TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Bad Debts

by

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TAX MANAGEMENT
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U.S. INCOME

Bad Debts

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Bad Debts*, No. 538-3rd, discusses the problems that may arise in taking full advantage of debts that become worthless or partially worthless. It includes a complete discussion of the Internal Revenue Code provisions that govern the deduction of worthless debts and the application of these provisions to normally recurring situations. In addition, IRS rulings and court decisions pertaining to this subject are examined.

The Portfolio also addresses problems which often arise in connection with bad debts, including: (1) whether a debt was worthless when incurred and, hence, not deductible under §166; (2) the application of §166 to obligations that arise by operation of law and to executory contracts; (3) status as debt, including the debt-equity issue in the §166 context; (4) the distinction between bad debts and losses; (5) determining when §165(g) (worthless securities) and §1271(a) (retirement or sale or exchange of debt instruments) apply instead of §166; (6) factors which establish worthlessness, and the distribution of the burden of proving worthlessness; (7) the consequences of repossessions and foreclosures; (8) the application of the tax benefit rule to recoveries of previously deducted bad debts; and (9) the application of the seven-year statute of limitations for refund claims on bad debts.

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DETAILED ANALYSIS

DETAILED ANALYSIS

I. Overview

Section 166[1] of the Internal Revenue Code prescribes three ways in which deductions may be taken for worthless debts:[2]

(1) as an ordinary deduction during a taxable year in which a business bad debt becomes completely worthless;[3]

(2) as an ordinary deduction, when a business bad debt becomes partially worthless during the taxable year, but only to the extent worthless;[4] and

(3) as a short-term capital loss, when a nonbusiness bad debt held by a taxpayer other than a corporation becomes completely worthless during the taxable year.[5]

In order to deduct a bad debt under §166, a taxpayer must prove five things, discussed below.

(1) The existence of a debtor-creditor relationship, i.e., that the debtor was legally obligated to pay the taxpayer-creditor a fixed or determinable sum of money.[6]

Note: The existence of a debt can be established, prima facie, either by presentment of an instrument creating the obligation or by production of other evidence, i.e., related documents, books and records, public filings, or corroborative witnesses proving the debtor-creditor relationship.[7]

(2) The obligation is one described in §166.[8]

Note: If evidenced by an instrument issued by a corporation or governmental unit with interest coupons attached or in registered form, worthless obligations are governed by §165 and are deductible as capital losses.[9] For noncorporate taxpayers, sub-classifying a §166 obligation as either a business or nonbusiness debt is important, because a nonbusiness bad debt is deductible only as a short-term capital loss and may, in some instances, not be allowable at all.[10]

(3) The debt's adjusted basis for determining loss if the debt was sold or exchanged.[11]

(4) If the debt represents an item of income (e.g., unpaid salary), the taxpayer must show that it has been (or is being) taken into income.[12]

Note: This rule prevents a cash-basis taxpayer from reaping a double benefit (exclusion from income *and* a deduction) where the item claimed under §166 was not previously reported in income. This item is related to item (3), above. That is, a worthless debt arising from unpaid salary or rent has no basis and is not deductible unless included in the taxpayer's income for the current or a prior taxable year.

(5) The debt became wholly worthless in the taxable year, or, if the debt is a business bad debt, that it was worthless at least to the extent of the portion charged off by the taxpayer.[13]

Note: The taxpayer's evidentiary burden includes proving that the debt did not become worthless in a prior or subsequent year.[14] The standard for deductibility under §166, "became worthless," is identical to the one described under §165(g) for worthless securities. Accordingly, case law applying this standard under the latter section may be used in evaluating worthlessness under §166, subject to the fact that §166 establishes a charge-off requirement for business debts that become partially worthless during the current year. In this situation, the taxpayer must also prove that the entire debt did not become worthless in a prior year.

The taxpayer may also have to prove that the "bad debt" is not: (i) within the jurisdiction of §165, (ii) a worthless security within the jurisdiction of §165(g), or (iii) a retired debt instrument within the jurisdiction of §1271.[15]

---

[1] Unless otherwise specified, all section references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] Until 1987, former §166(c) provided a fourth way: an addition to a reserve for bad debts. This provision was repealed for most taxpayers by the Tax Reform Act of 1986 (1986 TRA), P.L. 99-514, §805(a), (b), (d).

[3] §166(a)(1).

[4] §166(a)(2).

[5] §166(d); Regs. §1.166-5(a)(2) (no doctrine of partial worthlessness for nonbusiness bad debts).

[6] Regs. §1.166-1(c). *See, e.g.*, Rev. Rul. 77-383 (loss of personal savings incurred by depositor as result of bank's insolvency due to its employee's embezzlement of bank funds constitutes short-term capital loss under §166(d) and not theft loss under §165(c)(3), because relationship between bank and depositor was one of debtor and creditor). *But see* Rev. Rul. 77-215 (overdraft loss by bank under check-kiting scheme is §165 loss).

[7] *See Bauer v. Comr.*, T.C. Memo 1998-133 (bona fide debt found based on history of advances (and their repayment) from taxpayer to debtor); *Zimmerman v. U.S.*, 318 F.2d 611 (9th Cir. 1963) (bad debt deduction denied taxpayer who made advances to nonprofit medical association based on his failure to prove association's legal obligation to return amounts so advanced); *Hoffman v. Comr.*, T.C. Memo 1980-431 (debtor-creditor relationship not established in support of bad debt deduction where neither written instrument evidencing debt nor sufficient secondary evidence was presented at trial); *Constantin v. Comr.*, T.C. Memo 1966-27.

[8] Regs. §1.166-1(c).

[9] §166(e); §165(g)(2)(C); *Spring City Foundry Co. v. Comr.*, 292 U.S. 182 (1934).

[10] *See* §166(d)(2) (definition of nonbusiness bad debts). For further discussion, see IV., below.

[11] Regs. §§1.166-1(d)(1), 1.1011-1.

[12] Regs. §1.166-1(e); *Gertz v. Comr.*, 64 T.C. 598 (1975); *Giordano v. Comr.*, T.C. Memo 1977-95. *See Swenson v. Comr.*, 43 T.C. 897 (1965).

[13] Regs. §§1.166-2 (evidence of worthlessness), 1.166-3 (partial or total worthlessness).

[14] *See Winter & Hirsch, Inc. v. U.S.*, 571 F.2d 11 (Ct. Cl. 1978) (taxpayer reporting bad debts under reserve method could not subtract from its bad debt reserve debts for year subsequent to year in which debts became worthless despite fact that losses were undiscovered for period of years by reason of fraudulent conduct of one of its key officers). *See also Smith Elec. Co. v. U.S.*, 461 F.2d 790 (Ct. Cl. 1972). *See also Cole v. Comr.*, 871 F.2d 64 (7th Cir. 1989); *McGuffey v. Comr.*, T.C. Memo 1989-267 (bad debt deductions denied where taxpayers failed to prove that debts became worthless in tax years at issue).

[15] See discussion at III.B.3., below.

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If, in a subsequent year, the taxpayer receives payment on a debt previously deducted as worthless, the recovered amount is includible in gross income in the year of the recovery, but only if and to the extent that, the prior deduction was of tax benefit.[16]

Where the debt is cancelled, discharged, or forgiven, the debtor may be deemed to receive income,[17] a nontaxable gift under §102, or a contribution to capital.[18] However, a voluntary or gratuitous cancellation of an indebtedness by the creditor or holder of the debt does not (in theory) establish worthlessness under §166. But a "compromise" of a debt may raise the issue of partial, as opposed to total, worthlessness. The points described above are discussed throughout this portfolio.

[16] *See* §111(a). *See also Dobson v. Comr.*, 320 U.S. 489 (1943), *reh'g denied*, 321 U.S. 231 (1944); *Hillsboro Nat'l Bank v. Comr.*, 460 U.S. 370 (1983).

[17] Regs. §1.61-12(a).

[18] §§118 and 1017. For a detailed discussion of debt cancellation, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

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II. Legislative History

A. *Early History*

Express statutory provisions for deduction of bad debts have been in the income tax statutes for a long time. Section 28 of the Act of 1894[19] provided that "there shall be deducted … debts ascertained to be worthless … ." Section II(B) of the Act of 1932[20] provided "[t]hat in computing net income … there shall be allowed as deductions … debts due to the taxpayer actually ascertained to be worthless and charged off within the year … ."

The Revenue Act of 1921[21] introduced deductions for additions to a bad debt reserve and for partial worthlessness:

> Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part; … .

Much of the phrasing of the provision for partial worthlessness has come through to the modern statute.

The Revenue Act of 1932[22] modified the language to make the charge-off requirement apply to partial worthlessness: "the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The Revenue Act of 1938[23] modified the statutory language so that it did not allow a bad debt deduction for worthless or partially worthless securities (unless the taxpayer was a bank). The descendent of this rule is §166(e).

The Revenue Act of 1942[24] brought the basic statutory provisions for the specific charge-off of bad debts into substantially their current form. §124(a) of the Revenue Act of 1942 introduced the distinction between business and nonbusiness bad debts:

> In the case of a taxpayer, other than a corporation, if a nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.
>
> Until 1942, the statute required a bad debt to be "charged off" for the taxpayer to claim a deduction. The Revenue Act of 1942 eliminated this requirement, allowing deductions for: Debts which become worthless within the taxable year … and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part which becomes worthless within the taxable year, as a deduction … . This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a nonbusiness bad debt … .

The Revenue Act of 1942 also partially codified the tax benefit rule by enacting what has now become §111.[25]

B. *Internal Revenue Code of 1954*

1. *Bad Debts Originated by a Business*

Before 1954, a bad debt did not qualify as a business bad debt unless it became worthless (or, in the case of a partially worthless bad debt, partially worthless) while the taxpayer was engaged in a trade or business.[26] The Internal Revenue Code of 1954 broadened the rule by making the deduction allowable if the debt was a bona fide business asset at the time it was created or acquired.[27]

2. *Guarantor's Losses: Former §166(f)*

The Internal Revenue Code of 1954 made one other change: it gave noncorporate guarantors an ordinary loss in certain circumstances. Section 166(f), as in effect from 1954 to 1976 ("pre-1977 §166(f)"), provided for business bad debt treatment if: (1) payment was made by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor; (2) the debtor was a person other than a corporation; (3) the debtor's obligation to the lender was in fact worthless at the time of such payment; and (4) the proceeds of the loan were used in the debtor's trade or business.[28]

The deduction was allowed in the year in which the payment was made.

Where a noncorporate taxpayer made a direct loan to a noncorporate debtor, and the loan was not connected with his trade or business, he generally received a nonbusiness bad debt deduction when the debt became worthless. However, if the noncorporate taxpayer guaranteed a loan to a noncorporate debtor, who used the proceeds of the loan in his trade or business, pre-1977 §166(f) allowed a business bad debt deduction to the taxpayer even though extension of the guarantee was not connected with the guarantor's trade or business. In this respect, pre-1977 §166(f) put a premium on guaranteeing a loan rather than lending the money directly.

The Tax Reform Act of 1976 (1976 TRA) repealed pre-1977 §166(f),[29] and re-lettered the subsections of §166, so that former §166(g) became §166(f) (i.e., post-1976 §166(f)). This can be confusing, because both subsections deal with guarantors. Pre-1977 §166(f) dealt with guarantor's losses, while post-1976 §166(f) (former §166(g) (discussed in I.D., below)) dealt with guarantor's reserves. The Tax Reform Act of 1986 repealed the post-1976 version of §166(f).

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[19] 28 Stat. 509.
[20] 38 Stat. 114.
[21] 42 Stat. 227.
[22] 47 Stat. 169.
[23] 52 Stat. 447.
[24] 56 Stat. 798, §124(a).

[25] 56 Stat. 798, §116(a) (Internal Revenue Code of 1939, §22(b)(12)).
[26] Internal Revenue Code of 1939, §23(k).
[27] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 21–22 (1954).
[28] *See* Regs. §1.166-8. *See also Bugas v. Comr.*, T.C. Memo 1976-21. Three cases interpreted former §166(f): *Axelrod v. Comr.*, 320 F.2d 327 (6th Cir. 1963); *Andrew v. Comr.*, 54 T.C. 239 (1970), *acq.*, 1970-2 C.B. xviii; *Post v. Comr.*, T.C. Memo 1979-419, 39 T.C.M. 311 (1979).
[29] P.L. 94-455 §605(a).

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C. Technical Amendments Act of 1958

In 1958, Congress amended §166(d)(2)(A) to preclude a transferee of a business bad debt not engaged in a trade or business from claiming an ordinary deduction upon worthlessness.[30]

D. P.L. 89-722: Reserve for Guarantees

P. L. 89-722 (which was not given a name) added §166(g) in 1966.[31] Until its repeal in 1986, former §166(g) allowed contingent liabilities on discounted receivables to be included in a reserve for bad debts, but not without a price.

The reserve was required to be accounted for separately and had to be used in tandem with a “suspense account.” The reserve for guaranteed debt obligations applied to taxable years ending after October 21, 1965.[32]

E. The Tax Reform Act of 1986

The Tax Reform Act of 1986 (1986 TRA) repealed former §166(c), which had generally allowed taxpayers to establish a bad debt reserve for tax purposes.[33]

However, financial institutions (except banks with assets exceeding $500 million) were generally able to continue to use bad debt reserves under different statutory authority, and accrual method service providers were allowed an experienced-based exclusion from gross income for receivables unlikely to be collected. See VIII.B.4., below. The 1986 TRA also repealed former §166(g), allowing a special reserve for guarantor’s losses and former §81, providing for taxation of increases in suspense accounts under former §166(g).[34]

F. The Small Business Job Protection Act of 1996: Repeal of Special Thrift Provisions

The Small Business Job Protection Act of 1996 conformed the bad debt reserve rules applicable to thrifts (generally, savings and loans and mutual savings banks) to those applicable to banks.[35]

G. The Job Creation and Worker Assistance Act of 2002: Limiting the Service Provider Exclusion

As noted in II.E., above, the Tax Reform Act of 1986 allowed accrual method service providers an experienced-based exclusion from gross income for receivables unlikely to be collected. The Job Creation and Worker Assistance Act of 2002 severely restricted this relief provision by limiting it to taxpayers who either (i) provide services described in §448(d)(2) (mostly professional services) or (ii) have gross annual receipts of less than $5 million.[36]

[30] Technical Amendments Act of 1958, P.L. 85-866, §8; *see* H.R. Rep. No. 775, 1958-3 C.B. 811, 819 (1957), S. Rep. No. 1983, 1958-3 C.B. 922, 938–939 (1958).

[31] P.L. 89-722.

[32] P.L. 89-722 also allowed certain deductions claimed before Oct. 22, 1965, for such reserves. *See United Surgical Steel Co. v. Comr.*, 54 T.C. 1215 (1970); Rev. Rul. 68-313. This, in effect, overruled a number of Tax Court decisions denying a deduction for any guarantor’s reserve prior to enactment of former §166(g). *E.g.*, *Western Oaks Bldg. Corp. v. Comr.*, 49 T.C. 365, 375–6 (1968), *nonacq.*, 1968-2 C.B. 3; *Wilkins Pontiac v. Comr.*, 34 T.C. 1065 (1960), *rev'd*, 298 F.2d 893 (9th Cir. 1961); *Poplar Hills Dev. Corp. v. Comr.*, T.C. Memo 1968-208.

[33] P.L. 99-514, §805(a).

[34] 1986 TRA §805(b), (c)(1)(A).

[35] P.L. 104-188, §1616.

[36] §448(d)(5), as amended by P.L. 107-147, §403(a). See VIII.B.4.c., below, for a more detailed discussion of this provision.

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III. Existence and Nature of Debt

A. *Existence of a Bona Fide Debt*

1. *Basic Concept of Debt*

A bad debt can arise only if there is a bona fide debt. A bona fide debt is one which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.[37] An advance that is in part a contribution to capital or a gift does not qualify as debt for purposes of §166.[38] In other words, a taxpayer claiming a bad debt deduction under §166 must establish that the now worthless advance was originally made with a bona fide expectation that such amount would be repaid.[39]

The presence of a debtor-creditor relationship is determined on the basis of all relevant facts and circumstances pertinent to the advances, including the subjective intent of the parties, and no particular factor is dispositive.[40] Factors considered by the courts in finding the presence or absence of a bona fide debt include: (1) whether the obligation was evidenced by a note or other evidence of indebtedness, (2) the name given to the evidence of indebtedness, (3) whether interest was charged, (4) the presence or absence of a fixed maturity date and/or a fixed schedule for repayments set forth in the instrument or by agreement, (5) whether security or other collateral was given to ensure repayment, (6) the right to enforce repayment, (7) whether repayments were actually made, (8) whether the borrower was solvent and/or adequately capitalized at the time the advance was made, (9) the source of the payments, (10) participation in management as a result of the advance, (11) the use to which the advance was put, (12) identity of interest between creditor and shareholder, (13) the risk involved in making the advances, (14) the intent of the parties, and (15) whether the parties otherwise acted consistently with such transfer being a loan.[41] In addition, for genuine indebtedness to be present there must be both a good-faith intent on the part of the borrower to repay the debt and a good-faith intent by the lender to enforce payment of the debt.[42]

For example, in *Devine v. United States*,[43] the court held there was no bona fide debt where the taxpayer continuously advanced funds to his partner without a promissory note for the development of a property they equally owned, even though the express terms of their contract clearly stated that any funds advanced by the taxpayer to his partner required a promissory note. To the court, the failure to execute promissory notes, despite the contract, inferred evidence of a lack of indebtedness and that the parties did not intend to create a creditor-debtor relationship. Moreover, the court noted that the contract failed to provide an interest provision or maturity date for any of the advanced funds, which would have been typical of any standard loan obligation. Altogether these factors weighed heavily against a finding of a bona fide debt.

Where the purported debt obligation involves family members, strict scrutiny is given to determine whether the advance was in fact a gift.[44] The availability of a bad debt deduction for a loan to a family member is discussed in detail in IV.D., below.

If the underlying facts and circumstances make it highly unlikely or impossible to estimate whether and when the advances will be repaid, e.g., because payment is contingent on

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[37] Reg. §1.166-1(c). *E.g.*, *Kavanaugh v. United States*, 575 F. Supp. 41 (N.D. Ill. 1983). *See Hynard v. IRS*, 233 F. Supp.2d 502 (S.D. N.Y. 2002), *aff'd by summary order*, 87 Fed. Appx. 220 (2d Cir. 2004) (stepbrother's written promise to pay taxpayer (whom he had shot) $45,000 from potential inheritance from prospective decedent (who died in 1992) was not debt in 1988 or 1989 because time and amount were contingent); FAA 20150701F (bona fide debt does not exist where parties' settlement agreement specifically recites dispute over whether invoiced amounts are actual obligations and states that settlement is not admission of liability; nonpayment does not give rise to §165 or §166 loss).

[38] Reg. §1.166-1(c); *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018), *aff'd*, 943 F.3d 255 (5th Cir. 2019) (payment to subsidiary constituted contribution to capital and was not eligible for deduction as bad debt); *Hambeuchen v. Commissioner*, 43 T.C. 90 (1964). *See also Cenex, Inc. v. United States*, 38 Fed. Cl. 331 (1997) (advances by shareholder to pay shutdown costs were not loans giving rise to bad debt deduction, but short-term capital losses), *aff'd*, 156 F.3d 1377 (Fed. Cir. 1998).

