



1974

# The Shareholder-Guarantor's Fee: Tax Saving Idea for the Close Corporation

John E. Heer III  
*University of Kentucky*

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## Recommended Citation

Heer, John E. III (1974) "The Shareholder-Guarantor's Fee: Tax Saving Idea for the Close Corporation," *Kentucky Law Journal*: Vol. 62 : Iss. 4, Article 10.

Available at: <https://uknowledge.uky.edu/klj/vol62/iss4/10>

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THE SHAREHOLDER-GUARANTOR'S FEE:  
TAX SAVING IDEA FOR THE CLOSE CORPORATION

*The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.<sup>1</sup>*

In the spirit of the above statement by Justice Sutherland, American corporations have consistently sought to reduce their income taxes by (among other means) increasing business expense deductions allowable under the Internal Revenue Code of 1954.<sup>2</sup> [hereinafter IRC] In pursuit of this end, they have often sought to minimize non-deductible dividends to shareholders through the maximum utilization of legally deductible disguised dividends,<sup>3</sup> thereby reducing taxable income and circumventing the double taxation characteristic of the corporate distribution to shareholders.<sup>4</sup> This form of "tax planning" is possible since, according to the regulations, dividend treatment is not applicable "to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."<sup>5</sup> Thus, any distribution to a shareholder which can be successfully disbursed as a payment to an employee or a creditor will be deductible as a business expense by the corporation; and while the shareholder must still include the amount in his personal income, the double-taxation treatment accorded dividends is circumvented. Logically, disguised dividend situations arise much more frequently in connection with close corporations than with large, publicly-held corporations, since the shareholders of a close corporation are much more likely to be corporate employees or creditors than are the shareholders of a large corporation.

Among the dividend disguises which have been utilized by corpora-

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<sup>1</sup> Gregory v. Helvering, 283 U.S. 465, 469 (1934).

<sup>2</sup> INT. REV. CODE OF 1954, § 162 [hereinafter cited as I.R.C.] states in relevant part:

- (a) In general—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .

<sup>3</sup> Within the scope of this comment, the term "disguised dividend" is used to designate corporate distributions to shareholders which, under I.R.C. § 162, are legally deductible by the corporation as business expenses. In no way is the term "disguised dividend" meant to connote any scheme or deduction which is illegal or tax evasive. For a general discussion of these and other methods to avoid double taxation of corporate distributions to shareholders. see Comment, *Disguised Dividends: A Comprehensive Survey*, 3 U.C.L.A.L. REV. 207 (1956).

<sup>4</sup> For a basic discussion of the "double taxation" problem, see B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 620-29 (4th ed. 1972).

<sup>5</sup> Treas. Reg. § 1.301-1(c) (1955).

tions are salaries,<sup>6</sup> commissions,<sup>7</sup> bonuses,<sup>8</sup> payments for goodwill,<sup>9</sup> rents,<sup>10</sup> royalties,<sup>11</sup> and director's fees.<sup>12</sup> In addition to these, a recent decision by the United States District Court, Northern District of Texas, has added a new element to the corporate repertoire—the *guarantor's fee* for shareholder-guarantors. It is this new disguise which shall be afforded specific consideration herein.

In *Tulia Feedlot, Inc. v. United States*,<sup>13</sup> the stockholders of a cattle feedlot corporation collectively guaranteed a 1.8 million dollar loan to the corporation, with each shareholder personally guaranteeing an amount proportionate to his percentage of ownership of the stock of the corporation. In return, the corporation agreed to pay the shareholder-guarantors an annual fee of 3% of the amount personally guaranteed. This arrangement necessarily made the fee payments a pro rata distribution to the corporation's shareholders. This pro rata factor was a "red flag" to the Internal Revenue Service [hereinafter IRS], which disallowed the corporation's deduction of the fee as a business expense, claiming that the fee arrangement was merely an elaborate and unacceptable plan to avoid the double taxation of dividends to shareholders. However, the district court held that while the pro rata distribution was *prima facie* evidence of a dividend, the corporation's proof that the fees were "ordinary", "necessary", and "reasonable" expenses pursuant to a business purpose qualified the fees as a legitimately deductible business expense, presumably under the "other compensation for personal services"<sup>14</sup> language of Section 162 of the

