Unwarranted Tax Advantages in Corporate Financing: Shareholder Guaranteed Loans

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SHAREHOLDER GUARANTEED LOANS

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INTRODUCTION

Apart from the tax considerations of corporate financing which will be dealt with in detail subsequently, there is, with but one exception, no benefit derived nor disadvantage avoided whether the funding of the enterprise is effected by the issuance of stock, debt obligations or a combination of both. All funds coming into the corporate treasury are placed into the melting pot of "risk capital." The exception alluded to assumes corporate insolvency, in which case the investors, to the extent of their bond or other debt holdings, will generally receive creditors' rights over those holding solely proprietary interests.¹

Considered in the light of our revenue laws, however, a plan of debt financing, as will shortly be seen, presents several attractive benefits unavailable to a funding operation dependent exclusively, or to a large extent, upon original and subsequent stock issues. Dissatisfied with tax advantages attendant a reasonable balance between these two interests, some have placed undue emphasis upon borrowed capital thereby overloading the corporation with debt obligations and relegating equitable investments to a position of slight and even token significance. Thus, frequent but often unsuccessful use has been made of the "thin" or undercapitalized venture.²

† Member of the New York and Federal Bars.
² See Bryson, Stockholder Loans: "Thin" Capitalizations, N.Y.U. 8th Inst. on Fed. Tax. 732 (1950); De Stefano, Stock Or Debt—That Is The Question, 18 Fordham L. Rev. 251 (1949); LeSourd, Tax Treatment Of Stockholders'
The scope of this article will be confined, in the main, to a discussion and evaluation of several quite recent cases which may possibly open new avenues of tax avoidance via the "thin incorporation" route. Succinctly stated the question is: can the possible consequences attending a judicial or administrative interdiction of excessive thinning, in the case of direct shareholder loans, be effectively avoided by securing an outsider's loan guaranteed by an insider-shareholder? Discussion of this question will be mainly directed to the unsuccessful corporation, although consideration will also be given to the profitable corporation which is accumulating surplus in order to retire its obligations.

STOCK OR DEBT—TAX CONSEQUENCES

It is necessary to note some of the more important and readily apparent distinctions between these two interests. Thus, if an obligation is considered a debt, interest payments are deductible by the corporation, while a contrary finding would require such payments to be deemed dividends for which no deduction is obtainable. Receipt of interest payments is taxable in full whether the recipient be an individual or a corporation. However, if such installment payments are deemed to be dividends and are received by a corporation, the Internal Revenue Code provides for an 85% dividends received deduction, while an individual taxpayer would benefit by a $50 exclusion and a credit against tax equal to 4% of the dividends included within gross income. Notwithstanding the character of the recipient, taxation of dividends is, of course, dependent upon the presence of earnings and profits. Worthless securities, including stock and certain

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3 INT. REV. CODE OF 1954, §§ 162, 163.
4 Id. § 61(a)(4).
5 Id. § 243(a).
6 Id. § 116(a).
7 Id. § 34(a). See subdivision (b) for limitations on the amount of credit.
8 Id. § 316(a).
instruments of indebtedness in registered form or bearing interest coupons, result in capital loss. If the obligation is found to be a debt, worthlessness thereof will result in short term capital loss, i.e., a non-business bad debt deduction, unless incurred in the taxpayer's trade or business or unless the taxpayer happens to be a corporation. Statutory tests have been promulgated under the 1954 Code to determine whether stock redemptions or bond retirements shall receive capital gain or ordinary income treatment. If the debt obligation does not fall within the scope of the new bond retirement provision, taxable income will be realized only on the difference between the basis of the obligation and the redemption price. In addition, gain or loss may be realized by the corporation if retirement is at a discount or a premium.

A shareholder may withdraw a part of the earnings tax free because repayment of an advance does not constitute taxable income, whereas a dividends tax would be proper if the original "loan" was deemed a capital contribution. Should the venture prove unprofitable, it is well settled that, as the corporation's business is not that of the shareholder, debt obligations, in the ordinary situation, will give rise to a non-business bad debt deduction provided the stockholder-lender is not engaged in the business of lending money. On the other hand, one may be cast in the role of promoter rather than that of a passive investor. Thus, where a substantial amount of the promoter's time, energy and, perhaps even

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9 Id. § 165(g). The loss will be long term unless the instrument is purchased on or after July 1 in the year of worthlessness.
10 Id. § 166(d).
11 Id. § 166(a), (d). The non-business bad debt provision is inapplicable to corporations. Note also that no deductions may be taken for non-business bad debts proving only partially worthless.
12 Id. § 302(a), (b). Generally, if the taxpayer meets the requirements of (b)(1), (2) or (3), capital gain or loss will, in most instances, result upon stock redemptions. If Section 302 is not satisfied, a dividend tax will usually be imposed to the extent of earnings and profits. Section 1232(a) sets forth the test which will determine the amounts of capital gain or loss or ordinary income on the retirement of bonds and other evidences of indebtedness falling within the scope of this section.
13 But see Int. Rev. Code of 1954, § 332(c).
14 Burnet v. Clark, 287 U.S. 410, 415 (1932) (dictum); Omaha Nat'l Bank v. Commissioner, 183 F.2d 899, 901 (8th Cir. 1950) (dictum).
15 Commissioner v. Smith, 203 F.2d 310, 312 (2d Cir.) (dictum), cert. denied, 346 U.S. 816 (1953).
money, are spent in the pursuit of organizing or investing in business enterprises, business bad debt deductions have been sustained on the ground that such activities constitute a regular business separate and distinct from that of the corporation.\textsuperscript{16}