[39] *See, e.g.*, *Sarvak v. Commissioner*, 794 Fed. Appx. 670 (9th Cir. 2020) (unpub. op.), *aff'g* T.C. Memo 2018-68 (taxpayer failed to establish bona fide debt obligation where no existence of loan documentation or evidence of uncollectability in year of deduction); *Shaw v. Commissioner*, T.C. Memo 2013-170 (taxpayer, who made no serious effort to obtain repayment, failed to prove reasonable expectation of repayment where, as bookkeeper and chief financial officer of closely held company to which payment was made, she had full knowledge of company's inability to pay), *aff'd*, 623 Fed. Appx. 467 (9th Cir. 2015); *CMA Consol., Inc. & Subsidiaries, Inc. v. Commissioner*, T.C. Memo 2005-16 (no bona fide debtor-creditor relationship existed because, at time advances were made, debtor was in poor financial condition, so creditor could not have had reasonable expectation of repayment).

[40] *Fisher v. Commissioner*, 54 T.C. 905 (1970); *Miller v. Commissioner*, T.C. Memo 1982-629.

[41] *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980); *VHC, Inc. v. Commissioner*, 968 F.3d 839 (7th Cir. 2020); *Goldstein v. Commissioner*, T.C. Memo 1980-273, 40 T.C.M. 752 (1980). *See, e.g.*, *Kaider v. Commissioner*, T.C. Memo 2011-174 (debt was bona fide where the parties entered into written loan agreements; the agreements showed an intent to establish bona fide loans; there was no evidence that loan repayments were disguised compensation for services; and objective evidence of ability to repay, checks with "loan" in the memo line, agreements corresponding to the checks, fixed interest rate, and fixed repayment dates supported characterization as a debt); *Buchanan v. United States*, 892 F. Supp. 1073 (N.D. Ill. 1995) (debt held bona fide where taxpayer's reason for lack of formal indicia of debt was that loan was initially considered short-term; after debtor became insolvent, formal note was executed when it became apparent that debtor would not be extended bank credit without executed note), *rev'd on other grounds*, 87 F.3d 197 (7th Cir. 1996). *See also Cenex, Inc. v. United States*, 156 F.3d 1377 (Fed. Cir. 1998) (cooperative's obligation to make payments to oil pipeline company in connection with shutdown costs lacked traditional indicia of bona fide debt; payments were made in proportion to cooperative's ownership in pipeline, and agreement lacked repayment schedule and an interest rate).

[42] *See Wright v. Commissioner*, T.C. Memo 1992-60 (members of barter exchange unaware of borrowed trade units; necessary intent not present).

[43] 152 Fed. Cl. 175 (Fed. Cl. 2021), *reconsideration denied*, 155 Fed. Cl. 193 (Fed. Cl. 2021).

[44] *Rude v. Commissioner*, 48 T.C. 165 (1967); *Mercil v. Commissioner*, 24 T.C. 1150 (1955); *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951); *Clark v. Commissioner*, 18 T.C. 780, 783 (1952); *Grossman v. Commissioner*, 9 B.T.A. 643, 644 (1927); *Boneparte v. Commissioner*, T.C. Memo 2015-128. *See also Caligiuri v. Commissioner*, 549 F.2d 1155, 1157 (8th Cir. 1977) (a purported loan between family members is always subject to close scrutiny). *See, e.g.*, *Alpert v. Commissioner*, T.C. Memo 2014-70 (nonbusiness bad debt deduction denied because no bona fide debt existed where taxpayer made multiple transfers to trusts to benefit his sons and, despite promissory notes, no documents supported purported revolving line of credit, no repayment schedule existed, and no collection action was taken against purported debtors).

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future profits, the obligation may not constitute a debt for tax purposes, for lack of an unconditional obligation.[45]

One recurrent question in this area is whether advances made by an investor to his closely held or controlled company constitute debt or a capital contribution.[46] Several Circuit courts have articulated lists of factors that differentiate bona-fide debt from a capital contribution.[47] In *Fin Hay Realty Co. v. United States*,[48] the Third Circuit, in characterizing certain shareholder advances as capital, applied an objective test of economic reality by analyzing whether an independent and prudent lender would have made similar advances to the corporation. In *Wildes v. Commissioner*,[49] the Tax Court applied a similar risk analysis where a partner was denied a §166 deduction for unrecovered advances evidenced by unsecured notes to his partnership where such funds were used to purchase highly speculative oil and gas leases.

Similarly, in *Federal Projects, Inc. v. Commissioner*,[50] the Tax Court determined that advances by a real estate developer to limited partnerships did not constitute debt for which a bad debt deduction could be taken. The court determined that none of the advances was evidenced by any writing or secured by collateral, and that no interest rate or maturity date was stated. The court concluded that no independent lender would have been willing to make such advances.

In the case of a corporate obligation issued after October 24, 1992, the characterization of the obligation by the issuer (at the time of issuance) is: (i) binding on the issuer, (ii) binding on a holder of the instrument unless the holder discloses the inconsistent treatment on the holder's return, and (iii) not binding on the IRS.[51]

A voluntary undertaking to pay the debts of another may not create a bona fide debtor-creditor relationship. For example, in *Wortham Mach. v. United States*,[52] the taxpayer corporation had acquired the assets and assumed the liabilities of a corporation ("Target") which had some shareholders in common with the taxpayer. Target had net operating losses, which the acquiring corporation claimed by reason of a purported type C reorganization. The Tenth Circuit, however, citing the lack of business purpose based on the cessation of Target's business, invalidated the tax-free status of the reorganization and denied the carryover of Target's net operating losses under §381. In hope of salvaging some tax benefit, the taxpayer corporation claimed it was entitled to a bad debt deduction in the amount that its repayments of Target's liabilities exceeded the value of Target's assets. The court rejected the bad debt claim based on the absence of any obligation of the taxpayer corporation to make repayments on Target's loan or any reasonable expectation that Target would repay the taxpayer corporation's advances.[53]

A bailment does not constitute a debt for §166 purposes[54] because the person parting with the property, as bailor, expects the return of the specific property delivered to the bailee and not the return of money or other property of equal value. This distinction was thoroughly reviewed in *Stahl v. United States*,[55] where a taxpayer-bailor was permitted ordinary loss treatment under §165 for unrecovered securities loaned to another for meeting certain SEC requirements. When the securities were later sold by the bailee to repay outside loans, the government contended that the taxpayer's claim, which became worthless, was for money damages, and, as such, a deduction was available only under §166(d) (short-term capital loss). In rejecting

[45] *See Canelo v. Commissioner*, 53 T.C. 217, 223–225 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971) (advanced litigation costs to be repaid upon successful outcome of litigation not a debt); *Loewi & Co. v. Commissioner*, 232 F.2d 621 (7th Cir. 1956); *Bergstrom v. United States*, 37 Fed. Cl. 164 (1996) (nonrecourse purchase money debt that does not reasonably approximate fair market value of underlying property completely disregarded, because bona fide debt obligation does not arise when debt's economic significance is contingent upon property's substantial appreciation in value). *Fuscaldo v. United States*, 88 AFTR2d 2001-6833 (E.D. Pa. 2001) (advances to be repaid upon future generation of profits not debt because bona fide debt obligation does not arise where there is no unconditional right to repayment). *But see* Rev. Rul. 72-505 (partner's right to contribution as result of paying partnership debt (at time when it was unlikely his insolvent partner could ever repay) created bona fide debt and eventually resulted in bad debt deduction).

[46] *See, e.g., Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367 (1973); *A.R. Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970); *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969); *Montclair v. Commissioner*, 318 F.2d 38 (5th Cir. 1963). See also *Brooks v. Commissioner*, T.C. Memo 1990-259 (taxpayer's bad debts were deductible only as short-term capital losses, because loans made to corporation in which he was shareholder-employee were made primarily to protect his investment rather than protect income received as employee); *Am. Underwriters, Inc. v. Commissioner*, T.C. Memo 1996-548 (advances made between related corporations held to be bona fide debt).

[47] *See, e.g., Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987) (11 nonexclusive factors to determine whether an advance of funds gives rise to bona fide debt); *Keeton v. Commissioner*, No. 23-3750, 2024 BL 389251 (9th Cir. Oct. 30, 2024) (applying *Hardman* factors to advances made by shareholders to support equity finding); *Bell v. Commissioner*, 700 Fed. Appx. 654 (9th Cir. 2017) (applying 11-factor test articulated in *Hardman v. United States* to recharacterize asset purchase installment payment agreement as stock under §385); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) (11 factors for determining whether advances to corporation are debt or equity); *Indmar Prods. Co. v. Commissioner*, 444 F.3d 771 (6th Cir. 2006) (citing *Roth Steel Tube* factors, appellate court concluded that shareholder's advances to corporate were debt; deduction allowed); *Lane v. United States*, 742 F.2d 1311 (11th Cir. 1984) (13 factors for determining whether debt is bona fide); *Rutter v. Commissioner*, T.C. Memo 2017-174 (applying 9th Circuit's 11 factors to find advances to controlled corporation were not debt); *Tigrett v. United States*, 2005-1 USTC ¶50,310 (W.D. Tenn. 2005) (applying Sixth Circuit's 11 factors to find that officer's advance to corporation was capital contribution, not loan; §166 deduction denied).

[48] 398 F.2d 694 (3d Cir. 1968).

[49] T.C. Memo 1980-298.

[50] T.C. Memo 1987-202. See also *Litchfield v. Commissioner*, T.C. Memo 1994-585, *aff'd in unpub. op.*, 117 F.3d 1428 (10th Cir. 1997) (Tax Court cited *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973), in holding that attorney who accepted restricted stock that was issued by his corporate client as payment for legal fees was not creditor of corporation and, thus, was not entitled to §166 bad debt deduction when corporation (which filed for bankruptcy) reneged on its commitment to repurchase stock; however, he was entitled to §165(g) long-term capital loss for worthless stock).

[51] §385(c). *See* TAM 200419001 (consistency requirement of §385(c)(1) was not violated where there were no U.S. tax consequences to foreign subsidiary's treatment of investment (treated as equity by U.S. investor) as debt for home country tax and foreign investment limitation laws).

[52] 521 F.2d 160 (10th Cir. 1975).

[53] The payment also has income tax significance to the debtor effectively released from the obligation. *See Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). In addition, voluntary payment of another's debt does not constitute a loss under §165. *Putnam v. Commissioner*, 352 U.S. 82 (1956); *Commissioner v. Gilt Edge Textile Corp.*, 173 F.2d 801 (3d Cir. 1949), *rev'g* 9 T.C. 543 (1947). *See Commissioner v. Alamitos Land Co.*, 112 F.2d 648 (9th Cir. 1940); *Stahl v. United States*, 294 F. Supp. 243 (D.D.C. 1969), *aff'd*, 441 F.2d 999 (D.C. Cir. 1970).

[54] Such an obligation might be considered a liability for other tax purposes. *Cf. Orr v. Commissioner*, 78 T.C. 1059 (1982) (customer deposits held liabilities for §357(c) purposes).

[55] 294 F. Supp. 243 (D.D.C. 1969), *aff'd*, 441 F.2d 999 (D.C. Cir. 1970).

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this position, the court noted that merely because damages for breach of contract can be expressed in monetary terms does not make the relationship between the parties one of debtor-creditor where the failure to perform relates to the delivery of specific property and not the repayment of a determinable sum of money.[56]

Debts arise through many circumstances, including advances of money; extensions of credit; the securing of judgments; and the issuance of notes, bonds, and securities. For tax purposes, they may also include unpaid fees, rents, salaries, and interest that have previously been reported in income.[57]

For example, in *First Nat'l Bank of Duncanville v. United States*,[58] a promise to indemnify a lender for losses it might incur under a loan and security agreement was sufficient to constitute a debt for purposes of §166. The taxpayer made loans to a construction company and entered into a security agreement with the debtor which provided the debtor would be liable for any amounts paid by the taxpayer to maintain or preserve its collateral. Due to financial difficulties, it became necessary for the taxpayer to have one of its employees work with the debtor, which resulted in the taxpayer paying a 100% penalty for the debtor's failure pay over employment taxes. The taxpayer sought to deduct the penalty as a wholly worthless bad debt arising under the security agreement. The court, in a decision that can be distinguished from *Rude v. Commissioner*,[59] (discussed at III.C.4. below) and *Globe Prods. Corp. v. Commissioner*,[60] held that the contractual right to indemnity converted an otherwise nondeductible penalty into a deductible bad debt.[61]

2. *Debts Arising by Operation of Law*

In addition to the establishment of a debtor-creditor relationship based on the intent of the parties as evidenced by various objective facts, a debt can also arise by operation of law where a person involuntarily becomes obligated to pay a fixed or determinable sum of money.[62] For example, as illustrated in Rev. Rul. 72-505, a debt can arise through subrogation or similar doctrines when one person involuntarily pays the debt of another. In this ruling, a general partnership (consisting of the taxpayer and an equal partner) was dissolved while still owing a debt. The taxpayer's former partner subsequently died before the debt had been paid, and the taxpayer paid the partnership debt in full, because the creditor could collect the full amount from him. His payment of the entire debt gave rise to a right of contribution entitling the taxpayer to recover one-half of the payment from his deceased partner's successor in interest. However, the deceased partner's estate was insolvent, so the taxpayer was unable to recover the deceased partner's share of the debt. The amount paid by the taxpayer on behalf of the deceased partner was deemed by the IRS to be deductible under §166, because a debtor-creditor relationship was created between the taxpayer and the deceased partner's estate by virtue of the taxpayer's right of contribution.

A second illustration of a debtor-creditor relationship created by operation of law is provided by Rev. Rul. 69-458, wherein individual taxpayers made payments to a securities corporation toward the purchase of stock. The corporation subsequently went bankrupt and did not deliver the stock to the taxpayers or refund the monies paid. The IRS ruled that when the taxpayers' rights under the purchase contracts for the delivery of stock became unenforceable, their claim against the securities corporation became a right for repayment of money and a bona fide debtor-creditor relationship was created by operation of law.[63]

A debtor-creditor relationship was similarly established in *Iowa S. Util. Co. v. United States*[64] The corporation's shareholders were awarded money damages in a derivative suit against certain corporate officers for fraudulently inflating the value of property sold to the corporation. The corporation was allowed a bad debt deduction for the unrecovered balance of the unlawfully obtained profits. According to the Court of Claims, the breach of a fiduciary relationship under state law was sufficient to create a debtor-creditor relationship for the return of the net profits although such sum could not be determined until later court action.

The results in Rev. Rul. 69-458 and *Iowa S. Util. Co.*, stand in direct opposition to the views of the Tax Court in *Meyer v. Commissioner*[65] In a fact pattern similar to Rev. Rul. 69-458, the taxpayers in *Meyer*, after waiting nine months for a brokerage firm to deliver stock under a purchase order, instituted a suit to rescind the orders and obtain a refund of their advances. The district court awarded the taxpayers a judgment in the amount of their advances plus interest. A few weeks later, the taxpayers, realizing that the brokerage firm was facing bankruptcy, accepted a settlement for less than the amount of the judgment and claimed the difference as a deductible loss under §165. Citing *Iowa S. Util. Co.* and Rev. Rul. 69-458 as precedent, the Commissioner argued in *Meyer* that the taxpay-

[56] *But see Lorch v. Commissioner*, 605 F.2d 657 (2d Cir. 1979), *aff'g* 70 T.C. 674 (1978) (*Stahl* distinguished on ability of bailee of securities to satisfy its obligation by either returning the securities or repayment of cash or other securities); *Michtom v. Commissioner*, 626 F.2d 815 (Ct. Cl. 1980), *vac'g* 573 F.2d 58 (Ct. Cl. 1978) (loss incurred in exchange of rights under subordination agreement under which taxpayer deposited securities with brokerage firm, who had right to sell securities for preferred stock during term of agreement, constituted capital loss under §165(f)). *Contra Michtom v. Commissioner*, 626 F.2d 815 (Ct. Cl. 1980) (dissenting opinion).

[57] *See Community Rsch. & Dev. Corp. v. Commissioner*, T.C. Memo 1979-264 (unpaid rents cannot be deducted as bad debts if not previously included in income).

[58] 481 F. Supp. 633 (N.D. Tex. 1979). *But see* PLR 9719033 (indemnifying note issued in exchange for guarantee of equal amount characterized as part of indemnity agreement rather than debt instrument).

[59] 48 T.C. 165 (1967). *See also Arrigoni v. Commissioner*, 73 T.C. 792, 801, n. 9 (1980).

[60] 72 T.C. 609 (1979).

[61] *But see Arrigoni v. Commissioner*, 73 T.C. 792 (1980) (100% penalty under §6672 against responsible person is not deductible under §162(f) or §166, even if right to reimbursement exists); (*First Nat'l Bank of Duncanville* distinguished on basis of prior contractual right to reimbursement). *Cf. Stamos v. Commissioner*, 22 T.C. 885 (1954) (shareholder-officer granted nonbusiness bad debt deduction on payment of corporation's employment tax liability where no assessment for payment made against him personally).

[62] *Birdsboro Steel Foundry & Mach. Co. v. United States*, 3 F. Supp. 640 (1933).

[63] The IRS, which acknowledged that the transaction was also described under §165(c)(2), based its decision on *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934), where the Court held that §§165 and 166 are mutually exclusive and that if a transaction is described in both provisions, §166 controls.

[64] 348 F.2d 492 (Ct. Cl. 1965).

[65] T.C. Memo 1975-349, *aff'd per curiam*, 547 F.2d 943 (5th Cir. 1977).

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ers' deduction was a §166(d) nonbusiness bad debt rather than a §165 loss deduction.

The Tax Court in *Meyer* stated that the contractual breach by the brokerage firm to deliver under the contract provided the taxpayers with the alternative remedies of seeking either delivery of the stock or return of their purchase price, and the existence of these remedial choices did not create a "debt" arising at law.[66] The court distinguished *Iowa S. Util.* on the basis that, in that case, there was a finding of fraud giving rise to an obligation to repay, whereas in *Meyer*, there was a finding merely of breach of contract. Claiming that the rationale behind congressional passage of the nonbusiness bad debt provision of §166(d) was to put nonbusiness investments[67] in the form of loans on the same footing as other nonbusiness investments, the Tax Court claimed that the rationale indicated that the relationship between the taxpayers and the brokerage firm was not one of debtor and creditor. The *Meyer* court concluded that the loss was attributable to a transaction entered into for profit and therefore was an ordinary deduction under §165(c)(2).

Comment: The result seems jarringly inconsistent with any concept of consistency: if the taxpayers had obtained the stock and then lost it, its loss would have been a capital loss. The IRS appears to have made this argument, however, and nonetheless lost.

In *Exchange Enterprises of Salt Lake, Inc. v. Commissioner*,[68] the petitioner, a barter exchange, was not entitled to a bad debt deduction on account of debit balances in members' accounts, because: (1) there was no debtor-creditor relationship between the members and the exchange, (2) the exchange was not a guarantor of the members' debit balances, (3) the exchange had no basis in the debit balances, and (4) inactive accounts with debit balances were to the detriment of all the members of the exchange.

