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TAX CONSEQUENCES OF SHAREHOLDER GUARANTEES: THERE'S STILL HAY IN *TULIA* *FEEDLOT*

*Merle F. Wilberding**

Out in Swisher County in the Texas Panhandle lies a heavy concentration of feedlot operations, where the 45,000 head of feeder cattle in just one feedlot far outnumbers the whole county's population of 8,378 people.¹ One of these feedlot operations is conducted by Tulia Feedlot, Inc.² This feedlot operation is located in the South Tule Draw of the Red River Basin,³ about five miles south of Tulia, the county seat of Swisher County. From that feedlot operation arose a tax case, *Tulia Feedlot, Incorporated v. United States* ("*Tulia I*"),⁴ which continues to provide a platform for the Internal Revenue Service to attack the structure and operation of shareholders' guaranteeing the obligations of privately-owned corporations.⁵ Yet, properly

* Member, Coolidge, Wall, Womsley & Lombard Co., LPA, Dayton, Ohio. B.A., St. Mary's University (Minnesota) 1966; J.D., University of Notre Dame, 1969; LL.M (Taxation), George Washington University, 1972; M.B.A., University of Dayton, 1975. Member, bars of Ohio, Iowa, and District of Columbia.

1. Total population of Swisher County, Texas, based on census for year 2000. U.S. Census Bureau, Fact Finder. <http://quickfacts.census.gov/qfd/states/48/48437.html> (last visited May 11, 2004).

2. The Tulia Feedlot operation spreads over 225 acres. Cattle are fed two or three times a day and will eat about twenty-two to twenty-eight pounds per day. Letter from John Van Pelt, Manager of Tulia Feedlot, Inc., to Merle F. Wilberding (April 4, 2004) (on file with the author).

3. Red River Authority of Texas, <http://www.rra.dst.tx.us/misc/aboutbasin.cfm> (last visited August 25, 2004). The Red River Basin has a total drainage area of 94,450 square miles, of which 24,463 square miles lie within Texas. *Id.* (The remaining drainage areas are in Oklahoma, New Mexico, Arkansas and Louisiana where it discharges into the Mississippi River.)

4. *Tulia Feedlot Inc. v. U.S.*, 513 F.2d 800 (5th Cir. 1975), *cert. denied*, 423 U.S. 947 (1975).

5. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 82-11-005 (Nov. 27, 1981); I.R.S. Priv. Ltr. Rul. 86-10-009 (Nov. 14, 1985); I.R.S. Priv. Ltr. Rul. 86-10-010 (Nov. 14, 1985).

implemented *Tulia I* and its progeny⁶ can provide taxpayers a structure and procedure for compensating shareholders for the risk they assume in guaranteeing corporate obligations.

For most privately-owned corporations, shareholder guarantees of corporate obligations are a way of life, and shareholder guarantees are often an integral part of the ability of many corporations to conduct business. More attention needs to be given to the corporate and tax aspects of shareholder guarantees to insure that shareholders are properly compensated for the risks they assume and to insure that corporations are properly entitled to deductions as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code (the "Code").⁷

Tulia Feedlot, Inc. was incorporated in the State of Texas on March 29, 1963, with its business address in Tulia, Texas.⁸ Its purpose was to conduct cattle feeding operations which it established on land located about five miles south of the town of Tulia, Texas. In 1967, the Red River Authority of Texas created the Tulia Feedlot Reservoir by impounding the waters of the South Tule Draw with an earthen dam seventeen feet tall, with a crest length of 2,190 feet.⁹ Tulia Feedlot was one of many feedlot operations which were established in the 1950s and 1960s to take advantage of the abundant grain crops and other agricultural resources in that county.¹⁰ From its inception, the Tulia Feedlot operation grew rapidly and by 1970 it had reached its capacity of 28,000 head of cattle.¹¹

The nature of its operations was twofold. Primarily, it fed cattle owned by its customers.¹² To keep the feedlot running at maximum efficiency, it also purchased and fed cattle for its own account.¹³ Feeding cattle for its own account required large amounts of credit to carry the acquisition and feeding costs of this part of the operation.¹⁴ To satisfy the financial in-

