section 165(c)(2) loss does require a "profit" motive. See, e.g., Pollak v. Commissioner, 209 F.2d 57, 58-59 (3d Cir. 1954); Eugene H. Rietzke, 40 T.C. 443, 452-53 (1963); Charles B. Wigton, 13 T.C. 323 (1949). On the other hand, the seven year statute of limitations does not apply to section 165(c)(2) losses. Int. Rev. Code of 1954, § 6511(d)(1). The subrogation claim might have economic value greater than the tax benefit of an ordinary loss. See Propp, supra note 20, at 128, 131.

46. It is interesting to note the different approaches taken by taxpayers and often accepted by the courts where the guarantor is trying to set up a reserve for bad debts. See, e.g., Bolling v. Commissioner, 357 F.2d 3 (8th Cir. 1966). See also 3 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT & ESTATE TAXATION § 35.06, at 3552-53 b. (1968 rev., Supp. 1968).

47. Id. at 3544.

48. Treas. Reg. § 1.166-8 (1959). Section 166(f) of the 1954 Code also includes all of these.

49. E.g., 3 J. RABKIN & M. JOHNSON, supra note 46, at 3549-50; Propp, supra note 20, at 131. Where there is an indemnity, the taxpayer's biggest problem is showing that the loss requirements (transaction entered into for profit) were met.

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

51. E.g., J. C. Bradford, 22 T.C. 1057 (1954), rev'd on other grounds, 233 F.2d 935 (6th Cir. 1956); Dan R. Hanna, Jr., P-H Tax Cr. Mem. ¶ 51,180 (1951); J. B. Book, Jr.,
Putnam) expressly held that a debt did arise where the debtor was insolvent but still in existence, and suggested that the Fox doctrine was not sound. 52

A third means of avoiding subrogation rights generally turns on the provisions of the appropriate state statutes. Many such statutes provide that there shall be no subrogation rights if any part of the guaranty obligation remains unpaid. The reason for such a provision is sound: the guarantor (as to the part unpaid) should not be put on equal terms with the creditor in claims against the debtor. 53 Several cases have turned on this narrow concept. 54 In J. C. Bradford, 55 the taxpayer paid $53,000 of his $56,500 guaranty obligation and was allowed an ordinary loss deduction because he acquired no subrogation rights. There may be other situations where subrogation claims can be avoided by strict non-compliance with a state statute.

The most recent line of cases has involved payment by the guarantor to obtain a release from his guaranty. 56 For example, in Santa Anita Consolidated, Inc., 57 the taxpayer, with a $4,375,000 total potential

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52. See text, supra. The Court suggested that Fox was not sound because there was no economic difference between a guaranty loss and a loss from a direct loan, not because of any subrogation aspects.

53. See, e.g., J. J. Shea, 36 T.C. 577, 583 (1961), aff'd per curiam, 327 F.2d 1002 (5th Cir. 1964).


55. 22 T.C. 1057 (1954) (decided prior to Putnam), rev'd on other grounds, 233 F.2d 935 (6th Cir. 1956).

56. Commissioner v. Condit, 333 F.2d 585 (10th Cir. 1964), aff'd 40 T.C. 24 (1963); Santa Anita Consol., Inc., 50 T.C. No. 52 (July 2, 1968); Jack Schlosser, P-H Tax Ct. Mem. ¶ 65,186 (1965); J. J. Shea, 36 T.C. 577 (1961), aff'd per curiam, 327 F.2d 1002 (5th Cir. 1964). See Eugene H. Rietzke, 40 T.C. 443 (1963); John P. Dillon, 9 B.T.A. 177 (1927). The same result has been reached where expenses were incurred to settle or adjust the guaranty obligation. Peter Stamos, 22 T.C. 885 (1954); E. P. Addler, 44 B.T.A. 112 (1941); Marjorie Fleming Lloyd-Smith, 40 B.T.A. 214 (1939), aff'd on other grounds, 116 F.2d 642 (2d Cir.), cert. denied, 313 U.S. 588 (1941). But see Louis Schwartz, P-H Tax Ct. Mem. ¶ 64,247, at 64-1629 (1964) (dictum suggesting that the deduction could be disallowed altogether if consideration given for release cannot be valued).

57. 50 T.C. No. 52 (July 2, 1968).
guaranty obligation, transferred his stock (half interest) and $4,396,000 to a third party in return for the release of his guaranty obligation. ($4,375,000 was his total potential guaranty obligation.) The purchaser (who likewise obtained the other half interest) paid $5,000,000 on the loans and obtained the release of the guarantors-sellers. The Tax Court allowed the taxpayer an ordinary deduction. In Jack Schlosser, the taxpayer got an ordinary loss deduction where part of his payment was for the release of his guaranty obligation and part for indemnity against loss on another guaranty obligation.