A quasi-contractual debt should not be precluded from coming within §166, just because it has not been reduced to judgment.[69] Similarly, a debt which arose by way of subrogation should be deductible under §166 when it becomes worthless.[70]

However, in *Thompson v. Commissioner*,[71] the Ninth Circuit disregarded the type of remedy granted by "blue sky" laws to an investor in a limited partnership in determining whether an unrecovered investment was a debt for §166 purposes (and disallowed the claimed bad debt deduction). One of the grounds for the court's decision was that the result under §166 should be uniform among the states.

Note: It is not clear from the *Thompson* opinion if the result would have been different if the liability had rested on generally applicable principles of common law (e.g., fraud and deceit). However, a judgment obtained declaring the existence of such a debt would probably have sufficed.[72] In *Kliks v. United States*,[73] the district court held that a liability arising from a wrongful conversion gave rise to a bad debt deduction. There, the taxpayer pursued legal remedies, but it is not stated whether a judgment was obtained. Nevertheless, the fact of liability seems to have been conceded insofar as the taxpayer received partial payment. In *Delta Plastics Co. v. Commissioner*,[74] the Tax Court seemed willing to inquire whether the facts established the liability of a shareholder for restitution of dividend payments under Ohio law, but the record before the court did not establish the elements of such liability. *Thompson* is echoed in *Travis v. Commissioner*,[75] discussed below, in which the Sixth Circuit refused to require clear enforceability under local law for purposes of accrual of income.

In contrast to establishing a taxpayer-creditor's right to a fixed and determinable sum of money by application of a legal principle, such as by contribution or subrogation, it is generally accepted that a bona fide debt for §166 purposes does not arise where one voluntarily chooses to pay another's debt, without any legal obligation to do so and without a reasonable expectation of repayment.[76] Such payments are usually characterized as gifts or capital contributions. However, where business judgment mandates the payment of another's debts that are secured by the payor's property, this type of "involuntary" payment has supported a subsequent §166 deduction.[77]

Although the "voluntary" payment of another's obligation similarly fails to qualify for loss treatment under §165,[78] the item may be deductible under §162 as an ordinary and necessary business expense, e.g., where the taxpayer makes the payment to protect his creditworthiness or business reputation.[79] In *Lutz v. Commissioner*,[80] a taxpayer assumed and paid the debts of three controlled corporations in order to protect his credit rating as a broker of agricultural products and to maintain his license as a commission merchant. The Fifth Circuit held that the

[66] *See Lewellyn v. Elec. Reduction Co.*, 275 U.S. 243 (1927).

[67] The legislative history does not really bear out the court's claim: the impetus was a desire to prevent abuses of writing off loans to friends and relatives rather than a desire to achieve consistency for its own sake. H.R. Rep. No. 2333, 77th Cong., 2d Sess. at 76 (1942). For example, a profit motive generally is not required for a valid bad debt deduction. See discussion at IV.D., and V.C., below.

[68] T.C. Memo 1987-414.

[69] *See Conley v. Commissioner*, T.C. Memo 1977-406.

[70] Rev. Rul. 69-411; *Rude v. Commissioner*, 48 T.C. 165 (1967).

[71] 235 F.2d 599 (9th Cir. 1956).

[72] *See Hardy v. Commissioner*, 54 T.C. 1194 (1970); *Guggenheimer v. Commissioner*, 8 T.C. 789 (1947).

[73] 66-1 USTC ¶9199 (D. Ore. 1965).

[74] 54 T.C. 1287 (1970).

[75] 406 F.2d 987 (6th Cir. 1969).

[76] *Plante v. Commissioner*, T.C. Memo 1997-386 (shareholder's cancellation or forgiveness of debt owed by shareholder's closely held corporation is contribution to corporation's capital), *aff'd*, 168 F.3d 1279 (11th Cir. 1999); *Estate of Acheson v. Commissioner*, T.C. Memo Op. Dkt. 2712 (1944), *aff'd*, 155 F.2d 369 (5th Cir. 1946); *Putnam v. Commissioner*, 352 U.S. 82 (1956).

[77] *Martin v. Commissioner*, 38 T.C. 188 (1962), *acq.*, 1963-1 C.B. 4. For other cases focusing on the involuntary aspects, see *Wilson v. Commissioner*, 40 T.C. 543 (1963); *Dobyns-Taylor Hardware Co., Inc. v. United States*, 278 F. Supp. 538 (E.D. Tenn. 1967); *Lazynski v. United States*, 202 F. Supp. 785 (E.D. Wisc. 1962); *Justice Steel, Inc. v. Commissioner*, T.C. Memo 1980-466.

[78] *Putnam v. Commissioner*, 352 U.S. 82 (1956). *But see Stamos v. Commissioner*, 22 T.C. 885 (1954) (before §162(f)); *Medeiros v. Commissioner*, 77 T.C. 1255 (1981).

[79] *Milbank v. Commissioner*, 51 T.C. 805 (1969), *acq.*, 1970-2 C.B. xx; *Estate of Avery v. Commissioner*, T.C. Memo 1969-64. *But see Justice Steel, Inc. v. Commissioner*, T.C. Memo 1980-466 (corporation denied §162 deduction on payment of shareholders' obligation where business of corporation was not related to shareholder's business or investment in which debt was incurred); *Greenspan v. Commissioner*, T.C. Memo 1980-33 (taxpayer's reimbursement of alleged losses suffered by relatives on erroneous sale of bonds not deductible under §162).

[80] 282 F.2d 614 (5th Cir. 1960).

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taxpayer was permitted a §162 deduction in paying such obligations, distinguishing *Welch v. Helvering*[81] on its facts.

3. Unenforceable Obligations; Executory Contracts

The relationship of debtor and creditor requires that there be an enforceable obligation to pay an amount of money.[82] Such relationship may be established even where there is uncertainty as to the amount and the time for payment.[83] There is no debt for §166 purposes, however, when the debtor's obligation to pay money: (1) does not come into existence until the happening of a contingency (of the "objective" type) that has not occurred[84] or (2) has been extinguished by a contingency that has occurred.[85] Similarly, there is no debt if the underlying contract is void[86] or lacks valid consideration.[87]

In seeking to establish deductions for worthless obligations, taxpayers have argued that the government may not challenge their position on the basis of personal defenses available to the debtor so as to render his promise to pay void or voidable. This argument was rejected in *Harriman v. Commissioner*,[88] which denied a bad debt deduction for a usurious loan that was unenforceable under state law.

Comment: The fact that an obligation is void or voidable under state law, thus not a "debt" under §166, does not foreclose a deduction by application of an alternative theory. For example, in *Tharp v. Commissioner*,[89] the Tax Court held that because an unenforceable obligation to pay is not a "debt" for §166 purposes, a taxpayer was not precluded from claiming a loss on the same transaction under §165.[90]

In *Travis v. Commissioner*,[91] the Sixth Circuit held that contracts to provide dance lessons which were of doubtful enforceability under local law, were nonetheless eligible to be written off under §166 (in the form of additions to a bad debt reserve). In the same case the court held that income under the contracts must be accrued notwithstanding the doubts as to enforceability, and that disallowing a bad debt reserve would have been a harshly inconsistent result. Both results may have been affected by the fact that the debtors were usually unsophisticated and generally assumed their obligations to have been binding regardless of performance by the creditor.

Despite the requirement of enforceability, Reg. §1.166-1(c) provides that a debt arising out of the receivable of an accrual method taxpayer is deemed to be an enforceable obligation to the extent that the debt has been included in income, notwithstanding its nonenforceability under local law.

4. The Taxpayer Must Be the Creditor

a. General Rule

A taxpayer/creditor may receive a bad debt deduction only if the debt is owed to him.[92]

b. Notes Discounted on Recourse Basis

Where accounts or notes receivable are discounted by the taxpayer without recourse, they are no longer considered to be the taxpayer's assets and therefore are not deductible by him upon becoming worthless. From 1966 until the 1986 repeal of the Reserve Method, §166 contained rules allowing a dealer in property a reserve for bad debts with respect to assigned debts on which the assignee had recourse against the dealer as a guarantor, endorser, or indemnitor. Before 1966, a sharp conflict of authority developed between the Tax Court and the Appellate courts over whether such assigned debts and notes could be considered in determining a reasonable addition to the reserve of the assignor for the current year.[93]

5. Debts Worthless When Made

a. Poor Financial Condition of Debtor

A bona fide debtor-creditor relationship is not established for §166 purposes if a voluntary loan giving rise to a debt was worthless when created or acquired.[94] Therefore, loans made to an insolvent debtor are not debts for tax purposes, but instead are generally characterized as capital contributions or gifts.[95] There are other possibilities. For example, in *Garrett v. Commissioner*,[96] the taxpayers made payments to a contractor for their residence that exceeded the contract price, and tried to deduct the excess as a nonbusiness bad debt. The court held that the payments were, in substance, simply an additional cost for acquisition of the residence.

If a receivable is transferred, worthlessness at the time of the transfer may prevent the transferee from claiming a bad debt deduction, because the transferee generally takes a zero basis in the receivable. This is true even for a transfer between

[81] 290 U.S. 111 (1933).

[82] Reg. §1.166-1(c).

[83] *Birdsboro Steel Foundry & Mach. Co. v. Commissioner*, 3 F. Supp. 640 (Ct. Cl. 1933).

[84] *Tenn. Prod. & Chem. Corp. v. United States*, 297 F.2d 529 (6th Cir. 1962). *See Irbco Corp. v. Commissioner*, T.C. Memo 1966-67; *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971).

[85] *Watts v. Commissioner*, T.C. Memo 1968-183 (disbursements by lawyer under contingent-fee arrangements). See also the following cases in which the obligations were contingent on the success or profits of a business venture or law suit: *Bercaw v. Commissioner*, 165 F.2d 521 (4th Cir. 1948); *Ewing v. Commissioner*, 20 T.C. 216, *aff'd*, 213 F.2d 438 (2d Cir. 1954); *Clark v. Commissioner*, 18 T.C. 780, *aff'd per curiam*, 205 F.2d 353 (2d Cir. 1953); *Barnard v. Commissioner*, T.C. Memo 1963-338; and *Estate of Paine v. Commissioner*, T.C. Memo 1963-275.

[86] *See Simon v. Commissioner*, T.C. Memo 1955-324.

[87] See *Allen v. Commissioner*, 12 T.C.M. 994 (1953).

[88] T.C. Memo 1967-190.

[89] T.C. Memo 1972-10 (usurious loan).

[90] For other examples, see III.A.1., above.

[91] 406 F.2d 987 (6th Cir. 1969).

[92] *Anderson v. Commissioner*, 5 T.C. 482 (1945), *aff'd*, 156 F.2d 591 (2d Cir. 1946).

[93] *See* cases cited in H.R. Rep. No. 11782, 89th Cong., 2d Sess. (1966), N.2, 1966-2 C.B. 905, 906.

[94] *Wilkins Pontiac v. Commissioner*, 298 F.2d 893 (9th Cir. 1961), *rev'g* 34 T.C. 1065 (1960); *Foster Frosty Foods, Inc. v. Commissioner*, 39 T.C. 772 (1963), *rev'd*, 332 F.2d 230 (10th Cir. 1964); *Mike Persia Chevrolet, Inc. v. Commissioner*, 41 T.C. 198 (1963); *see also* Rev. Rul. 62-214.

[95] *Shiman v. Commissioner*, 60 F.2d 65 (2d Cir. 1932). *See Edwards v. Allen*, 216 F.2d 794 (5th Cir. 1954); *Wachovia Bank & Trust Co. v. United States*, 288 F.2d 750 (4th Cir. 1961); *W.F. Young, Inc. v. Commissioner*, 120 F.2d 159 (1st Cir. 1941); *Hunt v. Commissioner*, T.C. Memo 1989-335 (taxpayer's loans to children were bona fide indebtedness before children's insolvency but gifts after taxpayer had knowledge of their insolvency). The genesis of this principle can be found in the Supreme Court's decision in *Eckert v. Burnet*, 283 U.S. 140 (1931). *See Mountain Wholesale Co. v. Commissioner*, 17 T.C. 870 (1951) (partially worthless when acquired).

[96] 39 T.C. 316 (1962). *But see Martin v. Commissioner*, 38 T.C. 188 (1962) (payment compelled by possible loss of residence).

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unrelated parties, if the transfer is of multiple assets and basis is allocable in proportion to fair market value.

In *Fox v. Commissioner*,[97] a partnership attempted to write off certain receivables at face value which it had acquired after liquidating a controlled corporation. For purposes of determining gain on the corporate liquidation, the receivables had been valued at face. The claimed bad debt deductions were disallowed because the taxpayers failed to prove that, as of the date of the liquidating distribution, the receivables had value in excess of the amount eventually collected.[98]

One recurring fact pattern in this area involves advances that are made under bleak circumstances, i.e., advances to an insolvent debtor in hope of recovering some portion of prior loans. Such loans or advances have usually been characterized as contributions to capital or gifts and not as loans.[99]

The amount of the deduction allowed in the case of a continuous open account debt in such circumstances depends on whether those (partial) repayments that have been made are applied against the earlier advances (the debt) or the later ones (the capital contributions).[100]

In the event bad debt deduction treatment is unlikely, the taxpayer might try to deduct unrecovered advances as business expenses.[101] If both avenues are blocked, §165 loss treatment may be available in the year that such advances are made, provided the losses are reported in the proper year and within the applicable period of limitation. For example, in *Reading Co. v. Commissioner*,[102] the taxpayer was unsuccessful in claiming deductions for unrecovered advances under §166, §165, and §162. Moreover, the Third Circuit found that the loss occurred in a year before that claimed. In rejecting the §162 argument, the court cited *Welch v. Helvering*,[103] which held that "voluntary" advances made to create goodwill and business reputation are capital in nature. However, Welch has been distinguished,[104] and it is clearly settled that a legal obligation is not required in order for a payment to be deductible as a §162 business expense provided it is "ordinary and necessary."[105] In appropriate circumstances, the creditor might try to claim a §212 deduction.[106] In general, the taxpayer's main difficulty is to show that the advances were related to his trade or business[107] or were to protect the value of his investment above and beyond benefiting the corporation. Further, in the case of a §212 deduction or a §162 deduction based on one's trade or business as employee, the benefit of the deduction may be substantially reduced by the alternative minimum tax and limitations on itemized deductions.

Comment: The prudent course for a creditor to follow when faced with the necessity of making further advances to a debtor in financial straits is to have such obligations secured or given priority status in the event of default.

When priority status is practical, it should successfully counter the argument that the new loan had no value when made. It may be impractical, as there is often an institutional lender who not merely prevents priority but, in fact, demands subordination.[108]

Comment: Before making new advances to avoid issuing such funds to an insolvent obligor, a reorganization may also be an advisable alternative. If only a single major creditor is involved, it may be reasonably practicable.

b. Debts Arising by Operation of Law

The above rule as to expectation of repayment at time of issue, is generally inapplicable in analyzing debts arising by operation of law. If a taxpayer voluntarily makes a loan, yet the loan is worthless when made, one may infer that the taxpayer did not in fact expect repayment. If the debt arises by operation of law, no such inference is generally possible.

For example, in Rev. Rul. 69-411,[109] a beneficiary of an estate was permitted a §166(d)(1) nonbusiness bad debt deduction for the amount of estate taxes properly charged under §2206 against the recipient of the decedent's insurance proceeds. By paying all estate taxes out of his share of the estate, the beneficiary, through subrogation, became the creditor of the recipient of the insurance proceeds who was then insolvent. The IRS ruled in part, that where a debt is created involuntarily, the fact that there was no possibility of repayment does not bar a §166 deduction.

Similarly, a guarantor is permitted a deduction even though the obligation of the primary debtor to repay him may be worthless at the time such obligation "arises," i.e., upon dis-

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[97] 50 T.C. 813 (1968), *aff'd per curiam*, 70-1 USTC ¶9373 (9th Cir. 1970).

[98] *See Liberty Nat'l Bank & Trust Co. v. Commissioner*, T.C. Memo 1979-74 (1979), *aff'd on other issue*, 650 F.2d 1175 (10th Cir. 1981). *Cf. Myers v. Commissioner*, 42 T.C. 195, 208 (1964), *acq.*, 1964-2 C.B. 6 (shareholder advance to insolvent corporation pursuant to pre-existing contract qualified as debt).

[99] *Davis v. Commissioner*, 69 T.C. 814, 835–37 (1978); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980); *United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967), *rev'g* 64-2 USTC ¶9691 (E.D. Tex. 1964). *See also Troop Water Heater Co. v. Bingler*, 234 F. Supp. 642 (W.D. Pa. 1964); *United Eng'rs & Constructors, Inc. v. Smith*, 59-1 USTC ¶9322 (E.D. Pa. 1959); *Estate of Dunn v. Commissioner*, T.C. Memo 1990-401; *Leuthold v. Commissioner*, T.C. Memo 1987-610; *Davis v. Commissioner*, T.C. Memo 1965-134; *Gilford v. Commissioner*, T.C. Memo 1965-14; *Scotland Mills, Inc. v. Commissioner*, T.C. Memo 1965-48; *Westin v. Commissioner*, T.C. Memo 1987-238. *But see Oatman v. Commissioner*, T.C. Memo 1982-684 (incarcerated brother); *Sooy v. Commissioner*, 10 B.T.A. 493 (1928) (dying brother), *aff'd on other grounds*, 40 F.2d 634 (9th Cir. 1930). *See also Rogers v. United States*, 58 F. Supp.2d 1235 (D. Kan. 1999), *aff'd*, 281 F.3d 1108 (10th Cir. 2002) (purported loan by S corporation that owned baseball club to its 50% shareholder who was heavily indebted was recharacterized as stock redemption).

[100] *See C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649 (1968) (court reviewed).

[101] *See Myers v. Commissioner*, 42 T.C. 195 (1964) (alternative holding).

[102] 132 F.2d 306 (3d Cir. 1942); *Tigrett v. United States*, 2005-1 USTC ¶50,310 (W.D. Tenn. 2005) (taxpayer unsuccessful under §166, §165, and §162).

[103] 290 U.S. 111 (1933).

[104] *Lutz v. Commissioner*, 282 F.2d 614 (5th Cir. 1960), *distinguishing Welch v. Helvering*, 290 U.S. 111 (1933), *aff'g* 63 F.2d 976 (8th Cir. 1933).

[105] *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930); *Hopkins v. Commissioner*, 30 T.C. 1015, 1025 (1958), *acq.*, 1959-1 C.B. 4, *vac'd and rem'd on another ground*, 271 F.2d 166 (6th Cir. 1959).

[106] *But cf. Rand v. Commissioner*, 35 T.C. 956 (1961); *Balsam Trust v. Commissioner*, 3 T.C.M. 1204 (1944).

[107] The IRS will not issue rulings on whether a taxpayer is engaged in a trade or business. This does not include a request for a ruling that relies on a representation from a taxpayer that the taxpayer is or is not engaged in a trade or business, or a request for a ruling that relies on factual information provided by the taxpayer evidencing the active conduct of a trade or business (for example, a request that relies on the taxpayer's active conduct of a trade or business as evidenced by financial statements provided by the taxpayer). Rev. Proc. 2026-3, §3.01(40).

[108] *See Meinig Co. v. Commissioner*, 9 T.C. 976 (1947), *acq.*, 1948-1 C.B. 2.