Classification of a corporation as a personal holding company\textsuperscript{17} or a regulated investment company\textsuperscript{18} may well depend upon determination of the question, "stock or debt." The results of such a finding could have repercussions in the area of corporate organizations and reorganizations.\textsuperscript{19} The retention of corporate earnings to meet maturing obligations will not usually run afoul of the accumulated earnings tax,\textsuperscript{20} whereas the imposition of this penalty tax would undoubtedly be much more likely if a particular security or obligation represented, in effect, equity capital.

**Stock or Debt—Judicially Developed Criteria**

Many attempts have been made to employ the vehicle of undercapitalization in order to secure tax advantages which would not otherwise be available. Not infrequently these attempts would take the form of hybrid securities issued by the corporation purporting both to embody the advantages and avoid the consequences of these two types of interest. Therefore, it is not surprising that the courts early developed specific and now well established criteria to determine the question "stock or debt."

\textsuperscript{16} "A person of property, who devotes his time to the active management of it and also to active participation in the management of the companies in which his property is invested, and who maintains an office for that purpose where he spends a substantial part of his time, is carrying on business within the meaning of this statute." Foss v. Commissioner, 75 F.2d 326, 327-28 (1st Cir. 1935). A. Kingsley Ferguson, 16 T.C. 1248, 1257 (1951) (dictum) (note also dissent of Tietjen, J. at 1259); see Vincent C. Campbell, 11 T.C. 510 (1948); Friedman, Bad Debts: Business or Non-Business?, 5 Tax L. Rev. 412 (1950); Holland, Tax Effects of Stockholder Loans to Corporations, N.Y.U. 9th Inst. on Fed. Tax. 1083 (1951).

\textsuperscript{17} Int. Rev. Code of 1954, §§ 541-547.

\textsuperscript{18} Id. §§ 851-855.

\textsuperscript{19} Id. §§ 351-368.

\textsuperscript{20} Id. §§ 531-537.
Thus, the presence of a fixed maturity date when a sum certain becomes due and payable,\textsuperscript{21} a provision for the payment of interest,\textsuperscript{22} and equal treatment of the shareholder-creditor with the outside lender\textsuperscript{23} are all indicative of bona fide indebtedness. The fact that an obligation is secured\textsuperscript{24} and that repayment thereof is absolute and not conditioned upon some factor, such as the presence of corporate earnings,\textsuperscript{26} leads to a similar conclusion. In some cases the courts have looked to the nomenclature of a particular security or instrument.\textsuperscript{26} The fact that debenture holders have no voice in the management\textsuperscript{27} or no voting rights, absolute or conditional,\textsuperscript{28} militates against the finding of a proprietary interest. Conversely, in cases involving a high debt to stock ratio, "... a strong inference arises that the entire amount paid in is a contribution to the corporation's capital. ..."\textsuperscript{29} Probably the most decisive factor is the issuance of corporate stock in direct proportion to amounts advanced by stockholders. In such a case, the same persons receive identical amounts whether termed interest, principal or dividends.\textsuperscript{30}


\textsuperscript{22} Joseph B. Thomas, 2 T.C. 193, 196 (1943) (dictum).


\textsuperscript{26} New England Lime Co., 13 T.C. 799, 803 (1949) (dictum); Mullin Bldg. Corp., \textit{supra} note 24 at 358 (dictum).

\textsuperscript{27} Clyde Bacon, Inc., \textit{supra} note 25 at 1115 (dictum); Charles L. Huisking & Co., \textit{supra} note 23 at 599 (dictum).

\textsuperscript{28} B.M.C. Mfg. Corp., \textit{supra} note 25 at 328 (dictum); Clyde Bacon, Inc., \textit{supra} note 25 at 1116 (dictum).


\textsuperscript{30} 1432 Broadway Corp., 4 T.C. 1158, 1165-66 (1945) (dictum), \textit{aff'd per curiam}, 160 F.2d 885 (2d Cir. 1947); Edward G. Janeway, 2 T.C. 197, 202 (1943) (dictum), \textit{aff'd}, 147 F.2d 602 (2d Cir. 1945).
RECENT CIRCUIT COURT DECISIONS