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<sup>6</sup> See *Lihme v. Reinecke*, 59 F.2d 633 (7th Cir. 1932); but see *Duffey v. Lethert*, 11 AM. FED. TAX R.2d 1317 (D. Minn. 1963); *Doughboy Industries, Inc. v. United States*, 4 AM. FED. TAX R.2d 5021 (W.D. Wis. 1959); *Chesapeake Mfg. Co.*, 33 P-H TAX CT. MEM. ¶ 64,214 (1964), *aff'd mem.*, 347 F.2d 507 (4th Cir. 1965).

<sup>7</sup> See *Royal Cotton Mill Co. v. Commissioner*, 29 T.C. 761 (1958); but see *United Tailors and Cleaners Co. v. Commissioner*, 10 B.T.A. 172 (1928).

<sup>8</sup> See *Skyland Oldsmobile, Inc.*, 41 P-H TAX CT. MEM. ¶ 72,017 (1972); but see *W. C. Hudlow, Jr.*, 40 P-H TAX CT. MEM. ¶ 71,218 (1972); *Juneau Dairies, Inc. v. Commissioner*, 44 B.T.A. 759 (1941).

<sup>9</sup> See *William E. Lambie*, 36 P-H TAX CT. MEM. ¶ 67,185 (1967); but see *Sidney LeVine v. Commissioner*, 24 T.C. 147 (1955).

<sup>10</sup> See *General Film Corp.*, 274 F. 903 (2d Cir. 1921); but see *Armston v. Commissioner*, 188 F.2d 531 (5th Cir. 1951), *aff'g* 12 T.C. 539 (1949); *Limericks, Inc. v. Commissioner*, 165 F.2d 483 (5th Cir. 1948), *aff'g* 7 T.C. 1129 (1946).

<sup>11</sup> See *Nelson v. Commissioner*, 203 F.2d 1 (6th Cir. 1953), *rev'g* 21 P-H TAX CT. MEM. ¶ 52,006 (1952); but see *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949), *aff'g* 10 T.C. 1199 (1948); *Peterson & Pegau Baking Co.*, 2 B.T.A. 637 (1925).

<sup>12</sup> See *First Nat'l Bank*, 19 P-H TAX CT. MEM. ¶ 50,051 (1950); *Astorian-Budget Publishing Co. v. Commissioner*, 44 B.T.A. 969 (1941); but see *Outlet Clothing Co.*, 14 P-H TAX CT. MEM. ¶ 45,358 (1945).

<sup>13</sup> 366 F. Supp. 1089 (N.D. Tex. 1973).

<sup>14</sup> I.R.C. § 162(a)(1).

Internal Revenue Code of 1954. This novel scheme, sanctioned by the decision in *Tulia*, has great potential in the field of tax planning for the close corporation and is available for use in any situation which fulfills the specific requirements of IRC § 162.