6. See, e.g., *Tulia Feedlot, Inc. v. United States*, 231 Ct. Cl. 971 (1982); *Tulia Feedlot, Inc. v. United States*, 3 Cl. Ct. 364 (1983); *Olton Feed Yard, Inc. v. United States*, 592 F.2d 272 (5th Cir. 1979); *Stewart v. Comm'r*, 84 TCM (CCH) 175 (2002); *Seminole Thriftway, Inc. v. United States*, 42 Fed. Cl. 584 (1998); *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Sleiman v. Comm'r*, 187 F.3d 1352 (11th Cir. 1999); *Harrison and Sons, Inc. v. United States*, 86 TCM (CCH) 240 (2003).

7. I.R.C. § 162 (2005).

8. The articles of incorporation were filed on March 29, 1963. This information was found in the Public Records in the office of the Texas Secretary of State, available in LEXISNEXIS Library (last visited March 29, 2004).

9. Red River Authority of Texas, http://www.rra.dst.tx.us/survice_w/swisher/tulia_feedlot_reservoir.cfm (last visited March 27, 2004).

10. Red River Authority of Texas, http://www.rra.dst.tx.us/c_t/history/SWISHER/default1.cfm (last visited March 27, 2004).

11. *Tulia Feedlot Inc. v. United States*, 513 F.2d 800, 802 (5th Cir. 1975).

12. *Id.* at 803.

13. *Id.*

14. *Id.*

stitutions, the corporation pledged the real estate, the cattle, and the inventory feed as collateral. In addition to that collateral, the financial institution also required personal guarantees of its shareholders.¹⁵ Twelve principal shareholders of Tulia Feedlot, Inc. owned ninety-nine percent of the outstanding stock of the corporation.¹⁶ From the outset of the borrowings, the personal guarantees of the corporate obligations by the principal shareholders was in proportion to their stock holdings, with a specific ceiling to each of their guarantees.¹⁷ This ceiling was set initially at \$5,000 per principal shareholder, but gradually this amount increased to \$150,000 per principal shareholder.¹⁸

The guarantees were made without any monetary recognition of the risk attendant thereto. When the ceiling was raised from \$125,000 to \$150,000 per guarantor, the board of directors voted at a regular meeting on July 14, 1970, to compensate the shareholder-guarantors an "annual fee equal to three percent of the amount guaranteed by him."¹⁹ Each of the twelve shareholder-guarantors was also a director of the corporation and received \$2,400 per year as a director fee.²⁰ All together, the cumulative guarantee fees and director fees equaled \$82,200 for that tax year, generating a loss for the corporation for the fiscal year ending August 31, 1970, in the amount of \$6,309.07.²¹ The taxpayer deducted those guarantee fee payments, but the Commissioner disallowed the deductions, concluding that these payments constituted a distribution of property to its shareholders under section 316²² of the Code and that these payments were not an ordinary and necessary business expense under section 162 of the Code.²³

15. *Id.*

16. *Id.* at 802-803. Eleven of these shareholders owned 280 shares each. The twelfth shareholder owned his 280 shares with his son; however, for purposes of this discussion, the combined holdings of the father and son will be considered as one principal shareholder. The holdings of the twelve principal shareholders equaled 3,360. In addition, there were twenty-two shares owned by employees of the corporation. *Id.*

17. *Id.* at 803.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. I.R.C. § 316 (2005). Section 316 of the Code provides in relevant part that "the term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year . . . without regard to the amount of the earnings and profits at the time the distribution was made. *Id.* See also Daniel M. Schneider, *Characterization and Assignment of Corporate and Shareholder Income*, 14 N. ILL. L. REV. 133 (1994).