Four recent cases, decided by three different federal circuit courts, may have inadvertently opened the door to unwarranted tax benefits in the case of prospective investors, incorporators and shareholders of existing corporations about to finance embryonic ventures or going concerns. The Third Circuit in Pollak v. Commissioner 31 and Ansley v. Commissioner, 32 the Fifth Circuit in Edwards v. Allen, 33 and the Sixth Circuit in Cudlip v. Commissioner, 34 reached identical conclusions on substantially similar facts: a shareholder had guaranteed payment of some corporate obligations; the primary debtor was unable to comply upon demand for payment and the guarantor was called upon to discharge his obligation; payment was made at a time when the corporation was, in effect, insolvent; the guarantor, not having been reimbursed, claimed he had suffered a loss incurred in a transaction entered into for profit 35 and therefore deductible in full. In the Pollak 36 and Cudlip 37 cases, the Tax Court had held that the loss, in such a case, was limited in deductibility by the non-business bad debt provision. 38 The Ansley 39 case stated that the proper deduction would fall under the same section but held that the taxpayer had not met the burden of establishing worthlessness of the obligation in the year of deduction. In the Allen 40 case, the District Court of Georgia held the payments to be deductible in full as losses incurred in a transaction entered into for profit. Appeal was taken in all four decisions. The three Tax Court determinations were reversed, the taxpayer being permitted an ordinary loss deduction as in the lower court Allen decision, and the latter

31 209 F.2d 57 (3d Cir. 1954).
32 217 F.2d 252 (3d Cir. 1954).
33 216 F.2d 794 (5th Cir. 1954).
34 220 F.2d 565 (6th Cir. 1955).
case was affirmed. It is with these decisions that the writer takes issue on grounds of legal justification and the possible consequences apparently overlooked by the courts in arriving at their conclusion.

LEGAL JUSTIFICATION

A thorough analysis requires examination into the results and reasoning of prior decisional law. If precedent were the exclusive test of justification, the result of the instant decisions would be condemned ab initio; for it is without doubt that the conclusion of the several circuits flies in the teeth of an unbroken line of cases holding to the contrary.\footnote{See, e.g., Hamlen v. Welch, 116 F.2d 413 (1st Cir. 1940); Shiman v. Commissioner, 60 F.2d 65 (2d Cir. 1932); Whitcher v. Welch, 22 F. Supp. 763 (D. Mass. 1938); George Aftergood, 21 T.C. 60 (1953); Kate Baker Sherman, 18 T.C. 746 (1952); Warren Leslie, Sr., 6 T.C. 488 (1946); Alice Dupont Ortiz, 42 B.T.A. 173 (1940), rev'd on other grounds sub nom. Helvering v. Wilmington Trust Co., 124 F.2d 156 (3d Cir. 1941), rev'd, 316 U.S. 164 (1942); D. W. Pierce, 41 B.T.A. 1261 (1940); H. Rodney Sharp, 38 B.T.A. 166 (1938); Daniel Gimbel, 36 B.T.A. 539 (1937); see E. A. Roberts, 36 B.T.A. 549 (1937).} The propriety of a worthless debt deduction was not denied and, in fact, prior to this quadruple innovation, the question which most often plagued the courts was the difficulty of distinguishing between business and non-business bad debts. This succession of prior cases proceeded on the theory that, upon payment by a guarantor, a debt was created in his favor under the equitable doctrine of subrogation, by substituting him in the place of the original creditor; \footnote{Howell v. Commissioner, 69 F.2d 447, 451 (8th Cir.) (dictum), cert. denied, 292 U.S. 654 (1934).} that, as the prime obligor was insolvent at the time of payment, the debt became worthless upon acquisition eo instanti; \footnote{Daniel Gimbel, supra note 41 at 542 (dictum).} finally, that it was ascertained as worthless and properly charged off in the year of payment.\footnote{Payment, in fact, must be made and the mere giving of the guarantor's own notes will not support a deduction. See J. P. Badenhausen, 7 B.T.A. 910 (1927).} Exceptions were made to this rule in cases where the principal obligor was no longer in existence at the time of payment,\footnote{Fox v. Commissioner, 190 F.2d 101 (2d Cir. 1951); Abraham Greenspon, 8 T.C. 431 (1947); see 5 MERTENS, FEDERAL INCOME TAXATION § 28.70 (1953).} where payment was
made on a debt outlawed in bankruptcy or where only partial payment had been made by the guarantor. Sound reasoning rests behind these exceptions. Subrogation cannot create a debt without an obligor against whom it may attach, nor revive an obligation already discharged by law. Nevertheless, the courts were most careful to mention that a bad debt deduction would have been proper had the main debtor been in esse.

Inspection of these prior cases reveals constant repetition of the above principles, logical reasoning and well-founded conclusions. Upon what justifiable grounds then may the four decisions at bar be predicated? In the Pollak case, it was stated that a stockholder "... who thus loans his credit to his corporation does so in the hope ... that the corporation, with the additional credit ... will succeed in preserving or adding to the value of his stock", and not because he intends or expects to be repaid by the then existing and solvent corporation. One cannot help but conclude that the reasoning of these cases seeks to apply all the factors requisite for an ordinary bad debt to an obligation arising by operation of law. The court, in the Pollak decision, admits the corporation became indebted to its shareholder-guarantor via subrogation, but nevertheless seems to require a specific intent to create a debt already created by law. Were we to subscribe to this reasoning, we would be presented with the anomalous situation of a debt arising by operation of law which could not arise because intent to create it was lacking.

Payment was made under a valid and enforceable contract of guaranty—a voluntary element was totally absent. Therefore, the debt running to the guarantor was one acquired involuntarily in that he was not legally free to agree or refuse to make payment. "A voluntary loan which gives rise to a debt ... worthless when created or acquired ...