#### IS THE FEE "ORDINARY"?

The first specific requirement for deductibility of shareholder-guarantor's fees as business expenses is that the fees be "ordinary" within the meaning of IRC § 162. In different contexts, the term "ordinary" has been, and is, subject to different interpretations, but with respect to IRC § 162 the interpretive guideline for the use of the term has long been established and accepted. In *Welch v. Helvering*,<sup>15</sup> the Supreme Court, speaking through Justice Cardozo, stated that "'ordinary' in this context [IRC]<sup>16</sup> does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often,"<sup>17</sup> but rather that the expenses be ordinary in the sense that it is known "from experience that payments for such a purpose . . . are common and accepted"<sup>18</sup> occurrences in that particular field of business. At present, the reported incidents of fee payments to shareholders in return for services rendered as loan guarantors are not numerous enough to justify the claim that it is known "from experience that payments for such a purpose . . . are common and accepted",<sup>19</sup> yet the court in *Tulia*, without discussion, found the fee payments to be ordinary, perhaps indicating that such payments to shareholder-guarantors will henceforth be judicially accepted as ordinary once the further requirements of "necessary" and "reasonable" are fulfilled. In effect, the court seems to be saying, "You have satisfied us as to the necessity and reasonableness of the fees. Therefore we will not rule against you simply because your idea is novel and cannot be supported by volumes of cases in which the same idea has been successfully utilized. Far be it from this court to penalize ingenuity." If the decision in *Tulia* is accepted by the appellate courts<sup>20</sup> and by the Commissioner of Internal Revenue, it is very likely that numerous other close corporations will follow the lead of *Tulia Feedlot, Inc.* and that in a very few years such shareholder-guarantor's fees will

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<sup>15</sup> 290 U.S. 111 (1933).

<sup>16</sup> The actual statutes being considered were the Revenue Act of 1926 and the Revenue Act of 1928. These acts contained sections similar to I.R.C. § 162.

<sup>17</sup> 290 U.S. 111, 114 (1933).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> As of this writing there is no record of any direct appeal from the decision of the district court or of any acquiescence in the decision by the Commissioner of Internal Revenue.

indeed become "common and accepted", thus legitimately meeting the *Welch* standard for "ordinary" business expenses.

#### WHEN IS THE FEE "NECESSARY"?

The second requirement for deductibility of shareholder-guarantor's fee expenses under IRC § 162 is that such expenses be "necessary" for the production or collection of income. The presently operative definition of the term "necessary" as used in this context was also established by the Supreme Court in *Welch v. Helvering*,<sup>21</sup> wherein the Court found that certain expenditures "were necessary for the development of the petitioner's business, . . . in the sense that they were appropriate and helpful."<sup>22</sup> The Court later expanded this definition in *Lilly v. Commissioner*,<sup>23</sup> stating that certain payments fell within IRC § 162 since such payments were "'necessary' in the generally accepted meaning of that word. It was through making such payments that petitioners had been able to establish their business."<sup>24</sup>

Applying the above definition to the shareholder-guarantor's fee situation, and using *Tulia* as a reference point, three conditions arise upon which fulfillment of the "necessary" requirement of IRC § 162 seems to rest. First, the taxpayer must satisfy the court that the loans guaranteed by the shareholders were indeed essential to the maintenance and development of the business. In *Tulia*, the court examined the scope and history of the cattle feedlot business and concluded, "[I]t is obvious that this type of business could not be successfully carried on and enlarged by the plaintiff corporation without adequate and heavy financing."<sup>25</sup>

Second, the court must be satisfied that these essential loans are unavailable to the corporation unless they are personally guaranteed by the shareholders. This prerequisite is easily fulfilled, due largely to the simple financial reality that lending institutions require adequate assurance of repayment before approving a loan. A bank will always request the principal to endorse the note evidencing the debt; sometimes the signature of the authorized corporate officer is all that the bank will require. However, if the loan cannot be adequately assured by the financial statement of the borrowing corporation alone, a pledge of security may be required. In cases where the prospective borrower does not have enough capital *or* security to provide satis-

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<sup>21</sup> 290 U.S. 111 (1933).

<sup>22</sup> *Id.* at 113.

<sup>23</sup> 343 U.S. 90 (1952).

<sup>24</sup> *Id.* at 93.