[109] *See Martin v. Commissioner*, 38 T.C. 188 (1962), *acq.*, 1963-1 C.B. 4.

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charge of the guarantee obligation.[110] In *Putnam v. Commissioner*, the Supreme Court stated that the guarantor's payment does not create a new debt, but preserves the old debt, "merely substituting the guarantor for the creditor." If, as is usually the case, the debtor cannot pay, the "value is lost at the instant that the guarantor pays the creditor." In truth, the value is normally lost before the creditor requires the guarantor to pay. Nonetheless, according to the Supreme Court, it "becomes" worthless in the guarantor's hands.[111] The Court's discussion may simply be rationalization of what is clearly a sensible result. Although the Court's rationale in *Putnam* arguably required the existence of subrogation under local law, subsequent cases have applied *Putnam* even though there was no such subrogation.[112]

The deduction may be denied if, at the time the taxpayer guaranteed the obligation, it was probable that the original debtor would default on the primary obligation, so that the process of repayment to the guarantor was prospectively worthless. Indeed, the extension of a guarantee under such circumstances would probably be treated as a contribution of capital or a gift by the guarantor to the debtor.[113]

6. Shareholder-Held Debt Distinguished from Equity

a. Nature of the Problem

A prerequisite for a bad debt deduction is not merely that a "debt" exists under state law, but also that it be regarded as debt under federal tax law. If debt is held by an entity related to the debtor, the debt is frequently characterized for income tax purposes as a contribution to capital rather than as a debt.

Characterization of certain advances to a corporation as debt or equity is important not only for bad debt purposes, but also in other areas of the tax law. Some examples are:

(1) Whether payments designated as "interest," usually deductible under §163, are actually nondeductible dividend distributions;

(2) Whether loan repayments by a corporation can be recovered tax-free to the extent of debt basis and, where indebtedness is retired, whether amounts received in excess of basis qualify for capital gain treatment under §1271; or, instead, are treated as distributions made with respect to stock and taxable as dividends to the extent of earnings and profits;[114]

(3) Whether an S corporation's "debt" can be recharacterized as a second class of stock and cause an involuntary termination of an election under Subchapter S;[115] and

(4) Where property is transferred to a controlled corporation in exchange for notes, failure to qualify as debt may result in a carryover basis for assets acquired by the corporation.[116]

Because the same general criteria apply in all of these contexts, the body of applicable case law is very extensive.[117]

b. Factual Nature of Resolution

Tax Court decisions are subject to the same standards of appellate review as district court decisions in nonjury civil actions.[118] Accordingly, the Tax Court's conclusions on questions of law are reviewed de novo but its findings of fact may be set aside only if they are clearly erroneous.[119] However, distinguishing between legal and factual issues is difficult and where the question at issue requires the court to marshal the pertinent facts and apply a fact-dependent legal standard the appropriate standard of review may be for abuse of discretion, with the appellate court reversing a ruling if that ruling was based on an erroneous view of the law or on a clearly erroneous assessment of the evidence.[120]

The Federal,[121] Second,[122] Third,[123] Fourth,[124] Sixth,[125] and Ninth[126] Circuits consider the debt-equity question as primarily a question of fact. However, the Fifth Circuit views the question as one primarily of law[127] subject to de novo review and the D.C. Circuit applies an abuse of discretion standard reversing if the decision was based on an erroneous view of the law or on a clearly erroneous assessment of the evidence.[128]

Whether resolution of the debt-equity issue is viewed as a question of fact or of law, all relevant circumstances pertinent to the transaction are to be considered. Courts have identified and used numerous factors as aids in deciding whether an in-

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[110] *See Putnam v. Commissioner*, 352 U.S. 82 (1956). *See also Shiman v. Commissioner*, 60 F.2d 65 (2d Cir. 1932).

[111] *Putnam v. Commissioner*, 352 U.S. 82, 88–89 (1956).

[112] *Horne v. Commissioner*, 523 F.2d 1363 (9th Cir. 1975); *Stratmore v. United States*, 420 F.2d 461, 465 (3d Cir. 1970).

[113] *See, e.g., Brown Corp. of Ionia, Inc. v. Commissioner*, T.C. Memo 1982-683 (corporation that advanced funds to sister corporation to meet obligations under stock purchase agreement not entitled to bad debt deduction, where sole shareholder who controlled both corporations did not have intent that sister corporation repay such sum).

[114] *See* §301(c).

[115] Status as equity does not automatically result in status as a second class of stock. *See* Reg. §1.1361-1(l). In addition, the regulations provide a "straight debt safe harbor," under which S corporation debt that meets certain requirements will not be treated as stock. *See* Reg. §1.1361-1(l)(5). See generally 730 T.M., *S Corporations: Formation and Termination*.

[116] E.g., if the transaction would be described in §351; however, for transactions after June 8, 1997, if the asserted debt were reclassified as equity that was "nonqualified preferred stock" within the meaning of §351(g), the transferor would recognize gain and the corporation would be entitled to a corresponding increase in basis.

[117] Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369 (1971).

[118] §7482(a)(1).

[119] E.g., *Estate of Godley v. Commissioner*, 286 F.3d 210, (4th Cir. 2002).

[120] *See Cooter & Gell v. Hartmax Corp.*, 496 U.S. 384, 401 (1990).

[121] *Elec. Modules Corp. v. United States*, 695 F.2d 1367 (Fed. Cir. 1982).

[122] *Gilbert v. Commissioner*, 262 F.2d 512 (2d Cir. 1959). *See Becker v. IRS*, 286 B.R. 250 (S.D.N.Y. 2002) (citing *Gilbert*).

[123] *Diamond Bros. Co. v. Commissioner*, 322 F.2d 725 (3d Cir. 1963).

[124] *Piedmont Minerals Co. v. United States*, 429 F.2d 560 (4th Cir. 1970).

[125] *E.g., Smith v. Commissioner*, 370 F.2d 178 (6th Cir. 1966); *Indmar Prods. Co. v. Commissioner*, 444 F.3d 771 (6th Cir. 2006). However, at least one Sixth Circuit opinion has suggested it should be considered a question of law. *See, e.g., Austin Village, Inc. v. United States*, 432 F.2d 741 (6th Cir. 1970) (no need to decide whether to overrule prior precedents, because even if question of fact, lower court erred as matter of law in failing to apply proper criteria).

[126] *Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984); *O.H. Kruse Grain & Milling v. Commissioner*, 279 F.2d 123 (9th Cir. 1960).

[127] *E.g., Tex. Farm Bureau v. United States*, 725 F.2d 307 (5th Cir. 1984).

[128] *Cerand & Co. v. Commissioner*, 254 F.3d 258 (D.C. Cir. 2001).

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strument constitutes equity or debt.[129] Many of the factors were listed in *Dixie Dairies Corp. v. Commissioner*:[130]

(1) names given to certificates evidencing the indebtedness,

(2) presence or absence of a fixed maturity date,[131]

(3) source of payments,[132]

(4) right to enforce payments,

(5) participation in management as a result of the advances,[133]

(6) subordination to other creditors,

(7) intent of the parties to create a debt,

(8) whether the purported creditors are also stockholders,

(9) ratio of purported debt to equity,

(10) ability of debtor to otherwise obtain credit from outside sources,[134]

(11) use to which the advances were put,

(12) failure of debtor to repay, and

(13) risk involved in making advances.

Many of the factors identified by the courts in resolving this issue may be irrelevant to a particular fact pattern. Further, the weight, if any, assigned to a particular factor in reaching a final decision varies, and no single factor is controlling.[135] The factors are used only to guide a court in answering the basic question as to whether the parties intended to create a bona fide debtor-creditor relationship, in a manner comporting with economic reality, and in which the creditor was reasonable in his expectation of repayment.[136] Whether or not the advance had a business purpose or a tax avoidance motive is generally of secondary importance in arriving at the critical fact-finding.[137] However, the doctrines of business purpose or tax avoidance motive may be critical if the creation of the debt was used solely to obtain a double deduction.[138]

Although the cases consistently use such phrases as "intention to make a debt," the test is primarily, if not exclusively, an objective one, based upon all facts and circumstances, with the subjective intent of the parties to create a debt used only as a

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[129] *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976); *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969); *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974); *Thompson v. Commissioner*, 73 T.C. 878 (1980); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980); *LaStaiti v. Commissioner*, T.C. Memo 1980-547; *Stoneking v. Commissioner*, T.C. Memo 1985-532; *Leuthold v. Commissioner*, T.C. Memo 1987-610; *Sigmon v. Commissioner*, T.C. Memo 1988-377; *Miller v. Commissioner*, T.C. Memo 1989-153 (facts-and-circumstances test revealed the bulk of taxpayer's initial investment in wholly-owned corporation was a loan and not stock, for inter alia, taxpayer himself treated notes as indebtedness). *See J&W Fence Supply Co. v. United States*, 99-1 USTC ¶50,396 (S.D. Ind. 1999) (loans made to company that was 49% owned by sole shareholder of lender did not constitute bona fide debt, where (1) parties did not enter into written agreement, (2) there was no security for loan, and (3) borrower was thinly capitalized), *reh'g denied*, 85 AFTR2d 2000-337 (S.D. Ind. 1999), *aff'd*, 230 F.3d 896 (7th Cir. 2000); *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579 (1991) (thin capitalization considered strong indication of equity only if: (1) debt to equity ratio was initially high; (2) parties realized that it would likely go higher; and (3) substantial portions of these funds were used for purchase of capital assets and for meeting expenses needed to commence operations); *Owens v. Commissioner*, T.C. Memo 2017-157 (using borrowed funds to hire additional employees and purchase more equipment and vehicles for everyday business operations were indicative of bona fide indebtedness); *Shedd v. Commissioner*, T.C. Memo 2000-292) (advanced funds used to meet daily needs of corporation are indicative of bona fide indebtedness); *In re Rhea*, 97-1 USTC ¶50,451 (Bankr. S.D. Ala. 1997) (debt classification denied because of: (1) lack of supporting loan documentation, (2) failure to report advances on tax returns, (3) failure to charge interest, and (4) failure to provide security). The D.C. Circuit, in *Cerand & Co. v. Commissioner*, 254 F.3d 258 (D.C. Cir. 2001), remanded the case to the Tax Court because the Tax Court had failed to consider the fact that the shareholder/creditor had for several years reported interest income with respect to the obligation when determining that the instrument was equity. On remand, the Tax Court, in *Cerand & Co. v. Commissioner*, T.C. Memo 2001-271, held that the obligation was equity because of the lack of intent evidenced by the manner in which repayment was made and the lack of objective evidence of debt. *See also Am. Metallurgical Coal Co. v. Commissioner*, T.C. Memo 2016-139 (court applied factors and determined that parties' sole objective was to work together to create transaction that reduced their respective tax liabilities, rather than establish strict debtor-creditor relationship; parties' contract was equity investment).

[130] 74 T.C. 476, 493 (1980). *See Lane v. United States*, 742 F.2d 1311 (11th Cir. 1984) (lists 13 factors used by Eleventh Circuit; includes source of interest payments and does not include risk involved in making advances); *A.R. Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970) (lists 11 factors considered by Ninth Circuit in debt-versus-equity analysis, essentially the same as those listed in *Dixie Dairies*); *O.H. Kruse Grain & Milling Co. v. Commissioner*, 279 F.2d 123 (9th Cir. 1960).

[131] *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987) (absence of fixed maturity date shows that repayment was tied to fortunes of business); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (having maturity date in contract indicates fixed obligation to repay, characteristic of debt obligation); *Owens v. Commissioner*, T.C. Memo 2017-157 (even though taxpayer chose not to enforce repayment by maturity date, obligation still considered debt and not equity); *Bishop v. Commissioner*, T.C. Memo 2013-98 (same); *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo 2012-269.

[132] *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987) (if source of repayment dependent on earnings, then it is indicative of equity); *Owens v. Commissioner*, T.C. Memo 2017-157 (as *practical* matter, taxpayer's ability to be repaid would be harmed if borrower's business failed, but as *legal* matter taxpayer's advances were secured by deed of trust on property, and borrower was obliged to pay back advances plus interest; repayment amount considered debt and not equity); *Flint Indus., Inc. v. Commissioner*, T.C. Memo 2001-276 (if circumstances make it impossible to estimate when advance will be repaid because repayment depends on condition precedent, equity investment is indicated); *Provost v. Commissioner*, T.C. Memo 2000-177.

[133] *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987); *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579 (1991); *Provost v. Commissioner*, T.C. Memo 2000-177.

[134] *See Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579 (1991); *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987); *Owens v. Commissioner*, T.C. Memo 2017-157.

[135] *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *PK Ventures v. Commissioner*, T.C. Memo 2006-36; *Ellinger v. United States*, 470 F.3d 1325 (11th Cir. 2006) (court not bound to consider all 13 *Lane* factors, only those relevant to transaction).

[136] *See Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367 (1973); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957); *Novoselsky v. Commissioner*, T.C. Memo 2020-68 (repayment was contingent on uncertain outcome of litigation; funds not "advanced with reasonable expectations of repayment"); *LaStaiti v. Commissioner*, T.C. Memo 1980-547.

[137] *See Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), *rev'g* 21 T.C. 513 (1954); *Nassau Lens Co., Inc. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962). *Cf. Knetsch v. United States*, 364 U.S. 361 (1960). *But see J.S. Biritz Constr. Co. v. Commissioner*, 387 F.2d 451 (8th Cir. 1967); *Uneco, Inc. v. United States*, 75-1 USTC ¶9283 (D. Neb. 1975), *rev'd*, 532 F.2d 1204 (8th Cir. 1976).

[138] *See Am. Processing & Sales Co. v. United States*, 371 F.2d 842, 849–850 (Ct. Cl. 1967).

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single factor.[139] Of course, if it is shown that the debtor subjectively intended not to pay, that fact would be determinative.[140]

In *Uneco, Inc. v. United States*,[141] the taxpayer, realizing that a diversification of its business activities was necessary in order to survive economically, formed and acquired three separate corporations to attain such status. It then made advances to these corporations, and when the corporations failed to repay the advances in full, the taxpayer claimed bad debt deductions through additions to its bad debt reserve. After the taxpayer later filed for bankruptcy proceedings, the referee in bankruptcy agreed with the IRS, holding that although the actual intent of the parties was to create a debtor-creditor relationship, an objective analysis of the facts indicated that the transactions were contributions to capital rather than debts. The district court reversed the referee's order and held that the subjective intent of the parties to create a debtor-creditor relationship controlled, provided the loan had a business purpose and was not principally motivated by tax avoidance. After commenting that the standard employed by the district court was incorrect, the Eighth Circuit cited several objective facts, such as the undercapitalization of the affiliates, the unwillingness of outsiders to loan monies to the affiliates, the lack of a security requirement by the taxpayer for the replacement of the loans, and the high debt-to-equity ratio of each affiliate, as indicating that the advances were capital contributions instead of bona fide loans and held that the findings of the referee were not clearly erroneous. Accordingly, the decision of the district court was reversed.

However, in a situation where the objective facts do not clearly demonstrate the intent of the parties, consideration of subjective intent may become a key factor.[142] For example, in *Johnson v. Commissioner*,[143] the Tax Court held that certain advances clearly intended by the parties as loans were bona fide debts inasmuch as the parties had maintained a reasonable expectation that the loan agreements would be repaid and that such expectation was not without economic reality. This was so even though the obligations were not evidenced by a note, there was no security for repayment, no provision for interest, no fixed date for repayment, and a disinterested third party would not have advanced the same amount of money under the same terms.

In *Mills v. IRS*,[144] a corporation was liquidated without full payment of open accounts owed to an affiliate. The affiliate deducted the shortfall as a bad debt. Although the accounts were not evidenced by written agreements, the Fourth Circuit held for the taxpayer. Adopting a view of related companies as an integrated enterprise, the court held that the absorption of the loss by the parent was necessary to maintain the stability of the entire enterprise and its financial reputation with minority shareholders and outside creditors.[145]

In *J&W Fence Supply Co. v. United States*,[146] the Seventh Circuit discussed in dicta whether the lack of documentation of a debt mandates that an investment be deemed equity. The district court had held that loans made to a company that was 49% owned by the sole shareholder of the lender did not constitute a bona fide debt where: (1) the loan was not supported by documentation, (2) there was no security for the loan, and (3) the borrower was thinly capitalized. On the appeal of a separate issue, the Seventh Circuit responded to the IRS's contention that an investment must be deemed equity if it is not documented as debt, and suggested that an investment could be deemed debt if it is not documented as equity. The Seventh Circuit noted that in this instance, if the investment was equity, the lender would have owned 95%, not 49%, of the borrowing company, and that such a change in control was not reflected in the corporate records. The Seventh Circuit also noted the fact that the lender, which used the accrual method of accounting, booked interest due from the borrowing company (even though it was never received) and paid tax on that amount supported the assertion that the transaction was equity rather than debt. The court declined to comment further on the issue, noting that it was not the subject of the appeal from the district court.

Generally, the time for making a debt or equity classification of a particular transaction is at its inception.[147] However, the initial characterization of a particular investment as debt is not permanent and the same advance may be treated as debt for several years and then treated as equity at a later date.[148] Accordingly, the test is applied in the year in question.[149] Of course, if an advance is initially characterized as equity, it will not subsequently convert itself into debt, unless there is a recapitalization or the equivalent.

c. Section 385

Section 385 of the Internal Revenue Code authorizes the IRS to promulgate regulations characterizing an investment in a corporation as debt or equity. Section 385(b) provides that such regulations shall set forth factors to be taken into account in making the debt-equity determination and lists five factors that may be included.

Although the courts have used an all-or-nothing approach in resolving debt-equity cases, fragmenting a transaction into part debt and part equity may be an effective way to settle a

[139] *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121 (4th Cir. 1969); *Dillin v. United States*, 433 F.2d 1097 (5th Cir. 1970); *S. P. Realty Co. v. Commissioner*, T.C. Memo 1968-156.

[140] *See United States v. Pomponio*, 429 U.S. 10 (1976).

[141] 532 F.2d 1204 (8th Cir. 1976), *rev'g and rem'g* 75-1 USTC ¶9283 (D. Neb. 1975).

[142] *Tyler v. Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969).

[143] T.C. Memo 1977-436.

[144] 840 F.2d 229 (4th Cir. 1988), *rev'g* T.C. Memo 1986-94.

[145] *Mills v. IRS*, 840 F.2d 229, at 234–35 (4th Cir. 1988). *But cf. Kean v. Commissioner*, 91 T.C. 575 (1988) (where recipients were in severe financial trouble and lender could not reasonably expect repayment, loans between related companies were not bona fide debts).

[146] 230 F.3d 896 (7th Cir. 2000).

[147] *Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967). See Bittker and Eustice, *Federal Taxation of Corporations and Shareholders*, 4th ed. ¶4.02.

[148] *See Plante v. Commissioner*, 168 F.3d 1279 (11th Cir. 1999), *aff'g* T.C. Memo 1997-386 (transfer to corporation's equity account of debt owed by corporation to its sole shareholder, where transfer was made by sole shareholder pursuant to sole shareholder's agreement to sell corporation to third party, was contribution to corporation's capital rather than bad debt); *Cuyuna Realty Co. v. United States*, 382 F.2d 298 (Ct. Cl. 1967) (original debt of subsidiary changed to equity); *Tampa & G.C.R.R. v. Commissioner*, 469 F.2d 263 (5th Cir. 1972) (same). *See Hutton v. United States*, 501 F.2d 1055 (6th Cir. 1974); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *Zilkha & Sons v. Commissioner*, 52 T.C. 607 (1969).