23. *Tulia*, 513 F.2d at 803-804. See *supra* note 7. Section 162 of the Code provides in relevant part that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered." *Id.*

When the Commissioner asserted the deficiency, the taxpayer paid the assessment, immediately filed for a refund, and then brought suit in the United States District Court located in nearby Lubbock, Texas.²⁴ Since the Commissioner's disallowance of these claimed deductions carried with it the presumption of correctness²⁵ the taxpayer had the burden to prove not only that the Commissioner was wrong but also to establish the underlying facts supporting the deduction.²⁶ At trial there was evidence that the guarantee fee was approved before the taxpayer had determined its own profit or loss for the year.²⁷ More importantly, there was testimony that the bank would not have made the loan without the guarantees and that the guarantors would not make the guarantees without the payment of a fee.²⁸ Based on that testimony, the district court ruled the fee was properly deducted.²⁹ On appeal, the Fifth Circuit held that the district court's findings were "clearly erroneous"³⁰ because the taxpayer failed to introduce any evidence as to the "market price for guarantees for corporations of its type and size."³¹ Not content with setting that as a prerequisite for deductibility, the court went on to assert that the taxpayer failed to present any evidence "as to the possibility and likely cost of obtaining these guarantees in an arm's length transaction in the market."³² Setting that as the bar for deductibility enabled the Fifth Circuit

24. *Tulia Feedlot, Inc. v. United States*, 366 F. Supp. 1089 (N.D. Tex 1973), *rev'd*, 513 F.2d 800 (5th Cir. 1975), *cert. denied*, 423 U.S. 947 (1975).

25. *See, e.g., Welch v. Helvering*, 290 U.S. 111 (1933).

26. *See, e.g., Lenox Clothes Shops v. Comm'r*, 139 F.2d 56 (6th Cir. 1943).

27. The board of directors waited until eleven months of the tax year had passed before passing a resolution to pay a three percent fee on the entire credit line for the entire year. *Tulia Feedlot, Inc. v. United States*, 366 F. Supp. 1089 (N.D. Tex 1973), *rev'd*, 513 F.2d 800 (5th Cir. 1975), *cert. denied*, 423 U.S. 947 (1975). It appears that it was this hindsight declaration that may well have subjected the taxpayer to intense scrutiny by the Internal Revenue Service. Phrased another way, the silent suggestion is that if the corporation had been losing money after eleven months, it would not have paid any guarantee fee. So, the court may well have been influenced by this fact in concluding that this guarantee fee was a disguised dividend. *See also infra* note 76 and accompanying text.

28. *Id.* at 1092.

29. *Id.*

30. Under the "clearly erroneous" standard of review, "findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses." Fed. R. Civ. P. 52(a). In turn, the term "standard of review" means the extent to which a reviewing court will measure the findings of fact or conclusions of law that a trial court makes during the initial hearing. Richard H. W. Maloy, "Standards of Review" - *Just a Tip of the Icicle*, 77 U. DET. MERCY L. REV. 603, 604 (2000). In *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948), the Supreme Court ruled that "a finding is 'clearly erroneous' when, although there is evidence to support it, the reviewing court, on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *See also Icicle Seafoods v. Worthington*, 475 U.S. 709 (1986).

31. *Tulia Feedlot Inc. v. United States*, 513 F.2d 800, 806 (5th Cir. 1975).

32. *Id.* It is perhaps this imposition that is the most far removed from the reality of the business world in terms of the practical aspects of what it takes to obtain a bank loan. In the real world, a bank which concludes that the corporate borrower does not have the financial statement to support the loan, will look for other financial support for the loan. If there is a corporate parent, it will request the parent corporation to guarantee the loan. But far more

to concluded tersely that the taxpayer failed to prove the essential elements of its case and that, therefore, the district court's findings were clearly erroneous.³³ The Supreme Court denied certiorari.³⁴