One case has allowed an ordinary loss deduction upon payment of the guaranty obligation after the guarantor had released the debtor (in a bankruptcy proceeding). This case could have far reaching implications if followed by the courts in different fact situations.

**How Should Such Losses Be Treated?**

*The Subrogation Theory*

In attempting to determine the proper treatment for guaranty losses, the premise that the technical doctrine of subrogation is the answer must be rejected. Certainly, subrogation rights should be recognized and to the extent they provide recovery, there can be no deduction. But no sound reasons exist to treat the loss on a guaranteed loan differently because the guarantor acquired no subrogation claim, he acquired a partially worthless claim, or he acquired a totally worthless claim. At the least, the part that eventually proves to be worthless (whether it be all or only a part of the subrogation claim) should be treated the same in all cases.

The subrogation doctrine affects guarantors in a somewhat indiscriminate manner; it by no means gives the same tax treatment to all guarantors. Its application depends on such things as state subrogation laws and whether a corporation is dead or dying. It depends upon

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58. Note that the transaction could possibly be treated as part of a sale or purchase of capital stock. See text accompanying note 78, & note 78, infra.
61. The courts presently distinguish guaranties which were intended as gifts and allow no deduction for the same. There must be a reasonable expectation of recovery. See 3 J. Rabkin & M. Johnson, *supra* note 46, at 3546-47. As noted in the text, *supra*, the courts also distinguish business bad debts. Here we are concerned with uniform treatment of nonbusiness guaranty losses.
whether the debtor corporation is dissolved prior to guaranty payment—a fact which many stockholders can arrange.\textsuperscript{62} It distinguishes between no rights and empty rights.\textsuperscript{63} In many states it is significant whether a guarantor pays all or essentially all of his obligation.\textsuperscript{64} One who pays to be relieved of his obligation is favored over one who honors his guaranty obligation. In short, it gives an unreasonable, unrealistic solution to the problem.

Granted, the subrogation doctrine is about the only means of getting guaranty losses under section 166(d)(1)\textsuperscript{65} because, where there are no subrogation rights, there are no debts in a legal sense. However, this is avoiding the question: Should such losses be given ordinary loss or capital loss treatment?

\textit{Congressional Intent}

Material concerning the Congressional intent in this area is scarce. The statutes, of course, do not specifically mention guaranty losses except in section 166(f)\textsuperscript{66} (concerning guaranties of noncorporate obligations). While some have tried to use this section as support for a result, they have not been very convincing.\textsuperscript{67} The Committee Reports concerning section 166(d)(1) (nonbusiness bad debts)\textsuperscript{68} and section 166(f)\textsuperscript{69} have shed little light on the matter. The House Committee Report\textsuperscript{70} gave an example of an abuse (loans to friends and relatives with no expectation of recovery) which led to the adoption of the nonbusiness bad debt section. Such an example should not limit the application of a section of the Code as some taxpayers have contended.\textsuperscript{71}


\textsuperscript{63} See, e.g., Propp, supra note 20, at 127.

\textsuperscript{64} The superficiality of this approach is illustrated by J. C. Bradford, 22 \textit{T.C.} 1057 (1954) (discussed in text accompanying note 55, supra).

\textsuperscript{65} Another method would be to look through to the substance of the transaction, but, often, the absence of subrogation rights is a difference of substance, but not a difference justifying different tax treatment for guaranty losses.

\textsuperscript{66} \textit{Int. Rev. Code} of 1954, § 166(f).

\textsuperscript{67} See notes 42-44, supra, and accompanying text.


\textsuperscript{71} See note 6, supra. But see 57 \textit{COLUM. L. REV.}, supra note 62.
Even Congress' silence on the precise matter tells us little. From 1942 until 1956, a guarantor was usually allowed an ordinary loss deduction. In 1956, Putnam signaled a reversal of that trend. In recent years, the taxpayers again have been receiving favorable treatment with a high degree of regularity. Certainly, Congress has not "consented" to a uniform treatment of all guarantors. If Congress is condoning the subrogation theory, it is avoiding the issue because, again, that theory serves only as a stop-gap measure.

A Capital Loss?

The best argument for capital loss treatment is that there is no appreciable economic difference between a guaranty loss and a loss resulting from a direct loan or investment in stock. While each form of investment differs as to incidents, each is simply a means by which a stockholder seeks to increase the value of his present stockholdings by injecting funds into his business. Each investment looks to ultimate capital gain in this manner, so each should be given capital loss treatment.