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40 See Frank B. Ingersoll, 7 T.C. 34 (1946).
48 See Fox v. Commissioner, supra note 45 at 105; Abraham Greenspon, supra note 45 at 434.
may not then or subsequently be deducted as a bad debt. [But] . . . [w]here the debt is created involuntarily the foregoing rules do not apply and the taxpayer may be allowed a bad debt deduction upon the worthlessness of his claim. This principle finds illustration in the case of an endorsement . . . by a surety. . . . [T]he debt arises only when the indorser or surety pays. . . . In such cases a bad debt deduction may be allowed, but only if the principal debtor is still in existence." 50 In the Pollak case, the court draws no distinction between a case involving an insolvent debtor and a situation where the obligor is no longer in existence. It is respectfully submitted that this is a decisive factor. Subrogation looks not to one's impoverished state but seeks only to find one against whom the debt may be said to run. A debt may arise by operation of law but a debtor may not.

It must also be noted that at least two Tax Court decisions, decided after reversal in the Pollak case, have respectfully but quite firmly refused to follow the Third Circuit. 51

The case of Fox v. Commissioner 52 was also relied upon as authority for sustaining an ordinary loss deduction. The facts of that case were substantially as follows: H's wife (W) had pledged some of her securities as collateral for H's brokerage account and she subsequently executed a guaranty thereon. H died at a time when the debit balance of the account was quite substantial. The securities were sold in partial satisfaction and W paid the balance after H's insolvent estate had been wound up. The Court of Appeals for the Second Circuit reversed a Tax Court determination 53 limiting the taxpayer to a non-business bad debt deduction, and held that W had suffered an ordinary loss incurred in a transaction entered into for profit. Although the "profit" requirement was justified on the ground that no sound distinction could be drawn between cutting losses and showing

50 See 5 MERTENS, FEDERAL INCOME TAXATION § 30.11 (1953).
51 See Peter Stamos, 22 T.C. 885 (1954). "We are aware of the recent reversal of the Pollak case . . . . However, after carefully reexamining the problem we respectfully decline to follow the Court of Appeals for the Third Circuit in its reversal . . . ." Id. at 890. See also Max Greenhouse, P-H 1954 T.C. Mem. Dec. § 54250 (citing the Stamos decision).
52 190 F.2d 101 (2d Cir. 1951).
53 Agnes I. Fox, 14 T.C. 1160 (1950).
a positive gain, the validity of such a statement is debatable.\textsuperscript{54} Assuming, arguendo, that the \textit{"profit"} requirement was satisfied, the circumstances under which the guaranty was given in the \textit{Fox} case were quite different from those present in the four cases under discussion. In the latter, the courts themselves stated that the guaranties were made in the hope of preserving or even ameliorating the value of respective investments. Was not the real transaction entered into for profit the original stock purchase and the guaranty but a secondary or incidental step to insure against loss of value which eventually would be realized on subsequent disposition of the stock by sale, redemption or other manner of disposal?\textsuperscript{55} In the \textit{Fox} case no such situation existed. The corporation as such was not involved. Avowedly the main object of the guaranty was to avoid a forfeiture of securities pledged as collateral. This is not a transaction as may be said to be inextricably woven with the original purchase of stock. The guaranty may be looked upon as an independent and separate transaction quite unlike those involved in the instant decisions, the significance of which is but secondary when viewed in its proper context. Furthermore, the court's finding that no bad debt existed is entirely consistent with the reasoning of prior decisional law. When \textit{W} made payments under the contract of guaranty, \textit{H} was dead, his insolvent estate had been wound up and his executors had been discharged—there was no possible person against whom a debt could be said to run.\textsuperscript{56} Statements in the \textit{Fox} opinion itself leave no doubt but that a debt would have arisen had

\textsuperscript{54} Helvering v. Nat'l Grocery Co., 304 U.S. 282, 291 (1938) (dictum); Feine v. McGowan, 188 F.2d 738, 740 (2d Cir. 1951) (dictum).

\textsuperscript{55} Thus, in R. W. Hale, 32 B.T.A. 356 (1935), aff'd, 85 F.2d 819 (D.C. Cir. 1936), the petitioners sold stock to their sister at cost coupled with a one-year guarantee, agreeing to reimburse her for any loss she might sustain upon sale of the stock. The sister sold below cost and the petitioners paid the difference. The court allowed a loss arising from a transaction entered into for profit stating, "[t]hat [the guaranty] was only one of several steps, all of which can and must be retraced to find the origin of the transaction. We thus go back to June 6, 1929, when the stock was acquired by petitioners. That acquisition marked the inception of a 'transaction entered into for profit' . . . . The principle of relation back to inception is fundamental in the tax statutes." \textit{Id.} at 357 (emphasis added). See also Carl Hess, 7 T.C. 333 (1946).

\textsuperscript{56} Peter Stamos, 22 T.C. 885, 890 (1954) (dictum); see Max Greenhouse, P-H 1954 T.C. Mem. Dec. \# 54250.
the principal debtor been in existence at the time of payment. Such statements are reinforced by approval, in the Fox decision, of the principles of prior case law including the case of D. W. Pierce, which presented a situation identical to the one presented in the Fox case, save that the main debtor, although insolvent, was in existence at the time of the guarantor's payment. It was there held that a non-business bad debt deduction was proper.

