T.C. Memo. 1942-220

A taxpayer's payment as a guarantor of a corporate debt can be deductible as a business loss, not a non-business bad debt or capital contribution, if the guaranty was made primarily to protect the taxpayer's business interests and reputation rather than as an investment in the corporation.

Summary

Shiman, an attorney, guaranteed a bank loan for a family-owned laundry corporation. When the corporation reorganized and the bank sought payment on the guaranty, Shiman paid the bank. He then attempted to deduct this payment as a bad debt or business loss. The Tax Court disallowed the bad debt deduction but allowed a business loss deduction, finding that Shiman's primary motivation for the guaranty was to protect his professional relationship with the bank and his existing loans to the laundry, rather than to protect his relatively small stockholding.

Facts

Shiman, an attorney, owned a small percentage of stock (10%) in Fort Duquesne Laundry Co., a corporation largely owned by his family. The corporation faced financial difficulties, including significant water rent arrears. The Union Trust Co. held a mortgage note on the corporation and threatened foreclosure. Shiman, who had previously brought business to the bank, orally guaranteed the corporation's mortgage note to prevent foreclosure. He felt responsible, fearing damage to his reputation with the bank, and also had outstanding loans to the laundry. The corporation subsequently underwent reorganization under Chapter X of the Bankruptcy Act. As part of the reorganization, Union Trust Co. received 20% of its claim, but required Shiman to remain liable for the balance under his guaranty.

Procedural History

Shiman paid the remaining balance on the mortgage note to Union Trust Co. He then claimed a bad debt deduction on his 1941 income tax return, which the Commissioner disallowed. Shiman petitioned the Tax Court, arguing for the deduction either as a bad debt or as a business loss.

Issue(s)

1. Whether Shiman's payment on the guaranty should be treated as a bad debt deduction?
2. Whether Shiman's payment on the guaranty should be treated as a business loss deduction?

Holding

1. No, because there was never a debt owed directly to Shiman by either the bank or

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the laundry until he made the payment. After he paid, neither party owed him anything, and he was not subrogated to the bank's rights against the laundry.
2. Yes, because Shiman's primary motive for the guaranty was to protect his existing business relationships and financial interests, not solely to protect his investment in the corporation.

Court's Reasoning

The court rejected the bad debt argument because Shiman, a cash-basis taxpayer, incurred the debt only when he made the payment. The court distinguished the case from *Menihan v. Commissioner*, where payments were considered capital contributions to recover stock. Here, the court emphasized Shiman's testimony regarding his motives. The court quoted Shiman stating his motives were:
"Well, I think the principal motive that I had, that I already had $4,000 in that laundry and I owned a ten percent interest in it. I had another motive. I had established a credit at the Union Trust Company… I was very zealous and jealous of my reputation with that bank. I didn't want to see it sullied by them having to foreclose a mortgage in a concern in which I was interested."

The court also relied on *Daniel Gimbel, 36 B. T. A. 539*, stating, "When petitioner made his payments, both on his endorsements and his guaranties, he had no illusions about the condition of the corporation and no intention to invest more capital. He paid only because he was legally obligated to do so, and the obligation was not an incident of his being a shareholder, but was incurred with the intention of creating a potential debtor and creditor relation." The court concluded that Shiman's dominant motive was protecting his business interests, therefore the payment constituted a deductible business loss.

Practical Implications

This case illustrates that a guarantor's payment can be treated as a business loss if the guaranty is closely related to the taxpayer's trade or business. The key is to establish that the dominant motive for the guaranty was business-related, such as protecting customer relationships or securing financing for one's own business operations, rather than solely to protect a stock investment. Later cases applying *Shiman* often focus on the proportionality between the taxpayer's investment and the potential business benefits from the guaranty. Taxpayers claiming a business loss for guaranty payments should meticulously document their business motivations to support their position.

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