Tulia I was followed by another Texas cattle feedlot case, *Olton Feed Yard v. United States*.³⁵ In this case, the taxpayer was a corporation organized in 1969 and headquartered in Olton, Texas.³⁶ The stock was issued to approximately twenty individuals, five of whom were directors who owned about one-half of the outstanding stock.³⁷ To construct the feed yard facilities, the corporation set up a line of credit with the Production Credit Association of Plainview (the "PCA") that required each of the shareholders to sign a guarantee agreement in proportion to his stock ownership in the corporation.³⁸ When the feedlot expanded its operation to include the construction of grain elevators so that it could purchase and store large amounts of grain, the corporation went back to the PCA for a line of credit in the amount of \$3,300,000, the estimated cost for grain sufficient to fill the elevators to seventy-five percent of their capacity.³⁹ When this line of credit was set up, the management called a shareholders' meeting to seek approval and to tell them that "a reasonable fee, the amount of which would be determined at a later date, would be paid to them for their guarantees."⁴⁰ Based on that representation, all shareholders signed the guarantee agreements, although most (but not all) shareholders testified that they probably would have signed them without the promise of a fee in order to protect or enhance their investment in the corporation.⁴¹

The board of directors in *Olton Feed Yard* did not set the amount of the guarantee fee until August, 1974, almost one year after the guarantees were provided.⁴² The board, after checking with representatives of other feedlots, bankers, and lenders as to an appropriate guarantee fee, set the fee at 3 ¾ % of the entire line of credit (\$3,300,000), even though the outstanding loan balance never exceeded \$1,540,000.⁴³ Accordingly, the corporation paid out \$123,750 in guarantee fees and deducted the fees as ordinary

often, the bank looks to, expects, and requires that one or more of the shareholders guarantee the loan of the corporation.

33. *Id.*

34. *Tulia Feedlot Inc. v. United States*, 423 U.S. 947 (1975).

35. *Olton Feed Yard v. United States*, 592 F.2d 272 (5th Cir. 1979).

36. *Id.* at 274.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

and necessary expenses under section 162 of the Code.⁴⁴ The crucial question was whether these fees were "necessary" in light of the evidence that the shareholders signed the guarantees almost a year in advance of knowing the amount of the fee and the testimony from most shareholders that they would have personally guaranteed the loans without any fee in order to protect their investment. The jury found that these fees were paid *pro rata* based on each shareholder's stockholdings and, therefore, the fees were, in effect, dividends, and not deductible by the corporation.⁴⁵

The taxpayer appealed to the Fifth Circuit, asserting that the evidence did not support the verdict. In reviewing the case, the appellate court noted that whether a corporate distribution is a dividend or not is generally a question of fact,⁴⁶ and noted that with particular emphasis that the Commissioner of Internal Revenue's determination carries with it a presumption of correctness, forcing the taxpayer to show by a preponderance of the evidence that the Commissioner's determination is wrong.⁴⁷ The Fifth Circuit favorably quoted *Tulia I*, although it did note that there were some differences between the evidence in these two feedlot cases.⁴⁸ It concluded that there was ample evidence for the jury to conclude that these payments were indeed dividends.⁴⁹

Even while the *Olton Feed Yard* case was being appealed, the taxpayer from *Tulia I* was back in litigation on this same issue. For fiscal years 1976 and 1977, the taxpayer in *Tulia I* deducted guarantor fees of \$26,140.50 and \$33,004.10, respectively, relating to a line of credit with the PCA.⁵⁰ The Internal Revenue Service again disallowed the deductions, determined that they constituted dividends, and issued statutory notices of deficiency.⁵¹ Again, the taxpayer paid the deficiency, and sought a refund.

44. See *supra* note 7. Section 162 of the Code provides in relevant part that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

45. *Olton*, 592 F.2d at 275.

46. *Hardin v. United States*, 461 F.2d 865, 872 (5th Cir. 1972).

47. *Helvering v. Taylor*, 293 U.S. 507 (1935); *Welch v. Helvering*, 290 U.S. 111 (1933).