Another reason offered in denying a worthless debt deduction is that a debt worthless upon acquisition cannot, under the wording of the statute, become worthless within the taxable year. Prior to 1942, the test of deductibility was whether the debt was ascertained as worthless within the taxable year. Once this fact was established, the courts had no difficulty in reasoning that a debt, valueless upon creation, could be properly charged off. In 1942 the section was amended and the standard of determination was changed to whether the debt became worthless within the taxable period. As the amendment merely changed the standard from a subjective to an objective one, it cannot be seriously contended that the very real distinction between an ordinary and a capital loss may be said to hinge on such an attenuated subtlety.

In this same vein, much reliance is placed upon the case of Eckert v. Commissioner. Several cases, including the ones at bar, have cited the Supreme Court's affirmance of the Second Circuit Eckert decision as an authoritative holding to the effect that a debt worthless when acquired cannot be deducted as such since there is nothing to charge off. A brief statement of the facts, explained in their proper context and reinforced by subsequent decisions of the same circuit, may lead the reader, as it did the writer, to a much different con-
In that case a cash basis taxpayer had acted as an accommodation indorser on several corporate notes. Insolvency resulted and, when called upon to discharge his secondary liability, he and another delivered their joint personal note in the amount of the debt. The Court of Appeals for the Second Circuit denied a “trade and business loss” deduction and, concerning the taxpayer's contention that he was entitled to a bad debt deduction, stated: “[n]or is the taxpayer entitled to a deduction... as a debt ascertained to be worthless... because the debt was worthless when the taxpayer acquired it.”

On appeal to the Supreme Court of the United States, the decision was affirmed and a statement, very similar to the above cited quotation, was made. It is submitted that the precise issue decided in the Eckert case was that a cash basis taxpayer, upon giving his personal note in satisfaction of his liability as a guarantor, had made no payment as such, and therefore had suffered no loss upon which a deduction could be predicated. The very same circuit, two years later, in the case of Shiman v. Commissioner, hammered home this precise point with one hand and, with the other, allowed a bad debt deduction although the obligation was worthless when acquired by the guarantor. The court in the Shiman case, interpreting the words of the Supreme Court, stated: “[t]he court refused to allow the deduction, because [he]... was keeping his books on a cash basis, but it intimated that when he paid he might succeed. ... Yet if it were enough to defeat him that the debt was 'worthless when acquired,' the same objection ought to be good after he had paid; contrary to what was suggested. We cannot therefore think that the language so thrown out was intended as an authoritative statement by which we must be bound.”

In the Fox case why did the circuit court, the same circuit interestingly enough which decided both the Eckert and

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62 Id. at 159.
63 In Helvering v. Price, 309 U.S. 409 (1940), the Supreme Court, on facts very similar to those of the Eckert case, appears to leave the door slightly more than ajar for a bad debt deduction at some future time.
64 60 F.2d 65 (2d Cir. 1932).
65 Id. at 67 (emphasis added).
Shiman cases, state quite unequivocally that had the primary obligor been in existence at the time of payment, a worthless debt deduction would have been proper although, admittedly, it would have been worthless upon acquisition? Research has not indicated any repetition, by the Second Circuit, of its unfortunate dictum in the Eckert case, and apparently for good cause. As the court itself stated that the giving of a note by a cash basis taxpayer was not a payment in cash or equatable thereto, it follows that no right of subrogation could arise. Absent the operative principles of this equitable doctrine, no debt may be said to arise which runs in favor of the guarantor. Naturally no debt may be charged off if none is in existence. Therefore whatever was said by either court concerning bad debt deductions was but dictum of the weakest kind which has, apparently, since been repudiated by the Second Circuit. The Eckert decision merely required the taxpayer to clearly reflect his income. Had the deduction been allowed, he would have been permitted to report on a cash basis and deduct on an accrual basis merely because he had shifted the form of the obligation.

"The statement that a debt worthless when acquired cannot later become worthless has an attractive ring to it, which no doubt accounts for its frequent repetition. Yet it is only a rather inaccurate way of saying that a transaction which is donative from the outset, even though in form a loan or a guaranty . . . was a gift or a contribution to capital." 66 This doctrine merely prohibits a taxpayer from creating a deduction for himself by advancing funds to someone without reasonable expectation of repayment—it requires that the debtor-creditor relationship be real and not fictitious.67 Thus where a loan or guaranty is made at a time when circumstances preclude expectation of reimbursement, the transaction sounds in gift and all echoes of loan are muted.68 A