[149] *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). *But see* former Reg. §1.385-4 (status fixed at creation, but debt can later be reclassified as equity under the "second look" rule; however, equity cannot be converted into debt) (withdrawn July 6, 1983).

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close case before trial and would avoid the one winner — one loser effect of a court battle.[150] A 1989 amendment to §385 expanded the authority of the IRS to allow regulations that would characterize an investment in part as debt and in part as equity.[151] Any regulations issued under the 1989 amendment apply only to instruments issued after the date the IRS first provides public guidance as to the characterization of such instruments.[152]

The factors in the nonexhaustive list found in §385(b) are basically the same as those used by the courts, except that explicit recognition is given to the feature of convertible debt (i.e., into stock). This section was enacted in response to the tax treatment attendant to convertible debentures issued in corporate takeovers.[153] Nonetheless, the scope of §385 extends well beyond this issue.

Final and proposed regulations under §385 were issued and later withdrawn by the IRS with an explanation that they did not "fully reflect the position of the Treasury or the IRS on debt-equity matters."[154] In fact, the proposed regulations surfaced issues that had not been adequately considered, and generated substantial political pressure. Notwithstanding the 1989 amendment to §385, it is extremely doubtful that Treasury will attempt comprehensive debt-equity regulations in the foreseeable future.[155]

Thus, the case law in this area continues to be controlling.[156]

Section 385(c) provides that the characterization of an interest in a corporation as debt or equity at the time of its issuance generally is binding upon the issuer and on all holders of that interest. The characterization is not, of course, binding upon the IRS. Furthermore, a holder can dispute the characterization so long as he discloses on his return that he is treating the interest in a manner inconsistent with the issuer's characterization.

d. Capital Structure of Corporation

(1) Stock and Debt Held Pro Rata

Straight debt (as opposed to hybrid instruments) will rarely be held to be equity for tax purposes unless it is held proportionately to the stock. Conversely, an important factor supporting debt characterization is the presence of disproportionate ownership of purported debt and stock.

Where debt instruments issued in proportion to stockholdings are not freely transferable, the obligations strongly take on the appearance of equity.[157]

The courts have made some interesting and at times inconsistent observations in determining whether payments to shareholder-creditors are interest or dividends based on the payee-corporation's dividend policy. For example, if "dividends" are paid instead of "interest," it has been reasoned that the purported debt was stock because the logical conclusion would be that the corporation would have first retired outstanding high-interest debt.[158]

The absence of any formal resolutions declaring dividends does not bear much weight in establishing that payments of interest were not dividends. Indeed, the absence of formal dividend distributions has been an important factor in recharacterizing "interest" as dividends.[159] On the other hand, such reasoning was rejected in a case which upheld debt status to a thinly capitalized finance company which had borrowed sizeable amounts of money from an 85% stockholder.[160]

The need for special scrutiny in pro rata debt-equity situations is based further on the fact that controlling stockholders may be more willing to overlook the absence of interest payments or to decline to foreclose on the security where such action would impair the corporation's overall credit position.[161] It may also be inferred that if the business turned sour, the stockholders holding debt instruments would subordinate their debt to other creditors of the same class.[162]

This issue of proportionality frequently arises upon formation of a corporation where property is contributed for both stock and debt. Moreover, the step-transaction doctrine may be used to recharacterize a prior transfer of stock and a subsequent issuance of notes as simultaneous events.[163]

Although the courts have generally honored a taxpayer's decision to treat part of the funds advanced by him to his corporation as debt, where the facts otherwise support a bona fide indebtedness,[164] most courts have tended initially to look upon a pro rata debt-equity structure with skepticism, presumably on the basis that the prospects for repayment were at the risk of the business.[165]

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[150] In one case, the court did treat the obligation as being part debt and part equity. *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960).

[151] Pub. L. No. 101-239, §7208(a)(1).

[152] Pub. L. No. 101-239, §7208(a)(2).

[153] See S. Rep. No. 522, 91st Cong., 1st Sess. 17 (1969), 1969-3 C.B. 423, 510–19.

[154] 48 Fed. Reg. 31053 (July 6, 1983) (proposed withdrawal); T.D. 7920, 1983-2 C.B. 69 (actual withdrawal). The regulations were initially proposed on March 24, 1980 and were finalized on December 31, 1980. T.D. 7747, 45 Fed. Reg. 86459 (Dec. 31, 1980).

[155] Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7th ed. ¶4.02[8][a] (2000) ("reports of their life greatly exaggerated").

[156] For example, in Rev. Rul. 83-98, the IRS ignored §385 and its regulations in determining that adjustable rate convertible notes constituted equity for tax purposes. *See also Becker v. IRS*, 286 B.R. 250 (S.D.N.Y. 2002) (factors listed in §385(b) are relevant despite absence of regulatory guidance for determining debt-equity question).

[157] *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967); *Curry v. United States*, 396 F.2d 630 (5th Cir. 1968). Similarly, in *Rogers v. United States*, 58 F. Supp.2d 1235 (D. Kan. 1999), *aff'd*, 281 F.3d 1108 (10th Cir. 2002), the court recharacterized a purported loan by an S corporation that owned a baseball club to its 50% shareholder as a stock redemption. The court noted that the shareholder was heavily indebted, his only unencumbered asset was his stock in the corporation, the transaction was structured so that the shareholder would not have had the right to retain his stock by paying off the loan, and any amount the shareholder would have repaid would have reduced the amount that he was entitled to receive in exchange for his stock.

[158] *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

[159] *R.C. Owen Co. v. United States*, 180 F. Supp. 369 (Ct. Cl. 1960).

[160] *Jaeger Auto Fin. Co. v. Nelson*, 191 F. Supp. 693 (E.D. Wis. 1961).

[161] *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214 (Ct. Cl. 1968). *See also Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956). *Cf. O'Reilly v. Commissioner*, T.C. Memo 1968-291.

[162] *But see Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968) (where such an inference cannot be based merely on logic or supposition alone).

[163] *Nye v. Commissioner*, 50 T.C. 203 (1968), *acq.*, 1969-2 C.B. xxv.

[164] *See Rowan v. United States*, 219 F.2d 51, 55 (5th Cir. 1955); *Nassau Lens Co., Inc. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962).

[165] *E.g., Segal v. Commissioner*, 89 T.C. 816 (1987).

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Even where the stock and equity holdings are not held pro rata, the corporation's overall debt-equity ratio remains relevant.

(2) Thin Capitalization

"Thin capitalization" is an important factor in determining status as debt for tax purposes, especially where the debt-equity holdings are proportionate.[166] The courts, however, have not given consistent weight to this factor, nor are they in agreement as to what ratio of debt to equity is too thin.

Although the analysis employed under the thin capitalization concept could justify a reallocation of the "debt instruments" in question between debt and equity, the courts have generally used an all-or-nothing approach in determining debt-equity cases (such an approach may itself influence a court's decision).[167]

In *John Kelley Co. v. Commissioner*,[168] a case involving hybrid securities, the Supreme Court, presented with a four-to-one ratio of debt to stock, commented: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure."[169] After this decision was issued, many advisors concluded that a ratio of three- or four-to-one was a safe harbor.[170]

Such conclusions were unwise, because case law finds it nearly impossible to develop quantitative safe harbors. The Tax Court in *Gooding Amusement Co. v. Commissioner*[171] did much to destroy the reliance tax advisors had previously placed on a safe-harbor debt-equity ratio extrapolated from the *Kelley* case. Finding that there was no real intention to repay an obligation, the Tax Court recharacterized purported debt as equity despite a one-to-one ratio. This decision, however, gave taxpayers a basis to ask courts to ignore extremely high debt-equity ratios; and in some instances the taxpayers were successful in their efforts.[172] This attack on the prior conventional wisdom emanating from the dictum of the Supreme Court's *Kelley* opinion led several courts to ignore entirely the debtor's debt-equity ratio.[173]

For example, in *Murphy Logging Co. v. United States*,[174] a corporation with a 160:1 ratio was permitted interest deductions on loans where the shareholders contributed their substantial expertise and ability to negotiate and procure contracts to the corporation.

In determining debt-equity ratios, the courts have generally used market values instead of book values for assets.[175] Goodwill and other intangible assets are also accounted for in determining the ratio.[176] The amount of debt issued to outside or unrelated creditors must be taken into account, as well as debt to related creditors.[177] On the other hand, a computation of the debt-equity ratio in such a way that the risks of the business were exaggerated has been held sufficient grounds for reversing the trial court.[178]

As reflected by several favorable decisions, taxpayers may prevail in establishing bona fide debts from their controlled corporations even where the ratio of debt to stock is very high,[179] particularly where the taxpayer-lender is a successful corporation which both controls and finances the borrower (in which case there is no point in contributing equity).[180] Taxpayers may nonetheless suffer defeat where the ratio is less than the four-to-one ratio seemingly endorsed by the Supreme Court.[181]

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[166] Section 385 specifically mentions both the proportionality of debt to equity and the debt/equity ratio as important factors.

[167] *See Am. Processing & Sales Co. v. United States*, 371 F.2d 842, 856 (Ct. Cl. 1967); *Roth Steel Tube Co. v. Commissioner*, T.C. Memo 1985-58, *aff'd*, 800 F.2d 625 (6th Cir. 1986). *But see* §385(a) (parenthetical clause).

[168] 326 U.S. 521 (1946).

[169] 326 U.S. 521, 526 (1946).

[170] For subsequent cases that appear to confirm this informal safe harbor for debt-equity ratios, see *Gazette Tel. Co. v. Commissioner*, 19 T.C. 692 (1953), *acq.*, 1954-2 C.B. 4, *aff'd on other grounds*, 209 F.2d 926 (10th Cir. 1954); *Ruspyn Corp. v. Commissioner*, 18 T.C. 769 (1952), *acq.*, 1952-2 C.B. 3; *Bachrach v. Commissioner*, 18 T.C. 479 (1952), *aff'd per curiam*, 205 F.2d 151 (2d Cir. 1953); *Dobkin v. Commissioner*, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951).

[171] 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956).

[172] *Curry v. United States*, 396 F.2d 630 (5th Cir. 1968) (30:1 ratio not unreasonable based on substantial disproportion between debt and stocks, substantial equity contribution, and reasonable indenture terms); *Rosenthal v. Commissioner*, T.C. Memo 1965-254 (14:1 ratio not significant based on amount of cash invested and fact that notes were issued for property which corporation could have rented).

[173] *See Rowan v. United States*, 219 F.2d 51, 55 (5th Cir. 1955); *Gloucester Ice & Cold Storage Co. v. Commissioner*, 298 F.2d 183, 185 (1st Cir. 1962). *Cf. Sigmon v. Commissioner*, T.C. Memo 1988-377 (although company had substantial equity and reasonable debt-to-equity ratio, fact that company belonged to integrated group of companies which, in aggregate, was thinly capitalized lent support to conclusion that advance was contribution to capital).

[174] 378 F.2d 222 (9th Cir. 1967).

[175] Actual values were relied on in *Perrault v. Commissioner*, 25 T.C. 439 (1955), *acq.*, 1956-1 C.B. 5; *Mason-Dixon Sand & Gravel Co. v. Commissioner*, T.C. Memo 1961-259, and *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), *rev'g* 21 T.C. 513 (1954). *See also* Butler, "Thin Capitalization: Some Current Questions," 34 *TAXES* 830 (1956).

[176] *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967); *Nye v. Commissioner*, 50 T.C. 203 (1968), *acq.*, 1969-2 C.B. xxv.

[177] *Lockwood Realty v. Commissioner*, T.C. Memo 1958-49, *aff'd, rev'd, and rem'd*, 264 F.2d 241 (6th Cir. 1959); *Dobkin v. Commissioner*, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951). *But cf. J.A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273 (1958), *acq.*, 1959-1 C.B. 4.

[178] *Estate of Miller v. Commissioner*, 239 F.2d 729 (9th Cir. 1956), *rev'g* 24 T.C. 923 (1955).

[179] *See Royalty Serv. Corp. v. United States*, 178 F. Supp. 216 (D. Mont. 1959).

[180] *Byerlite Corp. v. Williams*, 286 F.2d 285 (6th Cir. 1960).

[181] *See Brake & Elec. Sales Corp. v. United States*, 185 F. Supp. 1 (D. Mass. 1960), *aff'd*, 287 F.2d 426 (1st Cir. 1961). *See also Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962).

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(3) Nature of Assets

Where an ongoing business is incorporated, the nature of the assets represented by the debt can be relevant. If the debt proceeds are invested in machinery, land, and buildings, the "debt" may be regarded as stock because it is a permanent investment and subject to the full risks of the business, particularly where other funds will be needed to finance initial improvements and operations.[182] In some cases, however, this factor has been ignored.[183]

(4) Availability of Outside Credit

Because the debt-equity ratio and nature-of-transferred-asset factors are somewhat mechanical means of resolving the ultimate question of whether the repayment of a loan was at the risk of the business, evidence that the borrower-corporation could not have obtained financing from nonstockholders is given significant if not conclusive weight.[184] It should not be necessary, however, that such financing be obtainable on the same terms as the shareholder loans.[185]

e. Nature of Instrument and Intent of Parties

(1) Appearance of Instrument

In general, an initial consideration in having a debt recognized for tax purposes is whether it possesses the usual characteristics of a debt instrument. Written evidence of the indebtedness is very helpful. Conversely, open account "debts" may be particularly vulnerable,[186] unless evidenced on the debtor's books of account with repayments being made on a continuous basis for some period of time.[187]

The weight given to the name of the instrument varies if it is labeled as a debt,[188] but a label such as "preferred stock" creates a substantial, although perhaps not insurmountable, hurdle for a taxpayer in proving a debt, even where such "stock" must be redeemed by a specific date.[189] The Tax Court has been reluctant to disregard the name assigned to an obligation when the debtor is subject to state control, such as in the case of insurance companies.[190] Since 1992, §385(c) has provided another hurdle: if the holder of an instrument labeled as being "stock" wishes to treat it as debt, he must disclose the inconsistency on his return, or be bound by its characterization as equity.

(2) Maturity Date

Status as debt is suspect if it is unclear when a debt falls due. The presence of a fixed maturity date is an important factor indicating the existence of a debt.[191] Demand notes and open-account advances are suspect if demand for payment is never made or the advances are not repaid on a regular basis.[192]

The absence of a maturity date was a particularly important factor in certain cases involving sales of land to cemetery corporations in exchange for notes where the seller was to receive a portion of the resale price as burial plots were sold. In the 1940s, the IRS acquiesced in a case won by a taxpayer, it withdrew its acquiescence in the 1960s and subsequently won a series of such cases.[193]

In addition to setting forth a specific date of maturity, the creditor should make efforts to collect the debt as it becomes due.[194] Evidence that a "creditor" was indifferent to the exact time the notes were to be paid clashes with the idea of an arm's-length creditor-debtor relationship.[195]

(3) Subordination

Subordination of a debt to claims of general creditors is an important indication that the debt is really equity.[196] However,

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[182] *Wachovia Bank & Trust Co. v. United States*, 288 F.2d 750 (4th Cir. 1961), *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969); *Aqualane Shores, Inc. v. Commissioner*, 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959); *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214 (Ct. Cl. 1968) (recapitalization occurred under prior law); *Burr Oaks v. Commissioner*, 365 F.2d 24 (7th Cir. 1966); *Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962); *Sansberry v. United States*, 70-1 USTC ¶9216 (S.D. Ind. 1970); *Plantation Patterns, Inc. v. Commissioner*, T.C. Memo 1970-182. *See also Sigmon v. Commissioner*, T.C. Memo 1988-377 (use of proceeds of advance to acquire capital assets, made in conjunction with recapitalization, supported finding that advance was contribution to capital).

[183] *See, e.g., Curry v. United States*, 396 F.2d 630 (5th Cir. 1968).

[184] *Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967); *Am. Processing & Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967); *Affiliated Rsch., Inc. v. United States*, 351 F.2d 646 (Ct. Cl. 1965); *Jaeger Auto Fin. Co. v. Nelson*, 191 F. Supp. 693 (E.D. Wis. 1961). *See also Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *aff'g* T.C. Memo 1985-58; *Indmar Prods. Co., Inc. v. Commissioner*, 444 F.3d 771 (6th Cir. 2006), *rev'g* T.C. Memo 2005-32; *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72 (2005) (citing *Roth Steel* factors, court held that it was extremely improbable that arm's-length lender would have made unsecured loan under given terms to entity in questionable financial condition).

[185] *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967). *But see S. P. Realty Co. Inc. v. Commissioner*, T.C. Memo 1968-156. *But cf. O.H. Kruse Grain & Milling Co. v. Commissioner*, 279 F.2d 123 (9th Cir. 1960).

[186] *Inness v. Commissioner*, T.C. Memo 1968-120, *rem'd*, 413 F.2d 290 (5th Cir. 1969). *But see Wilshire & West. Sandwiches Inc. v. Commissioner*, 175 F.2d 718 (9th Cir. 1949). *See also* §1275(a)(1) (definition of debt instrument under OID rules).

[187] *Am. Processing & Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967); *C.M. Gootch Lumber Sales Co. v. Commissioner*, 49 T.C. 649 (1968); *Anderson v. United States*, 78-1 USTC ¶9389 (N.D. Cal. 1975), *aff'd per curiam*, 555 F.2d 236 (9th Cir. 1977); *Ellinger v. United States*, 470 F.3d 1325 (11th Cir. 2006) (no promissory notes executed in connection with transfer of funds).

[188] *See Wynnefield Heights, Inc. v. Commissioner*, T.C. Memo 1966-185.

[189] *See Miele v. Commissioner*, 56 T.C. 556 (1971); *Dorsey v. United States*, 311 F. Supp. 625 (S.D. Fla. 1969); *Arthur R. Jones Syndicate v. Commissioner*, 23 F.2d 833 (7th Cir. 1927); *Bowersock Mills & Power Co. v. Commissioner*, 172 F.2d 904 (10th Cir. 1949). *See also Sunny Isles Ocean Beach Co. v. Coyle*, 62-1 USTC ¶9151 (W.D. N.Y. 1961).

[190] *Theodore v. Commissioner*, 38 T.C. 1011 (1962), *acq.*, 1966-2 C.B. 7.

[191] §385(b)(1); *Miele v. Commissioner*, 56 T.C. 556 (1971); *Swoby Corp. v. Commissioner*, 9 T.C. 887 (1947); *Wood Preserving Corp. of Balt. v. United States*, 347 F.2d 117, 119 (4th Cir. 1965). *Cf. Estate of Mixon v. United States*, 324 F. Supp. 977 (M.D. Alaska 1971). *But see Wynnefield Heights, Inc. v. Commissioner*, T.C. Memo 1966-185.

[192] *Jaeger Auto Fin. Co. v. Nelson*, 191 F. Supp. 693 (E.D. Wis. 1961) (demand notes tend to indicate equity). *See also Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127. *Cf. Piedmont Minerals Co., Inc. v. United States*, 429 F.2d 560 (4th Cir. 1970).

