***Putnam v. Commissioner*, 52 T.C. 39 (1969)**

A guarantor's payment on a debt, where the primary obligor is insolvent, gives rise to a nonbusiness bad debt deduction under Section 23(k)(4) of the Internal Revenue Code, and does not result in taxable income from the forgiveness of the underlying debt.

Summary

The case concerns the tax treatment of a guarantor's payment of a corporate debt. Putnam executed a promissory note as an accommodation to secure a debt owed by Hollyvogue Knitting Mills to Silverman. When Hollyvogue became insolvent, Silverman sued Putnam. Putnam settled the suit by paying $2,000, and claimed a business expense or loss deduction. The IRS argued the payment was for an individual obligation, and further that the $3,000 difference between the original note and the settlement was income. The Tax Court held that the payment constituted a nonbusiness bad debt, deductible as a short-term capital loss, and the settlement did not create taxable income. The court emphasized that the payment was a consequence of Putnam's role as a guarantor and a debt was created in Putnam's favor against the corporation.

Facts

- Hollyvogue Knitting Mills owed Silverman $5,000.
- Putnam executed a $5,000 promissory note as additional security for the debt. Putnam received nothing of value.
- Hollyvogue became insolvent.
- Silverman sued Putnam on the note.
- Putnam settled the suit by paying $2,000.
- Putnam claimed a business expense or loss deduction for the payment and alternatively requested deduction of the total debt, or a long-term capital loss.
- The IRS argued that the settlement payment was for an individual obligation and the $3,000 difference was income.

Procedural History

The case was heard by the United States Tax Court. The Tax Court ruled in favor of the petitioner (Putnam), allowing him to deduct the $2,000 payment as a nonbusiness bad debt under section 23(k)(4) of the Internal Revenue Code and held that there was no taxable gain from the note settlement.

Issue(s)

1. Whether the $2,000 payment made by Putnam in settlement of the note was deductible as a business expense or business loss.
2. Whether the release and cancellation of the remaining $3,000 of the note's value resulted in taxable income for Putnam.

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Holding

1. No, because the payment was for a nonbusiness bad debt under section 23(k)(4) of the Internal Revenue Code, deductible as a short-term capital loss.
2. No, because there was no taxable gain from the settlement transaction.

Court's Reasoning

The court determined that Putnam acted as a guarantor or accommodation maker for the debt owed by Hollyvogue Knitting Mills. As a guarantor, Putnam's liability was contingent. The court cited *Eckert v. Burnet* to establish that a deduction is only allowable when payment is actually made. The court reasoned that when Putnam, as the guarantor, fulfilled his obligation, the law created a debt in his favor against the principal debtor (Hollyvogue). The Court applied Section 23(k)(4) of the Internal Revenue Code, which addresses nonbusiness bad debts. This section allows a deduction for a debt that becomes worthless during the taxable year. Because the debt became worthless, the loss was considered a short-term capital loss. The court differentiated this case from other precedents (*Abraham Greenspon, Frank B. Ingersoll*) cited by the petitioner because the facts in those cases were different.

The Court stated: "Any resulting deduction must be on account of a nonbusiness bad debt under section 23 (k) (4) of the Code. When a guarantor 'is forced to answer and fulfill his obligation of guaranty, the law raises a debt in favor of the guarantor against the principal debtor.'"

Practical Implications

This case clarifies the tax implications for individuals who act as guarantors for business debts. The primary takeaway is that a guarantor's payment on a debt, where the original obligor is insolvent, will typically be treated as a nonbusiness bad debt. The court's decision highlights the importance of distinguishing between a guarantor's obligation and a direct business expense. Lawyers should advise clients who act as guarantors to keep meticulous records of their payments and the financial status of the primary obligor to support their claim for a nonbusiness bad debt deduction. Businesses that rely on guarantees should understand the tax implications for their owners or investors who provide such guarantees.

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