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66 Cudlip v. Commissioner, 220 F.2d 565, 571 (6th Cir. 1955) (dissenting opinion) (emphasis added).
67 See 5 MERTENS, FEDERAL INCOME TAXATION § 30.11 (1953).
68 See Hoyt v. Commissioner, 145 F.2d 634 (2d Cir. 1944) (guaranty made at a time when reimbursement, if the guarantor was made to pay, could not reasonably be expected); Ray Crowder, 19 T.C. 329 (1952) (payments made at a time when petitioner knew company would not, at any time, have sufficient funds to repay them).
worthless debt deduction is denied in such cases as the payment is deemed to have been voluntarily contributed.\textsuperscript{69} It is this so-called debt which must be deducted as a loss or not at all. In the case of a legally enforceable contract of guaranty entered into at a time when the prospective debtor is financially stable, no donative element is present. "...[T]he fact that it [the debt] was worthless at the time the payment creating the debt was made could not defeat the right of the taxpayer to the deduction since the binding obligation to pay had arisen long since when the party guaranteed was still solvent."\textsuperscript{70} The inquiry therefore must be directed to the debtor's financial condition at the time the guarantor bound himself to pay upon the obligor's default, and not when actual payment was made.

The reader may now be uncertain as to the tax consequences attendant a situation where the guarantor makes payment at a time when the main debtor is no longer \textit{in esse}. It is well established that the pertinent sections of the Internal Revenue Code allowing deductions for worthless debts and for losses incurred in business or profit transactions are mutually exclusive.\textsuperscript{71} Is a guarantor, who has met his obligation, to receive no tax benefit merely because the principal obligor is no longer in existence? Hardly! Execution of a guaranty per se does not give rise to a completed transaction upon which tax consequences may attach. Only after payment has been made does a debt arise by operation of law. It has been noted that a guarantor cannot receive subrogee's rights where the primary debtor is out of existence as there is no person against whom the debt may attach. The debtor-creditor relationship not having arisen, it would not violate sound reasoning to allow a loss deduction in such a situation. Acquisition of stock marks the first step of a profit-seeking transaction. A subsequent guaranty is but incidental to a general desire to avoid loss or even perhaps promote the value

\textsuperscript{69}See Reading Co. v. Commissioner, 132 F.2d 306 (3d Cir. 1942), \textit{cert. denied}, 318 U.S. 778 (1943).
\textsuperscript{70}W. F. Young, Inc. v. Commissioner, 120 F.2d 159, 165 (1st Cir. 1941). See Hamlen v. Welch, 116 F.2d 413, 418 (1st Cir. 1940); George Aftergood, 21 T.C. 60, 63 (1953).
\textsuperscript{71}Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189 (1934) (dictum).
of one's proprietary interest. If the corporate entity has disappeared at the time of payment, we may assume that the guarantor has previously disposed of his stock in one manner or another. Thus, a completed transaction [stock disposition] has preceded the payment. In such a situation, hindsight affords the opportunity of detachment and the payment may be regarded as a transaction in and of itself imbued with the "profit" qualifications of its completed brother transaction.

In the new Code, Congress added a subdivision to the section dealing with worthless debts. Section 166(f), in essence, provides that a payment by one other than a corporation in discharge of a guarantor's or indemnitor's liability on a non-corporate obligation, the proceeds of which loan were used in the borrower's trade or business, shall be deemed to give rise to a business bad debt deduction if the obligation was worthless at the time of payment. This section presents new problems when compared to the four decisions under discussion. Although it does not purport to deal with corporate obligations, one cannot help but conclude that it conflicts with a portion of the reasoning of Pollak and the other cases. It will be remembered that one of the reasons for denying bad debt deductions was that a debt worthless when acquired could not thereafter become worthless. Section 166(f) seems to discount this reason summarily as its applicability is, in fact, limited to instances where the debt was worthless at the time of the guarantor's payment. If the reasoning of these cases is sound, there appears to be no valid objection to the applicability of the same argument to non-corporate obligations. If such is the case, this new provision would be emasculated to a large extent, if not completely, as the deduction would fall under a different section entirely (loss incurred from a transaction entered into for profit). It cannot be assumed that this new section would have been enacted if its applicability was thought, in any way, to be perfunctory. It is interesting to note that only the circuit

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72 It should be noted that, as a result of this provision, a taxpayer who but partially discharges his liability as guarantor may deduct this amount if the balance of the obligation is worthless at the time of payment. Compare with cases cited in note 47 supra.
court decision in the Pollak case and the district court opinion in the Allen case had been handed down before the congressional hearings on the new Code. The decisions of the Tax Court in the Cudlip and Ansley cases upholding bad debt deductions had been published prior to the hearings, but the reversals did not occur until after the effective date of the new Code. Although the legislative history of this section throws no light upon this confused state of affairs, it is the writer's opinion that Section 166(f) was enacted not with the congressional intent of classifying an obligation worthless when acquired as a bad debt, but with a different purpose in mind. It seems that Section 166(f) was introduced to allow ordinary loss treatment where the taxpayer had made payment pursuant to a guaranty obligation which had been contracted in a business transaction, though not necessarily in his own trade or business. Notwithstanding this new provision and the section allowing deduction of expenses incurred in the production or collection of income, it seems that the deductibility of a direct loan, similar to one described in Section 166(f), must still be governed by the non-business bad debt section where there was no direct connection with the taxpayer's business as such.