[193] *See Gardens of Faith, Inc. v. Commissioner*, T.C. Memo 1964-178, *aff'd per curiam*, 345 F.2d 180 (4th Cir. 1965); *Sherwood Mem'l Gardens, Inc. v. Commissioner*, 350 F.2d 225 (7th Cir. 1965); Rev. Rul. 61-137. The former position was based on *Forest Lawn Mem'l Park Ass'n, Inc. v. Commissioner*, 45 B.T.A. 1091 (1941), *acq. withdrawn and nonacq. entered*, 1960-2 C.B. 8.

[194] *Burr Oaks v. Commissioner*, 365 F.2d 24 (7th Cir. 1966) (maturity date "extended").

[195] *See Gooding Amusement Co. v. Commissioner*, 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956).

[196] *See Harlan v. United States*, 409 F.2d 907 (5th Cir. 1969); *New England Lime Co. v. Commissioner*, 13 T.C. 799 (1949), *acq.*, 1950-1 C.B. 4; *Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962); *Fed. Projects Inc. v.*

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subordination per se is not always a fatal impediment to establishing a bona fide indebtedness.[197] For example, subordination to a mortgage debt has been assigned little weight where there was no subordination to general creditors.[198]

Where loans to a controlled corporation are in fact subordinated to the debts of other creditors, even though the debt instrument has no provision for subordination, the existence of equity is indicated.[199] Accordingly, an act of subordination subsequent to the issuance of the notes is held against the taxpayer.[200] In *Charter Wire, Inc. v. United States*, the Seventh Circuit affirmed the district court's holding that a guarantee by shareholders of an outside loan amounts to a de facto subordination of their own loan.[201] In more equivocal circumstances, the absence of a subordination clause is not necessarily held in the taxpayer's favor.[202]

(4) Security for Payment

A creditor's taking back proper security for the repayment of debt is a strong indication that repayment is not restricted to possible future profits. Conversely, an intention not to foreclose on a security interest in case of default would be consistent with the status of a shareholder. Very few of the litigated cases involve secured instruments, which may only mean that very few corporation-shareholder debts are secured. It appears that the absence of security is not a determinative factor in holding against the taxpayer. However, courts have noted otherwise where the original security has been later released.[203]

(5) Payment of Interest

If the corporation must pay "interest" annually, the instrument in that respect resembles debt because a corporation pays a dividend only when convenient, but would have to pay interest to a creditor on a regular basis.[204] If, on the other hand, the debtor has failed to make interest payments when due,[205] or the interest rate is subsequently lowered,[206] the opposite conclusion is indicated. Similarly, if the duty to make interest payments is conditioned (by the terms of the instrument or in fact) on the presence of net profits or earned surplus[207] or upon the discretion of the board of directors,[208] the instrument strongly resembles stock.

Lacking direct evidence, the courts look to the economic circumstances to ascertain whether the debtor's likelihood of business success made it reasonable for the note holder to expect to receive regular interest payments.[209] In other words, an outside lender would not make advances unless it anticipated receiving at least the regular interest payment.[210] However, the creditor need not have anticipated payment of interest out of assured future profits. Payment out of gross income (or out of equity capital) supports debt treatment if other (including anticipated) financial commitments are not excessive and the corporation has the continued capacity to generate sales or preserve the capital.[211] Similarly, the presence of current losses does not, per se, render unreasonable the prospects for the ultimate success of the business.[212] Hindsight may favor the taxpayer, but the unexpected failure of the business is not necessarily held against him.[213]

If the interest rate provided in the instrument is too high, the payments might look more like dividends than interest.[214] Similarly, where debt is issued in exchange for an asset, if the

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Commissioner, T.C. Memo 1987-202 (real estate developer's advances to limited partnership subordinate to other claims against partnership; also, no fixed maturity date or interest).

[197] *See Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11 (2d Cir. 1935); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956). The bonds in *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), were subordinated. *See also* FSA 199916005 (National Office, while acknowledging that neither statute nor case law would prevent challenge to debt characterization of unsecured, subordinate "junk bonds," including those traded on open market, advised against such challenge because of "severe litigation hazards").

[198] *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967); *Burke Golf Equip. Corp. v. United States*, 193 F. Supp. 615 (D. Ill. 1961). *See* Rev. Rul. 68-54.

[199] *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956); *Arnold v. Phillips*, 117 F.2d 497 (5th Cir. 1941).

[200] *Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962).

[201] *Florida-Georgia Corp. v. United States*, 331 F. Supp. 36 (M.D. Ga. 1971).

[202] *See Janeway v. Commissioner*, 147 F.2d 602 (2d Cir. 1945). The issue of subordination was not directly addressed in the withdrawn final and proposed regulations to §385. However, the existence of subordination is important for determining the value of the equity features (final regulations) or straight debt features (proposed regulations) of certain hybrid instruments.

[203] *Stanley, Inc. v. Schuster*, 295 F. Supp. 812 (S.D. Ohio 1969), *aff'd per curiam*, 421 F.2d 1360 (6th Cir. 1970), *Florida-Georgia Corp. v. United States*, 331 F. Supp. 36 (M.D. Ga. 1971); *Curry v. Commissioner*, 43 T.C. 667 (1965), *nonacq.*, 1968-2 C.B. 3.

[204] *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967), *aff'd on other grounds*, 415 F.2d 519 (9th Cir. 1969); *Kolkey v. Commissioner*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958). *See also Ellinger v. United States*, 470 F. 3d 1325 (11th Cir. 2006) (no interest rate or mutually agreed repayment schedule). Failure to provide for adequate interest may also have other tax consequences. *See* §7872(c)(1)(C).

[205] *Sayles Finishing Plants, Inc. v. United States*, 399 F.2d 214 (Ct. Cl. 1968); *United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967), *rev'g* 64-2 USTC ¶9691 (E.D. Tex. 1964). *See Zephyr Mills, Inc. v. Commissioner*, T.C. Memo 1959-181, *aff'd*, 279 F.2d 494 (3d Cir. 1960); *Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127. *Compare Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968) *with Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967), involving creditor's waiver of interest due.

[206] *Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962).

[207] *Bakers' Mutual Coop. Ass'n of Newark, N.J. v. Commissioner*, 117 F.2d 27 (3d Cir. 1941); *Crown Iron Works Co. v. Commissioner*, 245 F.2d 357 (8th Cir. 1957).

[208] *Bakers' Mutual Coop. Ass'n of Newark, N.J. v. Commissioner*, 117 F.2d 27 (3d Cir. 1941); *Gregg Co. of Delaware v. Commissioner*, 239 F.2d 498 (2d Cir. 1956); *Greensboro News Co. v. Commissioner*, 31 B.T.A. 812 (1934).

[209] *Aqualane Shores, Inc. v. Commissioner*, 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959).

[210] *See Curry v. United States*, 396 F.2d 630 (5th Cir. 1968); *Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127 (outside lender would not have advanced funds given corporation's minimal payments on debt and financial distress).

[211] *Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968); *Sun Props. v. United States*, 220 F.2d 171 (5th Cir. 1955); *Curry v. Commissioner*, 43 T.C. 667 (1965), *nonacq.*, 1968-2 C.B. 3; *Hogue v. Commissioner*, 459 F.2d 932 (10th Cir. 1972), *aff'g* 30 T.C.M. 311 (1971); *Wynnefield Heights, Inc. v. Commissioner*, T.C. Memo 1966-185; *Plastic Toys, Inc. v. Commissioner*, T.C. Memo 1968-143.

[212] *Cf. Am. Processing & Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967).

[213] *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968); *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536 (1968), *acq.*, 1969-2 C.B. 25.

[214] *See Elliot-Lewis Co. v. Commissioner*, 4 T.C.M. 136, *aff'd per curiam*, 154 F.2d 292 (3d Cir. 1946). For low rates of interest, other considerations are important. *See* §§7872, 2511, 2512, and 1276.

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"purchase price" is too high, a portion of the debt may be held to represent future profits and hence dividends.[215]

(6) Repayment of Principal

Although the actual or anticipated failure to repay principal has been cited in resolving debt-equity issues,[216] in most cases, this factor is related to the more prominent issue of the existence and reasonableness of the maturity date.[217] One area in which failure to repay has independent significance, however, is where a debt is payable on demand or is listed on an open account and the date of actual repayment is extended. As this period lengthens, the chances that a purported loan will be characterized as equity for tax purposes also increases.[218]

A financial institution may be willing to extend the maturity date of an obligation so long as interest is being paid or there is a combination of security for the debt and future prospects of success for the business. On the other hand, the extension or reissuance of an existing debt held by controlling stockholders may show that the stockholders, unlike the other creditors, are indifferent to being repaid. A creditor-shareholder's expectation of having a loan repaid at a fixed maturity date by his closely held corporation must be substantiated in fact, not theory.[219]

If the debtor has in fact repaid the loan (before the time an audit starts), or if he has made substantial payments of principal, that strongly supports classification of debt.

(7) Indirect Equity Holdings

The existence of voting rights or direct or indirect control of management by a creditor is consistent with a finding that the instrument represents equity,[220] but the absence of such rights or control is not particularly significant in supporting debt status for shareholder loans.[221]

(8) Use of Hindsight

A court will often resort to hindsight in evaluating whether a particular creditor did or did not view a given instrument as representing debt. Thus, if the debt is past due, it is relevant to inquire into the extent to which collection for payment was pressed.[222]

Note: In establishing a §166 deduction, the issue of a creditor's efforts to obtain repayment is important in satisfying the "worthlessness" requirement. Without such efforts, it will usually be difficult to satisfy the regulations' requirement that the taxpayer show that the debt is worthless.[223]

f. Guarantor Denied Status as Such

As discussed in V., below, shareholders who guarantee corporate debts to outside parties (generally for closely held family businesses) may not be given creditor status for tax purposes. In such instances, the IRS has successfully maintained, based on all facts and circumstances reviewed in a debt-equity case, that the guarantor's payment represents equity or risk capital.[224] Factors highlighted on this aspect of the general debt versus equity question include: (1) the capitalization of the primary debtor, (2) whether the guarantees were in proportion to equity holdings, (3) whether the guarantor was active in the management of the debtor, and (4) whether the lender actually expected to be repaid by the guarantor.[225] For example, in *Kavich v. United States*,[226] a guaranty was recharacterized as equity where the corporation-obligor was thinly capitalized in comparison with other corporations owned by the guarantor and the issuance of the guaranty was a substitute for placing additional capital into the corporation.[227]

7. Debt Distinguished from Equity in Partnership Context

A debt or equity determination with respect to a holder's entire investment in a partnership may significantly affect the allocation of the partnership's taxable income and losses. For example, in *TIFD III-E v. United States*,[228] the partnership

[215] *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *Burr Oaks v. Commissioner*, 365 F.2d 24 (7th Cir. 1966). *Cf. Gyro Eng'g Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969), *rev'g* 276 F. Supp. 454 (C.D. Cal. 1967); *Bergstrom v. United States*, 37 Fed. Cl. 164 (1996) (nonrecourse purchase money debt disregarded in nonshareholder context where debt unreasonably high).

[216] *See Gloucester Ice & Cold Storage Co. v. Commissioner*, 298 F.2d 183 (1st Cir. 1962); *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969); *Kraft Foods, Co. v. Commissioner*, 21 T.C. 513 (1954), *rev'd*, 232 F.2d 118 (2d Cir. 1956); *Sigmon v. Commissioner*, T.C. Memo 1988-377 (failure to repay promissory note in accordance with its terms supported finding that it was not bona fide indebtedness). *Cf. Brake & Elec. Sales Corp. v. United States*, 287 F.2d 426 (1st Cir. 1961).

[217] *Curry v. United States*, 396 F.2d 630 (5th Cir. 1968); *Piedmont Corp. v. Commissioner*, 388 F.2d 886 (4th Cir. 1968); *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1969) (cash flow projection); *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536 (1968), *acq.*, 1969-2 C.B. 25.

[218] *See Sansberry v. United States*, 70-1 USTC ¶9216 (S.D. Ind. 1970) (seven-year repayment date inconsistent with open account type of advance); *Am. Processing & Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967) (open account noninterest bearing advances "repaid" partly in kind); *Hudlow v. Commissioner*, T.C. Memo 1971-218; *Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127 (minimal repayment over five-year period).

[219] *Charter Wire, Inc. v. United States*, 309 F.2d 878 (7th Cir. 1962).

[220] *See R.C. Owen Co. v. United States*, 180 F. Supp. 369 (Ct. Cl. 1960) (debentures which provided that three fourths of holders could amend terms of obligation constituted equity interests for tax purposes); *Kolkey v. Commissioner*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958); *Zephyr Mills, Inc. v. Commissioner*, T.C. Memo 1959-181, *aff'd*, 279 F.2d 494 (3d Cir. 1960). *Cf. Plastic Toys, Inc. v. Commissioner*, T.C. Memo 1968-143.

[221] *See Jordan Co. v. Allen*, 85 F. Supp. 437, 443 (M.D. Ga. 1949).

[222] *See, e.g., Ludwig Baumann & Co. v. Commissioner*, T.C. Memo 1961-271, *aff'd*, 312 F.2d 557 (2d Cir. 1963) (no demand made on demand notes).

[223] Reg. §1.166-3(a)(2)(iii). *But see* Reg. §1.166-2(b) (legal action not required to show debt is uncollectible).

[224] *Plantation Patterns, Inc. v. Commissioner*, T.C. Memo 1970-182, *aff'd*, 462 F.2d 712 (5th Cir. 1972); *Casco Bank & Trust Co. v. United States*, 544 F.2d 528 (1st Cir. 1976); *In re Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976); *Kavich v. United States*, 507 F. Supp. 1339 (D. Neb. 1981). *But see Selfe v. Commissioner*, 778 F.2d 769 (11th Cir. 1985), *rev'g and rem'g unpub. district court opin.*

[225] *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536 (1968), *acq.*, 1969-2 C.B. 25; *Murphy Logging Co. v. United States*, 378 F.2d 222 (9th Cir. 1967); *Smyers v. Commissioner*, 57 T.C. 189 (1971).

[226] 507 F. Supp. 1339 (D. Neb. 1981).

[227] *See also In re Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976).

[228] 459 F.3d 220 (2d Cir. 2006), *rev'g and rem'g* 342 F. Supp.2d 94 (D. Conn. 2004). The case had a long procedural history before the Supreme Court denied certiorari. *TIFD III-E, Inc. v. United States*, 660 F. Supp.2d 367 (D. Conn. 2009), *rev'd*, 666 F.3d 836 (2d Cir. 2012), motion *denied*, 8 F.Supp.3d 142 (D. Conn. 2014), *rev'd*, 604 Fed. Appx. 69 (2d Cir. 2015), *cert. denied*, 136 S.Ct. 896 (2016). For an example where the court recharacterized an equity investment as debt, see *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 9/20/11) (debt determined to be masked as equity investment

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agreement allocated most of the income (which was substantial for income tax purposes, but was offset for capital account purposes by "book" depreciation that was not available for tax purposes) to two foreign banks which were not subject to U.S income tax. The Second Circuit held that foreign banks were lenders and did not have bona fide equity participations (and therefore were not partners), so all of the taxable income had to be allocated to the actual partners who were U.S taxpayers. As a general rule, the substantial economic effect rules under §704(b) and the §707 rules governing transactions between a partner and a partnership work in such a way that the reclassification of only a portion of a partner's interest in a partnership as debt will generally not have a significant effect on the partnership's allocations of income and loss.

For a detailed discussion of debt versus equity in the partnership context, see 648 T.M., *Reportable Transactions*, and 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

B. Bad Debts v. Losses

1. Importance of Distinction

The availability of a deduction for a bad debt (other than a debt evidenced by a corporate or government security) is determined under §166, while the availability of a deduction for losses, including any loss attributable to a worthless corporate or governmental security or to the sale or exchange of an asset, is determined under §165. The Supreme Court held that the provisions allowing a deduction for losses (now in §165(a)) and those allowing a deduction for bad debts (now in §166) are mutually exclusive, and that where a situation is described in both sets of provisions, the specific provisions relating to debts govern.[229]

The allowance, nature, and timing of a deduction may depend on whether it is a loss governed by §165[230] or a bad debt governed by §166. In general, losses described in §165 are not deductible by an individual unless such losses were incurred in a trade or business, or were incurred in a transaction entered into for profit.[231] In contrast, a bad debt described in §166 is deductible by an individual even if the loan was made for a purpose other than making a profit.[232]

For example, when a contractor absconded and the home owner was required to pay subcontractors' liens, the home owner became the creditor of the contractor by subrogation and could deduct the worthless claim as a nonbusiness bad debt. If the payments to subcontractors had resulted in a "loss," it would not have been deductible.[233]

Once a deduction is determined to be of the "loss" type, the rules for determining whether it is a capital loss or an ordinary loss vary depending on the type of asset or business[234] and the context of the loss,[235] rather than the self-contained rules (business debt versus nonbusiness debt) of §166 discussed in IV., below.

Losses under §165 are deductible only when evidenced by a closed and completed transaction, fixed by an identifiable event (subject to exceptions), and sustained during the taxable year.[236] A bad debt deduction is allowed during the taxable year in which the underlying obligation is partially (in the case of business bad debts) or wholly worthless.[237]

Note: For a complete discussion of the deductibility of losses under §165, see 527 T.M., *Loss Deductions.*

The distinction between a loss and a bad debt is also important in applying the special seven-year period of limitations for credit or refund that is applicable to bad debts and to worthless securities as defined in §165(g), in lieu of the normal three-year period for losses generally.[238]

2. Debt-Connected Losses Related to Worthlessness and Not Governed by §166

a. Corporate and Governmental Securities

Section 166 does not apply to a debt that is evidenced by a security as defined in §165(g)(2)(C).[239]

The deductibility of losses on such instruments is determined under §165, and the character of the loss depends on whether the instrument is a capital asset.[240] A debt instrument is a capital asset unless it falls within one of the §1221(a) exceptions to capital asset status, such as a debt instrument that (1) is stock in trade, inventory, or held for sale to customers (see §1236); (2) represents an account or note receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory, etc.; or (3) is part of hedging transaction as defined in §1221(b)(2).[241]

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because there was no possible upside potential (returns were capped) and funds were advanced with reasonable expectations of repayment regardless of success of venture at end of five-year investment period).

[229] *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934). *See also* Rev. Rul. 69-458; CCA 201107011 (casino entitled to deduction under §165 for marker discounts allowed to customers if discount is made to preserve and retain customers' continued patronage); TAM 9707002 (casino's settlement at less than face value of casino markers, which were included in gross income using proper method of accounting for gaming proceeds, could be deducted as: (1) business losses under §165, where settlement was to prevent injury to casino's gaming operations, or to protect, promote, retain, and preserve goodwill of business and continued patronage of its gaming customers; or (2) bad debts under §166, where settlement was based on considerations of collectability, worthlessness, or other similar factors relating to probability of recovery).

[230] §165(a) (generally allowing, as deduction, any loss sustained during tax year not compensated for by insurance or otherwise).

[231] §165(c). For exceptions to this general rule, see 527 T.M., *Loss Deductions.*

[232] §166(d). See the discussion of profit motive at IV.D., below. But see the discussion at III.A., above, regarding existence of a bona fide debt.

