7 T.C. 1310 (1946)

A guarantor who pays the debt of a primary obligor is not entitled to a tax deduction for that payment if the primary obligor has an implied agreement to reimburse the guarantor and is solvent.

Summary

Standard Oil Co. of New Jersey (petitioner) sought to deduct a payment made under a guaranty agreement as an ordinary and necessary business expense or as a loss. The petitioner and three other corporations had organized Export to handle export trade. As an incentive for Anglo-American Oil Co. shareholders to exchange their shares for Export's preferred stock, the petitioner and the other corporations guaranteed the preferred stock's value and dividends. The petitioner was required to cover a dividend payment under this guarantee and sought to deduct this amount. The Tax Court held that because Export was solvent and there was an implied agreement for reimbursement, the payment was not deductible as a business expense or a loss.

Facts

The Standard Oil Co. of New Jersey (petitioner) transferred oil-refining and marketing assets to a newly formed corporation, Standard Oil Co. of New Jersey (petitioner). The petitioner and three other corporations (Standard Oil Co. of Louisiana, Carter Oil Co., and Humble Oil & Refining Co.) formed Standard Oil Export Corporation (Export) to engage in export trade. As part of an arrangement to acquire Anglo-American Oil Co. Ltd. (Anglo), Export offered its preferred stock in exchange for Anglo's shares, with the petitioner and the other three corporations jointly and severally guaranteeing the preferred stock's value and dividends. The petitioner, along with the others, executed a guaranty to the shareholders of Anglo-American Oil Co. Ltd to ensure the payment of dividends.

Procedural History

The Commissioner of Internal Revenue disallowed the deduction claimed by Standard Oil Co. of New Jersey. The Tax Court reviewed the Commissioner's decision regarding the deductibility of the payment made under the guaranty agreement.

Issue(s)

Whether the payment made by Standard Oil Co. of New Jersey under its guaranty of dividends on Standard Oil Export Corporation's preferred stock is deductible as an ordinary and necessary business expense or as a loss under Section 23 of the Revenue Act of 1936.

Holding

No, because there was an implied agreement that Export would reimburse Standard Oil Co. of New Jersey for the payment, and Export was solvent.

Court's Reasoning

The court reasoned that the guaranty agreement created a secondary obligation for the petitioner, with Export being the primary obligor for the dividend payments. Under general legal principles, a guarantor who pays the debt of a primary obligor has a right to reimbursement from the primary obligor. The court found an implied agreement for Export to reimburse the petitioner. The court cited *Howell v. Commissioner, 69 F.2d 447*, where it was stated: "That in the case of suretyship or guaranty there is an implied agreement on the part of the principal debtor to reimburse his surety or guarantor is unquestioned." Because Export was solvent, the petitioner's claim for reimbursement was not worthless, and therefore the payment was not deductible as a business expense or a loss. The court distinguished *Camp Manufacturing Co., 3 T.C. 467*, because in that case, there was no right to reimbursement.

Practical Implications

This case clarifies that a guarantor's ability to deduct payments made under a guaranty agreement for tax purposes hinges on the primary obligor's solvency and the existence of an agreement for reimbursement. Taxpayers should consider the solvency of the primary obligor and any rights of reimbursement when structuring guaranty agreements. Guarantors should seek formal agreements with the primary obligor to ensure they can document their right to reimbursement. It informs tax planning and risk assessment in similar scenarios.