POSSIBLE CONSEQUENCES OF THESE DECISIONS

The tax advantages of debt financing have already been mentioned along with the pitfalls of "thin incorporation." It has also been seen that two of the most important elements guiding the courts in effecting a metamorphosis from debt to stock has been the high ratio of borrowed to invested capital, especially where the holdings of each interest are proportionate among the respective shareholders. But of what concern is the result of these decisions in this area of the law? Assume the following situation: A, B and C, doing business as partners, wish to incorporate. Each has $10,000 to invest and an attorney is consulted on the most profitable manner

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73 INT. REV. CODE OF 1954, § 212(1).
74 See Guterman, Some Problems In The Deduction For Bad Debts, 63 HARV. L. REV. 832, 836 (1950); Hanigsberg, Distinguishing a Fully Deductible Loss From a Non-Business Bad Debt, N.Y.U. 7TH INST. ON FED. TAX. 914 (1949).
of incorporation. He realizes that if $30,000 is immediately sunk into capital stock, a subsequent failure of the business will result only in capital loss (worthless stock). A reasonable balance between stock and debt capital will put the prospective investors in no better position if the corporate enterprise should subsequently prove unsuccessful. He is also aware of the possible consequences of undercapitalization and realizes that incorporation with, for example, $3,000 of capital stock and $27,000 in bonds, would present a structure bathed in suspicion. Having read the instant cases, he advises the following plan: the corporation is to issue $3,000 worth of stock, $1,000 to A, B and C; if additional funds are required a loan may be obtained from an outside third party; this advance is to be personally guaranteed by A, B and C and perhaps even secured by property worth approximately $27,000—the identical amount withheld upon incorporation. Several months later the corporation, now in need of additional funds, secures a loan from a bank which is guaranteed by the shareholders. The advances prove of no avail and a petition in bankruptcy is filed. The bank calls for repayment and A, B and C discharge their obligation in full. The reasoning of these decisions would now afford all three shareholders ordinary loss deductions which could be offset against any income from whatever source derived. Although the corporation has been financed, in the eyes of these cases no loan has been made and no additional stock has been purchased. This hypothecation would presumptively hold true regardless of the number of times this funding scheme was carried out.

Several reasons militate against the desirability of such a result. The mere fact that a taxpayer has risked his money by guaranteeing a corporate obligation, instead of making a direct loan or investing in additional stock, should not change the nature of the loss by obscuring the true nature of the transaction. Had the guaranty been made without a profit motive and not in one's trade or business, no deduction would be permissible under the result of these decisions.\(^7\) Had the

\(^7\) Moreover, if the corporation was financially rehabilitated thereby, no deduction would be permitted. See Jeremiah G. Menihan, 29 B.T.A. 169 (1933), aff'd, 79 F.2d 304 (2d Cir.), cert. denied, 296 U.S. 651 (1935).
loan been made without an intervening guaranty the original creditor would have been entitled to a bad debt deduction upon non-payment. The guarantor, after he has paid, is merely subrogated to the creditor's rights; he is now the creditor on the same claim and hence the result should be the same upon non-payment as in the case of the original creditor.

If the guaranty device is viewed as but a step toward a desired result, it is seen that such a transaction is nothing more or less than an indirect loan. The theoretical advance, created when the funds were originally made available to the corporation, now ripens into actuality when the guarantor is made to pay. This perspective clears the way for both administrative and judicial condemnation of this and similar tax avoidance plans. As the payment is now considered a corporate loan, it may be compared with the amount of the shareholder's proprietary interest and with any other direct loans he may have made; the function of the latter perhaps being only to dispel suspicion and lend an air of reality to the transaction. Once all these pieces have been fitted into their proper context, the government may now look to the overall debt to stock ratio and to the pro rata holdings of each interest. Assume it is found that A, B and C each guaranteed $9,000 of the total corporate obligations or that each received bonds in the face amount of $4,500 and had guaranteed $4,500 of the corporate loans. Numerous combinations, some more difficult to detect than others, are possible, but close scrutiny and proper evaluation will ferret out the real purpose behind these and similar plans. If the corporation is "put back on its feet" and repays its guarantors, the way is clear for a finding of a taxable dividend. Should the enterprise later prove unsuccessful, the appropriate deduction by the shareholder, in most instances, will be that of a non-business bad debt, thus equating tax treatment in cases of guaranty to instances of additional capital investments or direct loans which thereafter prove worthless.

Another consideration closely allied to this situation is the questionable applicability of the corporate accumulated

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earnings tax, which is aimed at corporations formed, or availed of, for the purpose of avoiding the surtax on shareholders by allowing earnings to accumulate. Assuming the existence of a bona fide relationship of debtor-creditor between corporation and stockholder, a retention of corporate earnings to retire outstanding obligations seems to fall outside the scope of the forbidden purpose. In such a case, the accumulation serves a proper and necessary business purpose. But a retention of earnings to repay "debts" of an excessively "thin" corporation would be difficult to justify. Quite possibly the government might invoke the accumulated earnings tax in several ways. Success might be attained by attacking the character of the alleged debt, claiming that, for tax purposes, the indebtedness represented invested capital. Once the "advances" are deemed capital contributions, the purpose for the accumulation disappears and successful advancement of this argument would certainly cast some doubt upon the propriety of setting aside earnings for annual interest payments and, eventually, repayment of principal amounts. Without going as far, it might well be proposed that the very creation of an excessive corporate debt structure indicates that the corporation was formed, or utilized, to avoid surtax imposition upon its shareholders. In furtherance of these arguments it may be pointed out that such a surtax risk is involved in any case in which the accumulation of profits may be thought to be for the benefit of the stockholders rather than for purposes germane to the business. This principle may find illustration in a situation