[233] *Martin v. Commissioner*, 38 T.C. 188 (1962). *But see Dapice v. Commissioner*, T.C. Memo 1983-377, where the court distinguished *Martin*, because the taxpayer failed to show that he could have established his claims against the contractors if he had pursued them.

[234] *See* §1221, §1231, §1233, §1234, §1234A, §1235, §1253, §1271.

[235] *See* §267, §269, §1236, §1237, §1239, §1242, §1244, §7872.

[236] Reg. §1.165-1(b).

[237] Reg. §1.166-1(a).

[238] §6511(d). See VIII.C., below.

[239] §166(e). A security defined in §165(g)(2)(C) is a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. *Note:* There is an exception for certain financial institutions. §166(f)(2), §582(c).

[240] §165(g)(1).

[241] *See Ark. Best v. Commissioner*, 485 U.S. 212 (1988). *E.g.*, TAM 9633001 (corporation's notes and trade receivables received in exchange for restricted stock were not capital assets where received in ordinary course of business; notes and receivables embody different legal entitlements than

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If a §165(g)(2)(C) security is not a capital asset in the taxpayer's hands, then the taxpayer is entitled to an ordinary loss when the debt becomes worthless or is sold, exchanged, or retired for an amount that is less than the taxpayer's adjusted basis.[242]

If a §165(g)(2)(C) security is a capital asset in the taxpayer's hands, then the taxpayer is entitled to a capital loss when the debt is sold or exchanged for an amount that is less than the taxpayer's adjusted basis.[243] Retirement of the debt is generally treated as a sale or exchange.[244] If the debt instrument is a capital asset and becomes worthless, the taxpayer recognizes a capital loss, unless the taxpayer is a domestic corporation and the debtor is a corporation affiliated with the taxpayer within the meaning of §165(g)(3), in which case the loss is an ordinary loss. The debtor is a corporation affiliated with the taxpayer within the meaning of §165(g)(3) if (1) the taxpayer owns directly at least 80% of the voting power and at least 80% of the total value of the debtor corporation[245] and (2) the debtor corporation derived more than 90% of its gross receipts from sources other than passive sources specified in the statute.

b. Breach of Contract

Section 166 does not apply unless there is an obligation to pay a sum of money based on a debtor-creditor relationship. In *Lewellyn v. Elec. Reduction Co.*,[246] the Supreme Court held that where a seller breached an executory contract after the buyer prepaid the purchase price for certain merchandise, the buyer's right under the agreement was not a "debt" in either the technical or the colloquial sense for §166 purposes. According to the Court, the purchaser simply possessed the usual remedies for breach of contract, which remedies, without more, do not elevate the status of a contractual promisee to that of a creditor. Accordingly, the buyer was entitled to a "loss" and was not entitled to a bad debt deduction for the unshipped merchandise.

Similarly, in *Meyer v. Commissioner*,[247] the taxpayer ordered and paid for stock from a broker who never delivered the certificates. After seeking legal recourse for the broker's failure to deliver the certificates, the taxpayer claimed a loss for the difference between amounts paid for the shares and the amount collected. The IRS argued that a debtor-creditor relationship arose as a result of the judgment for monetary damages awarded against the broker. In rejecting the IRS's position, the Fifth Circuit stated that despite the fact that stocks were not merchandise, the obligation of the broker in *Meyer* was not distinguishable from the obligation in *Lewellyn*, and thus the loss was deductible under §165.[248]

The rule set forth in *Lewellyn* depends on a technical legal analysis. Various theories can elevate a contract promisee to the status of a creditor. For example, in Rev. Rul. 69-457,[249] the IRS ruled that the loss of a deposit for the purchase of a residence held by a contractor who subsequently became insolvent entitled the taxpayer to a nonbusiness bad debt deduction. The IRS explained that when the taxpayer's right for specific performance, i.e., delivery of the house, became unenforceable, a right for repayment of the deposit arose that created a bona fide debtor-creditor relationship by operation of local law. Similarly in *DeLorenzo v. United States*,[250] a district court held that, where a taxpayer made a "deposit" for membership in an athletic club that became bankrupt before completion of certain facilities, the taxpayer was entitled to a nonbusiness bad debt deduction, because, pursuant to the membership agreement, if the club failed, it immediately became indebted to the taxpayer for a sum of money.

c. Theft and Embezzlement Losses

In the typical theft or embezzlement situation, the taxpayer may be entitled, subject to a number of special rules and limitations, to an ordinary loss deduction (in lieu of a bad debt deduction) in the year the theft is discovered.[251] This rule applies where the embezzler has no practical ability to make restitution. If, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, the §165 loss is not sustained until the taxable year in which it can be determined with reasonable certainty that such reimbursement will not be received.[252] If a taxpayer does have a reasonable prospect that reimbursement will be received (perhaps as the result of a solvent thief's promise to repay), but the claim for reimbursement subsequently becomes worthless, the deduction should be a §166 bad debt deduction rather than a §165 loss.[253]

The embezzlement of the taxpayer's property must, however, be distinguished from a bad debt incurred when a theft or embezzlement of the debtor's property renders the debtor un-

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stock). The Tax Relief Extension Act of 1999, Pub. L. No. 106-170, added several categories of assets, including hedging transactions, to those excluded by §1221 from capital asset status, effective for assets held, acquired, or entered into on or after December 17, 1999.

[242] Reg. §1.165-5(b).

[243] §165(g)(1); Reg. §1.165-5(c) (reference to §1.165-1(c)(3) (reference to §1.1011-1)).

[244] See the discussion of §1271 at III.B.3., below. (Exceptions apply to certain instruments issued before June 9, 1997.)

[245] §165(g)(3)(A) (reference to §1504(a)(2)). *Note:* For §165(g)(3) purposes, the IRS will not issue rulings on: (i) whether the source of any gross receipts may be determined by reference to the source of gross receipts of a counter party to an intercompany transaction, as defined in §1.1502-13(b)(1) (e.g., an intercompany distribution to which §1.1502-13(f)(2) applies), other than an intercompany transaction to which §381(a) applies; and (ii) in an intercompany transaction to which §381(a) applies, whether the acquiring corporation takes into account historic gross receipts of the distributor or transferor corporation, if the intercompany transaction is part of a plan to claim a deduction for worthless securities under §165(g)(3). Rev. Proc. 2026-3, §3.01(43).

[246] 275 U.S. 243 (1927).

[247] 547 F.2d 943 (5th Cir. 1977), *aff'g* T.C. Memo 1975-349.

[248] *Accord Proesel v. Commissioner*, 77 T.C. 992 (1981); *Hodges v. Commissioner*, T.C. Memo 1993-316; *Garber v. Commissioner*, T.C. Memo 1984-455; *Dapice v. Commissioner*, T.C. Memo 1983-377; *Schneider v. Commissioner*, T.C. Memo 1981-603; PLR 8501035.

[249] *See also* Rev. Rul. 69-458 (payment to brokerage firm for securities converted into right to receive repayment of cash). In *Meyer*, the court found the IRS's reliance on Rev. Rul. 69-458 unpersuasive.

[250] 308 F. Supp. 52 (D. Ore. 1969).

[251] *See generally* §165(a). For a discussion of the special rules and limitations under §165 that can limit, or eliminate, a taxpayer's loss deduction, see 527 T.M., *Loss Deductions*. *See also Grenada Bank v. Commissioner*, 32 B.T.A. 1290 (1935). However, as discussed in greater detail in 527 T.M., *Loss Deductions*, taxpayers who acquire stock on the open market for investment may not deduct as a theft loss the decline in market value of their stock, even if it is caused by disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock. *See, e.g., Paine v. Commissioner*, 63 T.C. 736, 740 (1975).

[252] Reg. §1.165-1(d)(3).

[253] *Douglas County Light & Water Co. v. Commissioner*, 43 F.2d 904 (9th Cir. 1930).

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able to pay. For example, in *Perrotto v. Commissioner*,[254] a taxpayer deposited funds in a bank that later collapsed as a result of embezzlement by bank officials. The Tax Court held that the bank's property, and not the taxpayer's property, was embezzled and allowed the taxpayer to claim a bad debt deduction.[255] Further, the IRS ruled in Rev. Rul. 77-383 that, where a bank was declared insolvent due to embezzlement by one of its employees, a depositor's loss in excess of the applicable deposit insurance was a nonbusiness bad debt[256] deductible as a short-term capital loss in the year the debt became worthless and not as a theft loss under §165(c)(3).[257]

If the taxpayer makes loans or advances as a result of the debtor's misrepresentations and the debt subsequently becomes worthless, it is necessary to determine whether the taxpayer has incurred a theft loss or a bad debt.[258] The determination as to whether the activity constitutes a theft is to be made under the laws of the state where the loss was sustained.[259] The positions of the taxpayer and the IRS will depend on the situation. An individual's theft losses are deductible only to the extent his net casualty losses for the year exceed a floor based on a percentage of the taxpayer's adjusted gross income. On the other hand, a bad debt often is deductible only as a capital loss.

For a complete discussion of the deductibility of casualty and theft losses, see 527 T.M., *Loss Deductions*.

d. Losses from Currency Revaluation

In *Bohm v. Commissioner*,[260] the taxpayer suffered a loss on repayment of a loan made in currency that had devalued over the loan term. The court held that §166 was inapplicable because the loan was repaid in full; consequently, the taxpayer was not entitled to claim a bad debt deduction. The situation is more complex under present law, because of the possible application of §988, which is beyond the scope of this discussion.[261]

e. Debts Becoming Worthless by Reason of Expropriation or Other Taking

A debt that becomes worthless as a result of its expropriation or seizure by a foreign government (for example where the taxpayer's business operations in a foreign nation are nationalized or seized) is deducted as a §165 loss, and not as a bad debt under §166.[262] The foregoing situation should be distinguished from situations in which a debt becomes worthless and is properly deductible under §166 because of a government action other than a seizure of the taxpayer's right to receive payment. Examples of situations in which the deduction would be properly claimed under §166 include: (1) when a debt becomes worthless because the debtor's assets are expropriated, (2) when a foreign government issues its own debt obligation (other than a security) in exchange for nationalized assets to the taxpayer upon the nationalization of a taxpayer's assets and the obligation subsequently becomes worthless,[263] and (3) when a foreign government unilaterally reduces the amounts payable to a taxpayer under contracts between the government and the taxpayer.[264]

f. Certain Payments Associated with Guarantees and Indemnities

A taxpayer who is required to make payment pursuant to a legally binding obligation, entered into in connection with the taxpayer's trade or business or with a profit motive, as a guarantor or an indemnitor and is unable to obtain reimbursement from the primary obligor is entitled to a bad debt deduction under §166.[265] This is true even if (1) the resulting subrogation rights are worthless at the time the payment is made,[266] or (2) no subrogation rights arise, for example, because only a partial payment is made or because the payor is an indemnitor rather than a guarantor.[267]

While §166 is applicable to payments made by a guarantor with respect to the guaranteed debt, a different result follows where a guarantor pays the obligee for a release from the guarantee before his guarantor liability is established. The reason for this difference in treatment is that no (actual or deemed) right of reimbursement has accrued against the debtor.[268] These payments may be deductible under §165.[269] However, if instead of releasing the guarantor from his obligations the payment merely results in a change to the terms of his obligation, the payment must be capitalized as a payment to renegotiate a financial interest.[270]

Further, if a guarantor's payments are associated with the acquisition, maintenance, or disposition of a capital asset they may be classified as capital expenditures or capital losses.[271]

In *Smith v. Commissioner*,[272] the taxpayer was the sole shareholder of a corporation which was the sole remaining member of an unincorporated entity owning real estate securing a $750,000 first mortgage guaranteed by the taxpayer and a second mortgage for which the taxpayer had no personal liability. Faced with foreclosure, the taxpayer placed the venture in a

[254] T.C. Memo 1977-99.

[255] *See also Sandquist v. Commissioner*, T.C. Memo 1978-281.

[256] But see III.B.2.h., below, regarding an election to treat such amounts as casualty losses in tax years after 1981.

[257] But see III.B.2.h., below, for a discussion of §165(l), which provides for elections to treat losses of certain deposits in financial institutions as §165 losses.

[258] *E.g.*, *Monteleone v. Commissioner*, 34 T.C. 688 (1960).

[259] *See Stoltz v. Commissioner*, 410 F. Supp.2d 734 (S.D. Ind. 2006) (no theft under state law; therefore, taxpayer not entitled to §165 theft loss where fraudulently induced to act as guarantor and subsequently called to repay loan and not entitled to a bad debt deduction because guarantee was not profit motivated).

[260] 34 T.C. 929 (1960).

[261] See 6660 T.M., *Tax Aspects of Foreign Currency*.

[262] Rev. Rul. 69-498.

[263] Rev. Rul. 72-1, clarified (as to another issue) by Rev. Rul. 75-501.

[264] TAM 8433008.

[265] See V., below, for a discussion of the classification of such payments as business or nonbusiness bad debts, and the application of a profit motive test to guarantors, even though such a motive is not usually required of bad debts.

[266] *Putnam v. Commissioner*, 352 U.S. 82 (1956).

[267] *Horne v. Commissioner*, 523 F.2d 1363 (9th Cir. 1975).

[268] *Shea v. Commissioner*, 36 T.C. 577 (1961), *aff'd per curiam*, 327 F.2d 1002 (5th Cir. 1964); *Schlosser v. Commissioner*, T.C. Memo 1965-186, 24 T.C.M. 972 (1965). *But cf. Vaughan v. Commissioner*, 719 F.2d 196 (6th Cir. 1983) (distinguishing the payments therein — which were payments to cover debts — from those in *Shea*).

[269] *Commissioner v. Condit*, 333 F.2d 585 (10th Cir. 1964); *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536 (1968); *Shea v. Commissioner*, 36 T.C. 577 (1961).

[270] *See* Reg. §1.263(a)-4(d)(2)(i).

[271] *See, e.g., Nalco Chem. Co. & Subs. v. United States*, 561 F. Supp. 1274 (N.D. Ill. 1983); *Fred H. Lenway & Co., Inc. v. Commissioner*, 69 T.C. 620 (1978).

[272] T.C. Memo 1994-149, *aff'd*, 65 F.3d 37 (5th Cir. 1995).

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voluntary Chapter 11 bankruptcy and, in his individual capacity, purchased the real property in a court approved bankruptcy sale for $837,316 (the total principal and unpaid interest under the first mortgage note) primarily financed by a $750,000 mortgage loan from a third party. The taxpayer also incurred transaction costs of $35,558. The bankruptcy sale eliminated the second mortgage's security interest in the property.

A few months after the bankruptcy sale, taxpayer obtained an appraisal that valued the property at $235,000 and claimed a nonbusiness bad debt deduction of $637,874 (the excess the bankruptcy sale price and additional costs over the property's appraised value) on his tax return for the year of the bankruptcy sale. The taxpayer asserted that he was entitled to the deduction because the transaction's tax consequences should be based on its substance rather than its form and, in the taxpayer's view, the substance was that he had paid just under $873,000 to discharge his guarantee and had received property worth only $235,000 with respect to his subrogation rights. The IRS disallowed the deduction on the grounds that the form of the transaction as a purchase of real property had to be respected (and, therefore no loss was allowable unless and until he disposed of the property for less than his basis (presumably just under $873,000)).

The Tax Court determined that no loss or bad debt could be allowed to the taxpayer on the transaction based on the substance of the transaction which the court determined was a mere refinancing of the property combined with a transfer of the property from its direct owner to its indirect owner and, alternatively, if the form of the transaction were respected the claimed bad debt deduction would be disallowed on the grounds that taxpayer's purchase of the property remained an open transaction and no loss had yet been realized. On appeal, the Fifth Circuit held that criteria for a taxpayer to disregard the form of a transaction had not been met and affirmed the Tax Court's disallowance of the bad debt deduction.[273]

g. Paying Debts of a Corporation Other Than Pursuant to a Guarantee

A taxpayer who controls a corporation as an adjunct to his business, or who is closely associated with the conduct of the corporation's business, may believe he is compelled to pay the corporation's debts in order to preserve his own business, or a business reputation he considers essential to his continued employment in the industry, although he is not required to do so by law. The Fifth Circuit, in *Lutz v. Commissioner*,[274] permitted a taxpayer to deduct payments of debts of three corporations, which were organized by the taxpayer to serve his individual business, on the theory that payments were made to protect his individual credit rating in the industry and to maintain his license under the Perishable Agriculture Commodities Act.[275]

In *Welch v. Helvering*,[276] the Supreme Court held that voluntary expenditures made to acquire goodwill were capital expenditures. Where expenditures have been made to retain or protect existing goodwill, other courts have frequently distinguished *Welch*, and held the expenditures deductible.[277] For example, in *Jenkins v. Commissioner*,[278] the Tax Court held that loan repayments made by Conway Twitty to investors in a defunct restaurant business known as "Twitty Burger, Inc.," were deductible as business expenses under §162. Twitty deducted these repayments on his 1973 and 1974 tax returns as bad debts or alternatively, as ordinary and necessary business expenses under §162. The IRS determined that these amounts were nondeductible personal expenses. In concluding that the repayments were deductible under §162, the Tax Court reasoned that Twitty repaid the corporate investors to protect his personal reputation, because there was an obvious similarity between the corporation's name and his stage name.

In *Rollins v. Commissioner*,[279] a deduction was denied for amounts contributed to a trust established to prevent the bankruptcy of a family member's business by paying its debts. The contributors failed to establish that the failure of the relative's business would have an adverse effect on their own business or financial reputations.

h. Certain Deposits in Financial Institutions

A taxpayer whose deposit in a financial institution becomes worthless is, in the absence of a §165(l) election, entitled to a §166 bad debt deduction.

Section 165(l)(1) allows an individual taxpayer to elect to treat a loss on a deposit in a qualified financial institution that becomes bankrupt or insolvent as a casualty loss deductible under §165(c)(3) if the amount of the loss can be reasonably estimated as of the close of the taxable year for which the loss is claimed. The advantage of an election under §165(l)(1) is that the loss may be claimed sooner than under §166 and as an ordinary loss, whereas a lost deposit would usually be a nonbusiness bad debt, deductible only as a capital loss. However, the percentage of the adjusted gross income floor applicable to casualty losses may more than offset these advantages.

If the financial institution is not federally insured, an individual taxpayer may, in lieu of making an election under §165(l)(1), elect, under §165(l)(5), to treat up to $20,000 per financial institution ($10,000 if married and filing separately) of the loss under §165(c)(2) (losses incurred in a transaction entered into for profit but not connected with a trade or business). The deduction for the losses is a miscellaneous itemized deduction and thus, not deductible in tax years beginning after 2017.[280]

If an election under §165(l) is made with respect to a loss on a deposit with a particular financial institution, it applies to all of the taxpayer's losses for such taxable year on deposits in that institution.[281] Section 166 does not apply to any loss to which an election under §165(l) applies.[282] If a taxpayer makes an election under §165(l)(5) and his loss for the year on deposits in the institution exceeds the $20,000 (or $10,000) limit,

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[273] 65 F.3d 37 (5th Cir. 1995).

[274] 282 F.2d 614 (5th Cir. 1960), *rev'g* T.C. Memo 1959-32.

[275] *See also M. L. Eakes Co., Inc. v. Commissioner*, T.C. Memo 1981-429; *Metro Land Co., Inc. v. Commissioner*, T.C. Memo 1981-335.