<sup>25</sup> *Tulia Feedlot, Inc. v. United States*, 366 F. Supp. 1089, 1091 (N.D. Tex. 1973).

factory assurance that the loan will be repaid, the corporation may be required to obtain guarantors who will agree to accept personal liability for the loan in the event the corporation should fail. Where a close corporation procures a large loan, the lending institution will usually *insist* upon such an arrangement,<sup>26</sup> and often the required guarantors will be selected from the shareholders of the corporation, thus creating the shareholder-guarantor situation. In *Tulia*, the court found that this "unavailability" condition was met by evidence which established that "the bank would not have made any of the loans involved unless . . . guarantees were received by the bank insuring individual liability on the part of the stockholder-directors."<sup>27</sup>

A third and final condition for fulfilling the "necessary" requirement in the shareholder-guarantor's fee situation is that the corporate taxpayer must be able to establish that the fee was demanded by the shareholders in return for their services as guarantors, and that the shareholders refused to provide such services unless the fee was approved and disbursed. Such was the case in *Tulia*, where the court found that the shareholders "would not have signed the . . . guarantee unless they received some remuneration. . . . Therefore, in order to operate and expand its business in an efficient manner, the plaintiff was required to pay the fee in this case."<sup>28</sup>

#### WHAT FEE IS "REASONABLE"?

The final and most determinative requirement with which the corporation must comply in order to assure deductibility of shareholder-guarantor's fees as a business expense is that the fees must be "reasonable" within the meaning of IRC § 162. The reasonableness requirement is, moreover, the most elusive and perplexing of the three criteria established by that provision. In connection with the business expense deduction (and with other areas of tax law),<sup>29</sup> the requirement of reasonableness "defies tax experts in the same manner that the legendary reasonable man escapes precise definition by negligence lawyers and the concept of reasonable doubt remains a major challenging factor in the criminal law."<sup>30</sup> So frustrating is this concept that a perplexed Supreme Court of Nebraska once wrote, "an attempt to

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<sup>26</sup> For a discussion of methods and problems of financing operations of a close corporation, see W. CASEY, *SUCCESSFUL TECHNIQUES THAT MULTIPLY PROFITS AND PERSONAL PAYOFF IN THE CLOSELY HELD CORPORATION* 1100-79 (1973).

<sup>27</sup> *Tulia Feedlot, Inc. v. United States*, 366 F. Supp. 1089, 1091 (N.D. Tex. 1973).

<sup>28</sup> *Id.* at 1091-92.

<sup>29</sup> See, e.g., I.R.C. §§ 167(a), 611(a), 166(c), 537(a).

<sup>30</sup> J. HOLDEN, *REASONABLE COMPENSATION A-3* (BNA Tax Management Portfolios No. 202-2d, 1971).

give specific meaning to the word 'reasonable' is trying to count what is not number, and measure what is not space."<sup>31</sup>

In spite of these difficulties, it is the task of the corporation, with the help of its tax attorney, to determine with as much certainty as possible what fee would constitute "reasonable" compensation for the services of a shareholder as a loan guarantor. The Internal Revenue Service has furnished some general guidelines in this area through the promulgation of Treasury Regulation § 1.162-7(3)<sup>32</sup> which provides that it is

... just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.<sup>33</sup>

The circumstances referred to in this regulation<sup>34</sup> vary with the type of compensation being considered (*e.g.*, salaries, bonuses, or commissions),<sup>35</sup> but with regard to the shareholder-guarantor's fee arrangement introduced in *Tulia*, five factors seem to be determinative of the outcome. These factors are:

1) *The usual and customary fee for guaranteeing such loans.*<sup>36</sup> This is not a reliable indicator at the present time since, as mentioned above, the shareholder-guarantor's fee is a novel idea and little evidence exists regarding usual and customary fees. This factor is listed, however, in anticipation of future situations wherein precedent and custom will be available for consideration.

2) *The risk involved.* Regarding this factor, one should consider a) the past loan and repayment record of the corporation, b) additional outstanding loans to the corporation, c) the duration of the loan involved, and d) the future profit prospects for the corporation.

3) *The nature of the operations of the corporation.* This factor is closely related to the risk element, although here one must consider the general situation of the industry of which the corporation is a part. In *Tulia*, for example, the court considered the "ups and downs"<sup>37</sup> of the cattle feedlot industry in making its decision as to reasonableness.