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77 See INT. REV. CODE of 1954, § 532(a).
78 . . . [W]e think petitioner was entitled to anticipate the substantial amounts which would fall due on its obligations in the next few years . . . section 102 did not require it to be an incorrigible optimist and distribute earnings, which unless good business continued, would surely be needed within 3 years to meet fixed maturities." Gazette Tel. Co., 19 T.C. 692, 707 (1953), aff'd, 209 F.2d 926 (10th Cir. 1954) (more than one-third of these obligations were due to stockholders); see U.S. Treas. Reg. 118, § 39.102-3 (1953); Holland, Tax Effects of Stockholder Loans to Corporations, N.Y.U. 9th Inst. on Fed. Tax. 1083, 1101-02 (1951); 7 Mertens, Federal Income Taxation § 40.12 (1953).
80 See Holland, supra note 78, at 1101-02.
81 See Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943); Beim Co. v. Landy, 113 F.2d 897 (8th Cir. 1940).
where the purpose of the accumulation is to free the shareholders from their guaranty obligations, rather than to retire corporate debts incurred in bona fide funding operations.

Quite apart from the situations heretofore discussed, imposition of the corporate surtax has been successfully maintained in another type of situation. Where one who is substantially the sole shareholder lends, without interest, large amounts of his personal funds to a corporation which continues to accumulate profits without distribution, application of the surtax has been upheld. The reasoning of these cases centers upon the fact that the taxpayer, well advanced in surtax brackets in his own right, by making such loans, has precluded his own normal use or investment of the funds which would have yielded additional amounts of taxable income to him. Thus, the income realized by corporate investment of these amounts was taxed at a fixed corporate rate and, as no distribution was made, the taxpayer completely escaped the individual surtax.

What effect, if any, will be given an attempted circumvention of the accumulated earnings tax by interposition of a third party creditor where a shareholder has guaranteed the obligation? Successful imposition of the surtax appears more difficult in this situation. Consonant with the writer's previous conclusion, if payment has been made by the guarantor, he may now be regarded as a creditor deemed to have loaned the exact amount he has been made to pay. Therefore, the same reasoning obtains as in situations involving direct shareholder loans. If, however, the corporation itself makes the payment, justification of a similar result on the corporate level still rests within the confines of sound reasoning. It has been previously noted that an unequal debt to stock ratio is a factor to be considered where transmutation of borrowed into equity capital is sought. Several Tax Court decisions have not restricted this ratio to merely "inside" or shareholder loans but have wisely included funds secured from outsiders. Once the entire amount of all debts is included

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83 See, e.g., George L. Sogg, P-H 1950 T.C. Mem. Dec. ¶ 50251, aff'd per
in this ratio, it may now be proposed that the very creation of a top-heavy debt structure indicates the presence of the forbidden purpose.

Although the doctrine of constructive dividend is well known to the courts, successful imposition of such a tax at the shareholder level is admittedly more uncertain than in situations involving repayment of direct stockholder advances. Similarly, a denial of corporate interest deductions becomes more uncertain when a third party has been interposed.

CONCLUSION

Sound economic reasons underlie promotion and expansion of business enterprise. If these attempts are met at each turn with restrictive taxation, a large stimulus to initiative disappears. On the other hand, and more specifically, abuse of tax laws in the area of corporate financing cannot be condoned. It is believed that the device of "outside loans" and "inside guaranties" was not envisaged by the courts of the several circuits as potential avenues of tax avoidance. In many instances, sound business practice may dictate the necessity of third party loans secured by shareholder guaranties in lieu of obtaining necessary capital by stock or bond issues. If such be the case, the burden of explanation is not an excessively onerous one on the taxpayer. Where, however, such a course is not reasonably justifiable, let this apparently isolated funding transaction be viewed in the light of the overall corporate structure. Only one question need be asked: WHY?

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curiam, 194 F.2d 540 (6th Cir. 1952); Isidor Dobkin, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951).

84 Cf. Ruben v. Commissioner, 97 F.2d 926 (8th Cir. 1938); Fred F. Fischer, P-H 1947 T.C. Mem. Dec. ¶ 47131; see Gazette Tel. Co., 19 T.C. 692 (1953), aff'd, 209 F.2d 926 (10th Cir. 1954) (There the Commissioner originally claimed that corporate repayments to an outside creditor were in fact distributions to shareholders. In his brief, however, the Commissioner conceded that these amounts were proper deductions.).

85 See Gazette Tel. Co., supra note 84.

86 It is interesting to note that the Eighth Circuit, in Putnam v. Commissioner, 5 CCH 1955 STAND. FED. TAX REP. (55-2 U.S.T.C.) ¶9604 (8th Cir. Aug. 11, 1955), recently stated that it would not follow the Cudlip, Pollak and Allen cases.