Benak v. Commissioner, 77 T. C. 1213 (1981)

Payments made on a guaranty and losses on stock redemption notes are deductible only as short-term capital losses, not as business bad debts or section 1244 ordinary losses.

Summary

In Benak v. Commissioner, the Tax Court ruled that Henry J. Benak and Margaret Benak could not deduct their payment on a loan guaranty as a business bad debt nor claim a section 1244 ordinary loss on a stock redemption note. The petitioners had invested in Scottie Shoppes of Illinois, Inc. , and later guaranteed a loan for the corporation. When Scottie defaulted, the Benaks paid the guaranty and sought to deduct this as a business bad debt. They also tried to claim an ordinary loss on a promissory note received from Scottie upon the redemption of their shares. The court held that the guaranty payment was a nonbusiness bad debt deductible as a short-term capital loss in the year of payment, and the note did not qualify as section 1244 stock, thus any loss on its worthlessness was also a short-term capital loss.

Facts

In 1972, Henry J. Benak and Margaret Benak purchased stock in Scottie Shoppes of Illinois, Inc. , which was intended to qualify as section 1244 stock. Later in 1972, Scottie redeemed the Benaks' shares and issued them a one-year, 8% promissory note. In 1973, Scottie borrowed funds with the Benaks and others as guarantors. Scottie became delinquent on the loan in 1974, and in 1975, the Benaks paid $28,172. 68 to satisfy their guaranty obligation. They sought to deduct this payment as a business bad debt in 1974 and the loss on the promissory note as a section 1244 ordinary loss in 1974.

Procedural History

The Commissioner determined a deficiency in the Benaks' 1974 federal income tax and disallowed the deductions. The Benaks petitioned the United States Tax Court, which heard the case and ruled in favor of the Commissioner, allowing the deductions only as short-term capital losses in 1975.

Issue(s)

1. Whether the Benaks may deduct, as a business bad debt, an amount paid in satisfaction of their obligation as guarantors of a loan.
2. Whether the Benaks may deduct the amount of their investment in Scottie as a loss on section 1244 stock.

Holding

1. No, because the Benaks failed to prove their dominant motivation for

guaranteeing the loan was for business purposes; thus, their payment is deductible as a nonbusiness bad debt, as a short-term capital loss in the year of payment.
2. No, because the note received upon redemption of the Benaks' stock did not constitute section 1244 stock; the loss on its worthlessness is deductible only as a short-term capital loss.

Court's Reasoning

The Tax Court applied the dominant motivation test from United States v. Generes, 405 U. S. 93 (1972), to determine that the Benaks' guaranty payment was not a business bad debt. The court found no evidence that their primary motivation was related to Mr. Benak's employment with B & G Quality Tool and Die, Inc. , rather than protecting their investment in Scottie. The court also ruled that no deduction was allowable in 1974 because the payment was made in 1975, and thus, the loss was not sustained until then. Regarding the promissory note, the court held it did not qualify as section 1244 stock because it was not common stock after redemption, and the Benaks failed to prove Scottie met the gross receipts test of section 1244(c)(1)(E). The court concluded the note represented a nonbusiness debt, and any loss was deductible as a short-term capital loss in 1975 when it became worthless.

Practical Implications

This decision clarifies that guaranty payments and losses on stock redemption notes are generally deductible as short-term capital losses, not business bad debts or section 1244 ordinary losses. Taxpayers must carefully document their motivations for entering into guaranty agreements to claim business bad debt deductions. The case also underscores the strict requirements for qualifying stock as section 1244 stock, particularly the need to meet the gross receipts test. Practitioners should advise clients on the timing of deductions, ensuring they are claimed in the year the loss is actually sustained. Subsequent cases have applied this ruling to similar situations involving guaranty payments and the treatment of stock redemption notes.