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<sup>31</sup> *Altshuler v. Coburn*, 57 N.W. 836, 838 (Neb. 1894).

<sup>32</sup> *Treas. Reg. § 1.162-7(3)* (1958).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> For a discussion of the factors to be considered in connection with salaries and such conventional compensation methods, see J. HOLDEN, *supra* note 30, at A-9 to A-13.

<sup>36</sup> See *A.A. & E.B. Jones Co.*, 29 P-H TAX CT. MEM. ¶ 60,284 (1960).

<sup>37</sup> *Tulia Feedlot, Inc. v. United States*, 366 F. Supp. 1089, 1091 (N.D. Tex. 1973).

4) *The effect of the guarantee on the credit line and net worth of the shareholder-guarantors.* Probably the best justification for the shareholder-guarantor's fee is that, in providing the loan guarantee, the shareholders necessarily suffer an impairment of their personal borrowing capacities and net worth, and a consequent reduction in their ability to take advantage of additional financial opportunities. To the extent of such financial impairment, they are deemed entitled to adequate compensation.

5) *The current interest rate being charged by banks for such loans.* While this factor, like the first, is not yet of primary importance, it is listed in anticipation of future payments based on the success of the scheme in *Tulia*. This variable, shaped by customary banking procedure and experience as well as by underlying economic forces, reflects the interrelationship of all of the above factors. When the interest rate charged on the loan in question is compared with the rates charged by the bank on other shareholder-guaranteed loans, tax attorneys, courts, and the IRS should be able to more easily and exactly calculate a "reasonable" rate of compensation in the particular situation.

Due to the number and nature of these determining factors, a decision as to reasonableness necessarily turns on, and is limited to, the particular circumstances presented in the case. For example, a decision that X fee is reasonable in Y situation decides very little about other situations in which X fee will be reasonable or about other fees which will be reasonable in Y situation. This thesis was borne out by a Supplemental Memorandum of Law<sup>38</sup> issued by the *Tulia* court after the Internal Revenue Service asserted that the shareholders of *Tulia Feedlot, Inc.* could, by raising the amount of the fee (indeed the shareholders had raised the fee from 3% in 1970 to 6% in 1971), remove all of the profits from the corporation without according dividend treatment to any part of such distributions. In reply, the court explicitly pointed out that its decision in *Tulia* was limited to a 3% fee, and that any other fee would be judged on its own merits when and if challenged by the IRS.

Due to this *ad hoc* method of determining reasonableness, earlier cases are of dubious precedential value, and the corporate tax attorney may never be entirely sure that his scheme will be free from attack. Nevertheless, challenges to the reasonableness of shareholder-guarantor's fees can largely be avoided by proper tax planning based on the five factors listed above and on a study of contemporaneous com-

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<sup>38</sup> *Tulia Feedlot, Inc. v. United States*, 33 AM. FED. TAX R.2d 74-584 (N.D. Tex. 1974).

pensation decisions. As mentioned above, however, there are no contemporaneous decisions (except *Tulia*) dealing with shareholder-guarantor's fees; therefore unless and until such a body of case law develops, the attorney must find an alternate source of guidance. What follows is an attempt to provide some basic direction in the utilization of this newest form of disguised dividend, based upon cases in which substantially similar payments were involved. The individual cases may differ from the shareholder-guarantor's fee situation in one or more aspects, including 1) the guarantor is not a shareholder, 2) the fee is not an annual payment for the life of the loan, or 3) the fee is not a pro-rata distribution to shareholders. In addition, some of the cases were decided prior to the enactment of the Internal Revenue Code of 1954; however the statutes under which they were decided contain substantially identical language to that of IRC § 162.<sup>39</sup>

In *Guarantee Liquid Measure Co. v. Commissioner*,<sup>40</sup> a \$25,000 payment to the corporation's president was allowed as reasonable compensation for services in connection with negotiating the purchase of the Marvel Equipment Company and for personally guaranteeing the \$250,000 loan necessary to make the purchase. This 10% fee must be adjusted downward somewhat since it was a lump sum rather than an annual payment and since it was to compensate for services not only as a guarantor, but also as a negotiator.