48. In *Tulia I* there was no evidence that the amount of the fees were reasonable, while in *Olton Feed Yard* the government did not challenge the reasonableness of the payments as guarantor's fees. *Olton*, 592 F.2d at 275. The court went on to note that in *Olton Feed Yard* it appeared that the decision to pay and the amount to pay was not determined until the eleventh month of the fiscal year, after the corporation realized that it had substantial taxable income. *Id.* at 276. In making the distinction, the court again favorably quoted *Tulia I* to the effect that the presence of reasonableness of the fee is *not* dispositive, although the absence of such evidence would be dispositive. *Id.*; *Tulia Feedlot v. United States*, 513 F.2d 800, 806 (5th Cir. 1975).

49. *Olton*, 592 F.2d at 276.

50. *Tulia Feedlot, Inc. v. United States*, 3 Cl. Ct. 364, 83-2 U.S.T.C. ¶ 9516 (US Cl. Ct. 1983).

51. Once the Internal Revenue Service issues its statutory notice of deficiency, the taxpayer has ninety days in which to submit a petition to the Tax Court or the assessment becomes fixed. I.R.C. § 6213(a) (2005). The taxpayer's alternative is to pay the tax, make a

However, instead of suing for a refund in the United States District Court,⁵² the taxpayer sued for a refund in the United States Court of Claims. The taxpayer was met with a motion for summary judgment by the Commissioner, based on a theory of collateral estoppel since, in the Commissioner's view, this case had been decided adversely to the taxpayer in *Tulia I*.⁵³ However, in an order ("*Tulia II*") dated September 10, 1982,⁵⁴ the Court of Claims found that there were significant and disputed facts in *Tulia II* that were different from the facts in *Tulia I*. Accordingly, the taxpayer deserved the opportunity to proceed with its case for refund.

Because of the statutory realignment of the judicial administration of claims against the United States,⁵⁵ the case known as *Tulia II* was transferred from the Court of Claims to the newly established Claims Court where the case became known as "*Tulia III*."⁵⁶ This time the taxpayer had different and better facts to support its argument. The Claims Court noted the following as significant differences in the facts present in *Tulia III* than the facts present in *Tulia I*:

claim for refund under Section 6511(a) of the Code within three years of the date of the tax return or within two years of the payment, whichever first expires. *Id.*

52. Once the taxpayer has made its claim for refund, it must wait at least six months to file a suit for refund, unless the Internal Revenue Service earlier rejects its claim, in which case it can immediately file. I.R.C. §§ 6532(a)(1), 7422(a) (2005). The taxpayer then has its choice as to whether to file its refund suit in the U.S. District Court pursuant to 28 U.S.C. 1346(a)(1) or to file in the U.S. Court of Federal Claims pursuant to 28 U.S.C. 1491(a)(1). *Id.*

53. As one author described this issue, "collateral estoppel should apply to as many issues as possible to eliminate repetitive litigation. On the other hand, the doctrine should be applied narrowly enough to ensure each party a fair hearing on all issues." Charles A. Heckman, *Collateral Estoppel as the Answer to Multiple Litigation Problems in Federal Tax Law: Another View of Sunnen and The Evergreens*, 19 CASE W. RES. L. REV. 230, 234 (1968). See also *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *The Evergreens v. Nunan*, 141 F.2d 927 (2d Cir. 1944); *Tait v. Western Maryland Ry Co.*, 289 U.S. 620 (1933); *Limbach v. Hooven & Allison*, 466 U.S. 353 (1984); Note, *Collateral Estoppel: Loosening the Mutuality Rule in Tax Litigation*, 73 MICH. L. REV. 604 (1975).

54. *Tulia Feedlot, Inc. v. United States*, 231 Ct. Cl. 971 (1982).

55. Federal Courts Improvement Act of 1982, Pub. L. No. 96-164 at 403, 96 Stat. 25, 57-58. Under this statute, the Article III court known as the Court of Claims was abolished and much of its jurisdiction was transferred to the new United States Court of Appeals for the Federal Circuit. *Id.* Federal Judicial Center http://www.fjc.gov/history/home.nsf/page/coc_bdy (last visited May 12, 2004). That same statute created the "Claims Court" which was established as an Article I court. Federal Judicial Center, http://www.fjc.gov/history/home.nsf/page/cofc_bdy (last visited May 12, 2004). In 1992, the Claims Court was renamed the United States Court of Federal Claims. Federal Court Administration Act of 1992, Pub. L. No. 102-572, 106 Stat. 4506 (1992); WILSON COWEN, PHILIP NICHOLAS, JR., & MARION T. BENNETT, *THE UNITED STATES COURT OF CLAIMS - A HISTORY, PART II* (1978).