Further, it is argued that payments to be relieved from or in partial fulfillment of guaranty obligations are a direct result of the guaranty; therefore, they should be treated like other guaranty losses (where subrogation rights arise) under Putnam.

There are several methods of achieving this result by judicial interpretation. If subrogation rights exist, then that doctrine, of course, can be applied. If the guaranty is in substance a loan, then it should be treated as such. The courts have suggested this latter result, but have not applied it to guaranty losses. Of course, the direct loan (as is the case with the "subrogation" debt) will be deductible as a capital loss when it is shown to be worthless.

72. See Putnam v. Commissioner, 352 U.S. 82, 92-93 (1956); Note, supra note 15. For an example of the argument employed, see, e.g., Brief for Petitioner at 15-17, Commissioner v. Condit, 333 F.2d 585 (10th Cir. 1964). See text, infra, for important differences as to incidents of the various investments.
73. See, e.g., Eugene H. Rietzke, 40 T.C. 443 (1963); Brief for Petitioner at 9-10, Commissioner v. Condit, 333 F.2d 585 (10th Cir. 1964).
74. 68 Harv. L. Rev. 1079, 1080 (1955) suggests that this doctrine could apply even in a case where the corporation had been dissolved prior to the guarantor's payment. This contention has no support, and little foundation.
76. See generally 5 J. MERTENS, supra note 6, at 320-21, § 30.52, at 108-09; 3 J. RABKIN & M. JOHNSON, supra note 46, at 3551-52; Propp, supra note 20, at 117-19.
If, when the guaranty is made, there appears to be no reasonable chance of recovering this "loan," or if the guarantor pays the creditor for release from the guaranty obligation (and, at the same time, releases the debtor), the transaction may be treated as a contribution to capital. The payment would then be added to the basis of the stock. Not only would any loss be a capital loss, but it would be deferred until the stock was sold or became worthless.\(^7\)

Some courts have held that *indemnity* payments were in fact part of the purchase price of stock, and should have been added to the basis of the investment.\(^7\) Thus, the taxpayer was limited to a capital loss. (This same rule might apply to guaranty losses.)\(^7\)

Some have suggested that the guarantor's loss deduction simply not be allowed to rise higher than the creditor's—that the creditor's potential loss be transferred to the guarantor upon any payment (including part payment) of his obligation. This doctrine was apparently applied to limit the taxpayer to a capital loss in *United States v. Keeler*\(^6\) where there was an indemnity to absorb the loss of other stockholders on their investments.

**An Ordinary Loss?**

There do exist, however, sound arguments that all guaranty losses

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77. See Bratton v. Commissioner, 217 F.2d 486 (6th Cir. 1954); Santa Anita Consol., Inc., 50 T.C. No. 52 at 50-376-79 (July 2, 1968); Isidor Dobkin, 15 T.C. 31 (1950), aff'd, 192 F.2d 392 (2d Cir. 1951). For a thorough discussion, see Petitioner's Opening Brief at 27-66 & Petitioner's Reply Brief at 15-31, Santa Anita Consol., Inc., 50 T.C. No. 52 (July 2, 1968). The Government has unsuccessfully urged that stockholders' guaranties of corporate indebtedness were capital contributions to the corporation in cases dealing with matters other than guaranty losses. Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967); Ackerson v. United States, 277 F. Supp. 475 (W.D. Ky. 1967); Fors Farms Inc. v. United States, 17 A.F.T.R.2d 222 (W.D. Wash. 1965).


80. 308 F.2d 424 (9th Cir. 1962), cert. denied, 373 U.S. 932 (1962). But see Commissioner v. Condit, 333 F.2d 585 (10th Cir. 1964). This involves another economics reality type approach.
should be given ordinary loss treatment under section 165(c)(2).\textsuperscript{81} In most cases, payment is based on the contractual obligation alone and no debt (from debtor to guarantor) is contemplated at the time of the guaranty agreement or when payment is made. The guaranty transaction is one unto itself.\textsuperscript{82}

Each form of investment looks for capital gains resulting from the increase in value of stock already owned because of the injection of funds into the stockholder's business. In addition, a direct loan looks to interest payments (but to a capital loss if there be any); and a stock purchase looks to dividends and to further capital gain in case of sale at a profit (but to a capital loss if there be any). A nonbusiness guaranty looks for no additional income or gain; therefore, it should be allowed the benefit of ordinary loss treatment (if there be any loss).