*Davis B. Thornton*<sup>41</sup> involved a shareholder's assignment of a life insurance policy and thirty shares of A.T. & T. stock to a bank as collateral for a \$30,000 loan to the corporation. A fee of \$1,281.45 (the exact premium due on the insurance policy) was allowed as a business expense deduction. This was a 4.3% lump sum payment.

In *T. Jack Foster*,<sup>42</sup> the sole shareholder and president of a development company was paid \$80,000 for services as guarantor of a \$5,000,000 loan. This 1.6% payment was held to be reasonable compensation.

Perhaps all that can be gleaned from these few examples<sup>43</sup> is a very rudimentary feel for the reasonableness limitations imposed on the shareholder-guarantor's annual fee by IRC § 162. Unfortunately,

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<sup>39</sup> See Revenue Act of 1936, ch. 690, § 23(a), 49 Stat. 1658-59; Revenue Act of 1924, ch. 234, § 234(a)(1), 43 Stat. 283.

<sup>40</sup> 20 B.T.A. 758 (1930).

<sup>41</sup> 14 P-H TAX CT. MEM. ¶ 45,011 (1945).

<sup>42</sup> 35 P-H TAX CT. MEM. ¶ 66,273 (1966).

<sup>43</sup> See also *Wiggin Terminals v. United States*, 36 F.2d 893 (1st Cir. 1929); *In re Concord Silversmiths Corp.*, 32 F. Supp. 128 (D.N.H. 1940); *A.A. & E.B. Jones Co.*, 29 P-H TAX CT. MEM. ¶ 60,284 (1960); *Monroe Sand & Gravel Co.*, 36 B.T.A. 747 (1937); *Moxa Bldg. Co.*, 31 B.T.A. 457 (1934), *aff'd mem.*, 79 F.2d 1004 (2d Cir. 1935); *Gillespie Coal Co. v. Commissioner*, 13 B.T.A. 926 (1928).

such cases offer possibly the only positive advance guidance available to corporations wishing to utilize this form of disguised dividend, since Revenue Procedure 72-9<sup>44</sup> provides that the IRS will not issue advance rulings regarding the reasonableness of compensation under IRC § 162.<sup>45</sup> Thus, until the shareholder-guarantor's fee becomes more widely used and litigated, the attorney must rely heavily on his own judgment and discretion in advising corporate clients as to the validity and desirability of that arrangement.

#### CONCLUSION

In spite of the uncertainties and risks involved, planning possibilities abound in connection with the shareholder-guarantor's fee. The use of this fee can relieve some of the problems presently associated with drawing profits out of the close corporation through the use of "reasonable" salaries, bonuses, and the like, since it can be utilized instead of or in addition to such payments. Through the chary use of this innovation, in careful combination with other accepted business expense deductions, the close corporation and its shareholders can achieve maximum flow-through of corporate profits. Clearly, the attractiveness as well as the legality of such a scheme, as Justice Sutherland stated, "cannot be doubted."<sup>46</sup>

*John E. Heer, III*

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<sup>44</sup> Rev. Proc. 72-9, 1972-1 CUM. BULL. 719.

<sup>45</sup> However, an advance ruling as to whether a fee is "ordinary and necessary" may be obtained in proper circumstances. For a summary of when advance opinion may be sought from the I.R.S., see *How to Get an "Advance Look" at the Tax Consequences of Corporate Maneuvers*, CLOSELY HELD CORPORATION IDEAS 1-2 (Dec. 1973).

<sup>46</sup> *Gregory v. Helvering*, 293 U.S. 465, 469 (1934).