56. Because of that technicality, *Tulia II* was reduced to an order denying summary judgment. The order does not express new law, except for its express finding that the enforcement by the Internal Revenue Service of *Tulia I* would not be a matter of law, but indeed would be a case by case analysis of the facts to determine whether the guarantee fees paid out in any one case were ordinary and necessary business expenses or whether they were distributions to shareholders treated as dividends. 231 Ct. Cl. at 972-973. From time to time, *Tulia I*, *Tulia II*, and *Tulia III* will collectively be referred to as the "*Tulia Feedlot Cases*."

- The board of directors unsuccessfully sought loan sources that would not require individual guarantees, and were able to identify three banks in addition to the PCA.⁵⁷
- The board of directors unsuccessfully sought independent non-shareholder parties who would be willing and financially able to guarantee the corporation's loans from the PCA.⁵⁸
- The guarantor fees were based on the amounts of the guarantees and not on the amounts of stock owned by the guarantors.⁵⁹
- The guarantors were unwilling to provide the required guarantees unless they received guarantor fees of three percent and this was agreed to by the corporation.⁶⁰

On the basis of the evidence presented at trial in *Tulia III*, the Claims Court, although recognizing that transactions between a corporation and its shareholders are subject to special scrutiny,⁶¹ still concluded and found that the guarantor fees which the corporation paid to shareholders for fiscal years 1976 and 1977 were ordinary in the sense that they were of a known type and commonly made by persons in the type of business carried

57. All of these potential sources for loans informed the directors that no loan would be made to the corporation unless it was personally guaranteed in full by individuals having adequate financial resources to make good on the commitments (83-2 U.S.T.C. at 87,837).

58. The taxpayer did present evidence that it sought non-shareholders to act as guarantors. Clearly, this was an effort to address one complaint in *Tulia I* which seemed to suggest that taxpayers could find that type of person. *Tulia Feedlot Inc. v. United States*, 513 F.2d 800, 806 (5th Cir. 1975). See also *Jones v. Comm'r*, 19 TCM (CCH) 1561 (1960). This prescription by the Fifth Circuit in *Tulia I* is, in the author's view, a requirement that seems totally unrealistic in the corporate and financial world. Perhaps the biggest reason for the difficulty in finding such a person is, in the author's view, that the person would be subjected to potential liability for defaults when in all likelihood that person would not be in a position to control the actions of the borrower.

59. The eleven directors owned equal amounts of the corporation's stock. Eight of those directors guaranteed \$200,000 each. Two directors guaranteed only \$50,000, and the other director guaranteed \$150,000. 83-2 U.S.T.C. at 87838. Consequently, the court noted that the "guarantor fees were based on the amounts of the guarantees, and not on the amounts of stock owned by the guarantors. This discredits the defendant's argument that the guarantor fees were really dividends in disguise." *Id.*

60. There is little doubt that the taxpayer and its board of directors had approached this issue in 1976 and 1977 in a very different manner than it had during tax years 1970 and 1971 which were under review in *Tulia I*. Indeed, when the opinion in *Tulia I* was released by the Fifth Circuit on June 2, 1975, it certainly highlighted the evidentiary points that the taxpayer needed to address when it authorized new guarantor fees in August of 1976 and 1977, and seems like the corporation attempted to provide all of the evidence in 1976 and 1977 that the Fifth Circuit said was missing in *Tulia I*. 513 F. 2d at 805-806

61. See, e.g., *Dillin v. United States*, 433 F.2d 1097 (5th Cir. 1970).

