***Stoody v. Commissioner, 66 T. C. 710 (1976)***

Payments made by a guarantor to settle lawsuits are deductible only as nonbusiness bad debts under section 166(d) of the Internal Revenue Code.

**Summary**

Winston Stoody guaranteed debts for Know 'Em You, Inc. , a retail discount store that failed shortly after opening. When the store closed, Stoody faced lawsuits from creditors as a guarantor. He settled these lawsuits, claiming the payments as full deductions on his tax returns. The Tax Court held that these payments were deductible only as nonbusiness bad debts under section 166(d), subject to capital loss limitations, because they were not related to Stoody's trade or business. The decision hinged on the origin of the claims settled, not Stoody's motives for settling, and on the recognition of the corporate status of Know 'Em You, Inc. , despite its failure to issue stock or hold formal meetings.

**Facts**

In 1961, Winston Stoody was approached by Vincent Zazzara to help establish a retail discount store, Know 'Em You, Inc. (KEY), in Burbank, California. Stoody agreed to guarantee KEY's obligations under lease agreements with American Guaranty Corp. for equipment and fixtures. KEY opened in November 1961 but ceased operations by March 1962. After KEY's failure, creditors, including American Guaranty Corp. , sued Stoody as a guarantor. In 1968, Stoody settled these lawsuits, agreeing to pay $44,400 over five years. He deducted these payments on his tax returns for 1968 and 1969, claiming them as business expenses. The IRS disallowed these deductions, treating them as nonbusiness bad debt losses subject to capital loss limitations.

**Procedural History**

The IRS determined deficiencies in Stoody's federal income tax for 1968 and 1969, disallowing all but $1,000 of the claimed deductions. Stoody petitioned the Tax Court, arguing that the payments were deductible in full as business expenses or losses from a transaction entered into for profit. The Tax Court upheld the IRS's position, ruling that the payments were deductible only as nonbusiness bad debts under section 166(d).

**Issue(s)**

1. Whether the payments made by Stoody under the settlement agreement are deductible in full in the years paid or are subject to the capital loss limitations of section 1211?
2. Whether the payments were made under Stoody's obligation as a guarantor of corporate debts, thus qualifying as bad debt losses under section 166?
3. Whether the debts guaranteed by Stoody were corporate or noncorporate

 

obligations, affecting the applicability of section 166(f)?

## Holding

1. No, because the payments were made as a guarantor and are therefore subject to the capital loss limitations under section 1211.
2. Yes, because the payments were made to settle claims arising from Stoody's guaranty of KEY's obligations.
3. No, because KEY was a valid corporation under California law, and thus section 166(f) does not apply to the payments.

## Court's Reasoning

The Tax Court reasoned that the deductibility of Stoody's payments depended on the origin of the claims settled, not his motive for settling. The court found that the payments were made to settle claims against Stoody as a guarantor of KEY's debts, thus qualifying as bad debt losses under section 166. The court rejected Stoody's arguments that the payments were for avoiding litigation costs or that KEY was not a valid corporation. Under California law, KEY's corporate existence was established upon filing articles of incorporation, and the court recognized its corporate status for federal tax purposes. The court also determined that the payments were not related to Stoody's trade or business, classifying them as nonbusiness bad debts subject to the capital loss limitations of section 1211. The court cited Ninth Circuit precedent to support its conclusion that subrogation was not required to characterize the payments as bad debt losses.

## Practical Implications

This decision clarifies that payments made by a guarantor to settle lawsuits are treated as bad debt losses, subject to capital loss limitations, unless they are connected to the guarantor's trade or business. It emphasizes the importance of the origin of claims in determining deductibility, not the taxpayer's motives. Practitioners should advise clients that guaranteeing corporate debts can result in nonbusiness bad debt treatment, with limited deductions. The ruling also highlights the need to recognize the corporate status of entities for tax purposes, even if they fail to issue stock or hold formal meetings. Subsequent cases have followed this precedent, reinforcing the treatment of guarantor payments as bad debts unless directly related to the guarantor's business activities.

 