In addition, section 166(f)\textsuperscript{83} gives a guarantor of a noncorporate obligation (if the proceeds are used in the borrower's trade or business) an ordinary loss deduction. Why should guarantors of corporate obligations be discriminated against? This question is magnified when it is recognized that there is less room to question the trade or business use in such a case.\textsuperscript{84}

Sections 1242 and 1244\textsuperscript{85} give favorable treatment to losses on small business investment company stock and small business stock, respectively. It is ironical that (in these limited areas, at least) direct loans and guaranty losses might be treated as capital losses; whereas, losses on capital stock will usually be ordinary losses.

At the present time, such a judicial result (ordinary loss treatment) usually occurs whenever the taxpayer himself avoids acquiring a subrogation claim.\textsuperscript{86} However, \textit{Putnam} would have to be overruled by the Supreme Court before this result could be obtained in any other manner in the courts.

82. \textit{See}, e.g., \textit{Plowman}, \textit{supra} note 28, at 151.
84. \textit{See} 5 \textit{J. Mertens}, \textit{supra} note 6, at 321 & n. 57; 3 \textit{J. Rabkin & M. Johnson}, \textit{supra} note 46, at 3543; 57 Colum. L. Rev. 577, 579-80 (1957). \textit{But see Plowman}, \textit{supra} note 28, at 150.
86. Assuming for the sake of argument that all taxpayers have the power to avoid any subrogation claim, this would still not be an equitable solution. As discussed in note 45, \textit{supra}, there may be other considerations which require that the taxpayer accept the subrogation rights. If he does, any loss is a capital one under present law.
Conclusion

Generally, the tax treatment of losses resulting from individual non-business guaranties of corporate obligations is decided on the basis of subrogation theory. If the guarantor acquires a subrogation right, then he gets a nonbusiness bad debt deduction (limited to capital loss treatment) when such claim becomes worthless. If he gets no subrogation claim, then he has an ordinary loss deduction if his guaranty was part of a transaction entered into for profit. Often there is a close question of fact as to whether the guarantor does acquire a subrogation claim. More often, he clearly acquires a claim which is worthless at its inception. Herein lies the real difficulty with the subrogation doctrine as applied in this area—that one who acquires a worthless claim should be limited to a capital loss, whereas one who acquires no claim gets an ordinary deduction. This problem is especially acute where the latter has avoided obtaining a subrogation claim by not paying all of his guaranty obligation or by paying to be relieved of his obligation. If nothing else, all nonbusiness guaranty losses should be given similar treatment without regard to such technical differences. Certainly, the distinctions made are unrealistic.

The best solution to this problem would be for Congress to amend the statutes in such a way as to make specific provision for these non-business guaranties. Both sides appear to have good arguments; Congress should decide whether the loss or the bad debt provisions should apply. The following provision [adopted from section 166(f)\(^87\)] would be appropriate if an ordinary loss deduction were preferred:

A payment by the taxpayer (other than a corporation) in discharge of or for release of part or all of his obligation as a guarantor, endorser, or indemnitor of a corporate obligation shall be treated as a debt becoming worthless within such taxable year for purposes of this section [except that subsection (d) shall not apply].

Subsection (d),\(^88\) of course, created capital loss treatment for non-business bad debts. The latter part of section 166(f) which requires that the principal obligation be worthless at the time the guaranty is paid was dropped. Such a provision would exclude most transactions

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88. *Id.* at § 166(d).
where there is a payment for release of the guaranty obligation or where there is a partially worthless subrogation claim. These two situations should be given the same treatment as other guaranty loss transactions.

If capital loss treatment were desired, the above language would accomplish that objective if the last phrase (in brackets) were dropped. Such transactions would simply "be treated" as bad debts, and the capital loss provisions of the nonbusiness bad debt section would apply.

Until such time as Congress resolves this nagging problem, the courts must do the best they can. While the reasoning in current cases appears highly technical and stifled, the courts should continue to make such distinctions under the present statutory scheme. Usually, the only way to bring such a guaranty transaction under the nonbusiness bad debt section is to find a debt resulting from a subrogation claim. At the same time, courts have little choice but to apply that section when a subrogation claim has ever existed. No distinction should be made for such claims which are worthless when acquired—they should be treated as bad debts the same as claims which are worthless the day after they are acquired. The courts should continue to allow an ordinary loss deduction (no matter how unjust) whenever no subrogation claim is acquired—because the corporation has been dissolved or because the guarantor simply paid to be released from his guaranty obligation. At least, if the courts would consistently follow such a close technical doctrine, the taxpayer would know what to expect and could plan his transaction with some degree of certainty.

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