[276] 290 U.S. 111 (1933).

[277] *See United States v. E. L. Bruce Co., Inc.*, 180 F.2d 846 (6th Cir. 1950), and cases cited therein.

[278] T.C. Memo 1983-667.

[279] T.C. Memo 1979-331.

[280] *See* §67(g) (miscellaneous itemized deductions are not allowable in tax years beginning in 2018 through 2025). §67(a), §67(b), and §67(h).

[281] §165(l)(6).

[282] §165(l)(7).

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the balance cannot be deducted as a casualty loss under §165(l)(1);[283] it must be deducted as a bad debt under §166.

For a discussion of the procedures for filing either a §165(l)(1) or §165(l)(5) election, see the Worksheets, below.

3. Treatment of Amounts Received on Retirement

a. Application of §1271(a)(1)

Under §1271(a)(1), amounts received by the holder on retirement of certain debt instruments ("§1271 debt instruments") are generally considered as amounts received in an exchange. In order for there to be a deemed exchange under §1271(a)(1), there must be: (1) a debt instrument within the meaning of §1271 and (2) a retirement.

Where a taxpayer is unable to establish the worthlessness of a debt with sufficient certainty to assure the deduction in the current year, he may be able to assure the deduction by arranging for the §1271 debt instrument to be retired in the current year. This strategy is most likely to be attractive where the nature (capital or ordinary) of the resulting deduction will be the same whether the deduction is for a §165 loss or a §166 bad debt.

It should not matter that the retirement is effected at the taxpayer's request, or that the taxpayer had tax motivations in wanting the instrument to be retired in a particular year.[284]

If the §1271 debt instrument represents a debt with respect to which a bad debt deduction would be an ordinary deduction to the holder and the debt constitutes a capital asset, worthlessness generally results in a bad debt deduction while the deemed sale or exchange upon retirement results in a capital loss. Thus, in these situations, the holder may prefer to avoid a retirement (or at least defer it until a deduction for partial worthlessness could be claimed).

If an obligation is a capital asset in the hands of the holder and the obligation is not one whose worthlessness will result in a capital loss under §165(g)(1), avoiding or deferring retirement of the obligation may transmute into an ordinary bad debt deduction what would otherwise be a capital loss. Review of the language of §§165(g) and 1271(a) will reveal that there are only three situations in which this can happen. In two of these situations, §165(g)(1) does not apply to worthlessness and §1271(a) will apply if there is a retirement. One is in the case of any obligation issued by a natural person before June 9, 1997.[285] The second is where the debt instrument is issued by a corporation or a government (including a political subdivision), is not in registered form, does not have interest coupons and is not a registration-required obligation.[286] The third possibility is where the holder is a domestic corporation holding the §1271 debt instrument as a capital asset and the issuer is at least 80% owned by the holder and has derived more than 90% of its gross receipts from nonpassive sources (i.e., an affiliate).[287]

Note: In determining whether a debt instrument was issued after July 1, 1982, or June 8, 1997, one needs to consider whether any formal or de facto changes to the debt instrument have resulted in a reissuance under Reg. §1.1001-3.

b. Debt Instruments Within the Meaning of §1271(a)(1)

For purposes of §1271, the regulations define the term "debt instrument" as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law," except for certain annuity contracts defined in §1275(a)(1)(B).[288]

Section 1271 applies to all debt instruments (other than certain grandfathered noncorporate, nongovernmental instruments).[289] For purposes of determining whether an instrument is grandfathered, the regulations that apply to §§1271 through 1274 provide that if an entity is a primary obligor under a debt instrument, the debt instrument is considered to be issued by the entity and not by a natural person, even if a natural person is a co-maker and is jointly liable for the instrument's repayment. A debt instrument issued by a partnership is considered to be issued by the partnership as an entity even if the partnership is composed entirely of natural persons.[290]

Section 1271(a)(1) replaced former §1232(a)(1), which had provided a substantially identical rule for retirements of bonds, debentures, notes, or certificates or other evidences of indebtedness that were capital assets in the hands of the taxpayer, and that were issued by any corporation, or by any government or political subdivision thereof. Section 1271(a)(1) eliminated the requirement that the debt instrument be a capital asset and codified a longstanding exception for certain annuity contracts.[291]

The phrase "bond, debenture, note, or certificate or other evidence of indebtedness" is broad enough to cover any debt evidenced in writing. At least one court held that, under a predecessor statute (§1232), the phrase did not include bank passbook accounts;[292] however, in 1971, the §1232 regulations were amended so that they specifically included deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.[293] The current regulations do not have this specific reference (presumably because they cover the point more broadly), but they state that a "debt instrument" means any instrument or contractual arrangement constituting indebtedness under general principles of federal income tax law.[294]

Comment: The regulation's reference to a contractual arrangement may be intended to reach unwritten contractual arrangements. If so, the regulation is difficult to square with the

[283] §165(l)(6)(A).

[284] *See Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[285] *See* §1271(b)(1), §1271(b)(2).

[286] *See* §165(g)(1), §165(g)(2), §165(j)(2). Registration-required obligations are discussed in III.C.1.b., below.

[287] *See* §165(g)(3) (reference to §1504(a)(2)); Reg. §1.165-5(d).

[288] Reg. §1.1275-1(d), generally effective for debt instruments issued on or after Apr. 4, 1994. *See also* Reg. §1.1271-0.

[289] Grandfathered obligations are those issued before (a) June 9, 1997, by a natural person, or (b) July 2, 1982, by an issuer who was neither a corporation nor a government (including a political subdivision), but only if the taxpayer purchased the obligation before June 9, 1997. §1271(b).

[290] Reg. §1.1275-1(g).

[291] *See* §1271(a)(1) and §1275(a)(1); *Cobbs v. Commissioner*, 39 B.T.A. 642 (1939). *See also* I.T. 2261, C.B. XI-2, 39 (1932).

[292] *Redak v. Commissioner*, T.C. Memo 1968-213, 27 T.C.M. 1053 (1968).

[293] *See* T.D. 7154, 1972-1 C.B. 236; Reg. §1.1232-1(d); former Prop. Reg. §1.1275-1(b) (FI-189-84, 57 Fed. Reg. 60750 (Dec. 22, 1992). This specific language was removed from the final regulations, probably on the ground that the reference to "contractual arrangements" made it unnecessary. *See* Reg. §1.1275-1(d).

[294] Reg. §1.1275-1(d).

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statute: §1275(a)(1)(A) defines a debt instrument as a "bond, debenture, note, or certificate or other evidence of indebtedness." This language may or may not require a formal document such as a promissory note, but it at the very minimum contemplates some sort of separate writing. For example, it is doubtful that an account receivable would constitute a debt instrument if its only written evidence consists of notations in books of account.

The question of debt that is evidenced solely by computer memory is more difficult. Such debt is impossible to fit within the literal statutory language, but it may be fully equivalent to traditional debt instruments.

c. What Is a Retirement?

The term "retirement" was broadly construed by the Supreme Court in *McClain v. Commissioner*,[295] interpreting §117(f) of the Revenue Act of 1934, a predecessor to §1271:

> The statute does not use the word [retirement] in an unusual or artificial sense. In common understanding and according to dictionary definition the word "retirement" is broader in scope than "redemption."

A retirement thus occurs where, in exchange for a payment (whether in the form of cash or property) from the debtor, debt instruments (within the meaning of §1271) are retired in the sense of the underlying obligation being extinguished. But a retirement can occur even if the underlying obligation continues to exist: in one case, bonds were deemed to have been retired, even though they were actually left in existence as security for a new obligation.[296] Further, the term "retirement" is not merely limited to final payments on an obligation but also includes partial or successive distributions.[297] Each partial payment with respect to an obligation is considered a retirement of that portion of the underlying indebtedness.[298]

The exchange of property for other property differing materially in kind or extent is a transaction that results in the realization of gain or loss.[299] The significant modification of a debt is deemed to result in an exchange of the old debt instrument for a new debt instrument differing materially in kind or extent and thus results in realization of gain or loss.[300] Under the cases and rulings addressing the consequences of modifying a debt instrument, fairly modest changes in an instrument's terms may be deemed a significant modification.[301] Further, it can be argued that the Supreme Court's opinion in *Cottage Savings Ass'n v. Commissioner*[302] implied that any modification of a debt instrument will result in a deemed sale or exchange. In response to the issues raised by the *Cottage Savings* decision, the IRS issued regulations[303] specifying what constitutes a significant modification of a debt instrument which results in a deemed issuance of a new instrument for the old one (and effectively establishing some safe harbors as to what does not result in a reissuance). Under the regulations significant modifications include, among other things: (i) a change in the annual yield of more than the greater of (a) 25 basis points or (b) 5% of the unmodified annual yield; (ii) a material deferral of payments; (iii) an extension of final maturity by more than the lesser of five years or 50% of the original term; (iv) a material change in the collateral securing a nonrecourse note; and (v) a change in the obligor of a recourse note.[304] The determination of the yield on the unpaid portion of the note is presumably determined under the OID regulations.[305]

Inasmuch as a material modification of the terms of an outstanding debt obligation is deemed an issuance of a new debt instrument in exchange for the existing (old) debt instrument, the modification presumably constitutes a retirement of the original instrument.

The foreclosure of a mortgage results in the creditor receiving the fair market value of any property (and the amount of any cash) received in satisfaction of the mortgage note. Where there is no deficiency judgment, the entire mortgage note is retired and §1271 may apply, as discussed at VII.B.1., below.

4. Installment Obligations

Section 453B governs gain and loss on the sale or other disposition of an installment obligation. Suppose an installment obligation (that is not a §165(g) "security") becomes worthless: is a deduction denied because there has been no sale or other disposition? In *Am. Offshore, Inc. v. Commissioner*,[306] the IRS argued that, where the gain on a sale was being reported on the installment method, §453B barred a bad debt deduction, because there had been no disposition of the debt. The court held that §453B does not preclude a bad debt deduction.

Comment: Of course, a bad debt deduction is limited to the taxpayer's basis in the obligation, which in the case of an installment obligation would be less than its face amount[307] — allowing a deduction for the face amount would in effect allow a deduction not only for the basis but also for the unrecognized gain.

C. Special Reasons for Disallowance

The nature of a debt, or the circumstances in which it arises, may bring into play special reasons for the disallowance of a deduction for a loss on the debt. Some possible reasons, both statutory and judicial, are discussed below; others may emerge in the future.

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[295] 311 U.S. 527 (1941).
[296] *Shaw v. Commissioner*, 117 F.2d 587 (7th Cir. 1941).
[297] *Campbell v. Sailer*, 224 F.2d 641 (5th Cir. 1955); *Avery v. Commissioner*, 13 T.C. 351 (1949), *acq.*, 1950-1 C.B. 1.
[298] *Avery v. Commissioner*, 13 T.C. 351 (1949), *acq.*, 1950-1 C.B. 1.
[299] Reg. §1.1001-1(a).
[300] Rev. Rul. 89-122; Rev. Rul. 81-169; Reg. §1.1001-3(b).
[301] *See Field v. Commissioner*, 41 B.T.A. 183, 196 (1940) (increase in interest rate and other undisclosed changes); Rev. Rul. 87-19 (waiver of right to 156 basis point increase in interest rate under tax adjustment clause is sale or exchange). *But see* Rev. Rul. 73-160 (no exchange as result of extension of maturity date); PLR 8833050 (no exchange as a result of three basis point increase in yield to maturity).
[302] 499 U.S. 554 (1991).
[303] Reg. §1.1001-3.
[304] Reg. §1.1001-3(e).
[305] *See* Reg. §1.1272-1(j), *Ex.* 6.
[306] 97 T.C. 579 (1991).
[307] Generally, the basis in the note would be the basis of the property sold, plus the gain recognized minus the cash received.

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1. *Special Statutory Disallowances*

a. *Section 269: Acquisition to Avoid Tax*

If any persons acquire at least 50% of the voting power or value of the stock of a corporation, or if a corporation acquires assets of another corporation (in certain circumstances), and the principal purpose of the acquisition is the avoidance of tax by obtaining the benefit of a deduction that the acquirer would not otherwise enjoy, the deduction can be disallowed. Application of §269 with respect to a bad debt deduction is unlikely, but possible in principle. In *Am. Processing & Sales Co. v. United States*,[308] the issue was whether the taxpayer created the debtor corporation (by incorporating a division) to secure a bad debt deduction. If this had been the case, the deduction could have been disallowed under what is now §269, as an attempt to avoid or evade income tax; but the court held for the taxpayer on the facts in allowing bad debt deductions for open account loans made to the subsidiary corporation.

b. *Section 165(j): Registration Required Obligations*

Section 165(j) totally denies a loss deduction on any "registration-required obligation" (including an obligation issued by a governmental entity) that is not in "registered form" and was not subject to tax under §4701, which is a special excise tax on certain unregistered obligations.[309] For this purpose, the Code provides that all obligations are registration-required obligations except ones that: (1) are issued by a natural person, (2) are not of a type offered to the public, or (3) have a maturity (at issuance) of not more than one year.[310] For guidance on the definitions of "registration-required obligation" and "registered form" see 536 T.M., *Interest Expense Deductions*, and 741 T.M., *REMICs, Mortgage REITs, Mortgage Trusts and Other Real Estate Mortgage Securitization Vehicles.*

Section 165(j) refers not only to §165(a), but also to "any other provision of law," and therefore can disallow losses not only under §165, but also under other provisions, including §166.[311] A "registration-required obligation" would normally also qualify as a "security" within the meaning of §165(g), so that §165 rather than §166 would apply. But if, for some reason, a "registration-required obligation" were not registered and not a §165(g) "security," §165(j) would bar a deduction under §166 for its worthlessness.

c. *Section 271: Debts Owed by Political Parties*

Losses arising from worthless debts owed by political parties, including any organization that accepted contributions or incurred expenses to influence an election, are not deductible, subject to two major exceptions. The purpose of the rule is to prevent political contributions from being deducted through the form of a loan (or security) which could not be repaid. This provision applies not only to unpaid advances, but also to the failure to pay for goods and services rendered.[312]

The first exception is that the rule does not apply to banks as defined in §581.[313]

The second exception is that taxpayers who use the accrual method of accounting are allowed a deduction for an unpaid debt which accrued as a receivable on a bona fide sale of goods or services to political parties in the ordinary course of the taxpayer's trade or business, provided that more than 30% of all receivables accrued in the taxpayer's trade or business were due from political parties in the taxable year in which the receivable accrued, and the taxpayer made a substantial and continual effort to collect payment.[314]

d. *Section 280E: Certain Illegal Activities*

No deduction is allowed for bad debts suffered by drug dealers in the course of carrying on a trade or business of a criminal nature (unless, arguably, the bad debt offsets a previous inclusion in income).[315]

2. *Where Allowance Would Result in Extra Tax Benefit*

The deduction for a bona fide debt that represents income is allowed only to the extent the loan amount has been included in the taxpayer's gross income for the year in which the bad debt deduction is claimed or for a prior taxable year. Thus, wages, rent, interest payable, and other amounts due a cash-basis taxpayer, as well as child support payments which are never includible in a spouse's gross income, cannot support a bad debt deduction.[316] The result can be regarded as simply the consequence of the fact that the taxpayer has a zero basis in the items.

3. *Avoiding Double Deduction Where Creditor and Debtor Are Affiliated*

Where an advance is made by one member of an affiliated group to another and the debt becomes worthless, the opportunity exists for a double tax benefit with respect to the same diminution of the debtor's assets — e.g., first as an operating

[308] 371 F.2d 842, 849–50 (Ct. Cl. 1967).

[309] In lieu of being in registered form, §165(j)(1) provides that a deduction will not be disallowed if the obligation was subject to tax under §4701.

[310] §165(j)(2) (reference to §163(f)(2)).

[311] See also the same language in Reg. 1.165-12(a) and Prop. Reg. §1.165-12(a), REG-125374-16, 82 Fed. Reg. 43,720 (Sept. 19, 2017), proposed to apply to obligations issued after March 18, 2012. Reg. 1.165-12(c) sets forth conditions under which the holder of a registration-required obligation not in registered form will not be subject to §165(j)(1).

[312] §271. *See Klein v. United States*, 67-1 USTC ¶9316 (W.D. Ky. 1967) (government granted summary judgment denying refund claim for unpaid bills for advertising services plaintiff-taxpayer rendered to various political organizations), and companion cases.

[313] *See* §271(a).

[314] §271(c). *See* S. Rep. No. 938, 94th Cong., 2d Sess. 401–402 (1976).

[315] §280E.

[316] Reg. §1.166-1(e); *Washburn v. Commissioner*, T.C. Memo 1991-195, *aff'd per curiam in unpub. opin.*, 992 F.2d 321 (2d Cir. 1993); *Beshear v. Commissioner*, T.C. Memo 1990-544; *Odom v. Commissioner*, T.C. Memo 1979-53; *Walter v. Commissioner*, T.C. Memo 1996-200 (uncollected punitive damage award). In *Nichols v. Commissioner*, 29 T.C. 1140 (1958), the Tax Court denied a partnership a bad debt deduction on materials "advanced" to a corporation where the value of those items was previously deducted from inventory without a corresponding credit to sales in computing taxable income. The "flip-side" of this principle is embodied in §265(a)(1) which denies otherwise allowable deductions that can be traced or allocated to a certain class or classes of income exempt from tax. *See* §71(c) (payments for child support under decree, instrument, or agreement, are not includible in gross income under §71(a)). *Note:* Section 71 was repealed by Pub. L. No. 115-97, §11051(b)(1)(B), for divorce or separation instruments executed after December 31, 2018 or for instruments executed before then, if the instrument is modified after December 31, 2018 and the modification expressly provides that the §71 repeal applies. Pub. L. No. 115-97, §11051(c).

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loss of the debtor-affiliate availed of by the creditor during a consolidated return period, and second as a bad debt deduction.[317] The debtor-affiliate's operating loss reduces the parent's basis in the stock of the debtor-affiliate, thus increasing potential gain on ultimate disposition (or reducing potential loss), so the bad debt deduction is theoretically balanced by an income item at some indefinite future time. Nonetheless, in a practical sense, there would be a double benefit. The consolidated return regulations that were in effect for transactions that occurred before July 12, 1995, prevented such a double benefit by treating the bad debt deduction as a deferred intercompany transaction which might result in an ordinary deduction and a capital gain.

Under the regulations applicable to post-July 11, 1995, transactions, the timing, character, and source of the bad debt deduction and related item of income will generally "match," i.e., be identical. Specifically, Reg. §1.1502-13(g) provides, in part, that if the creditor member of the group claims a bad debt deduction, the debt will be deemed to have been satisfied. Also, if any debt remains in existence, it will be deemed to have been reissued for an appropriate amount of cash.[318]

> *Example:* On October 15 of Year 1, C, a member of the consolidated return group, loans D, also a member of the group, $100 payable February 15, of Year 2. As of December 31, Year 1, C claims a partial worthlessness deduction of $40. D is treated as having satisfied the debt for $60, and C is treated as having made a new loan of $60 to D. The effect is that in Year 1, D recognizes $40 of cancellation of indebtedness and C has a $40 deduction.[319]
>
> If D is insolvent and thus avoids recognizing the cancellation of indebtedness income, D's shareholder will generally have to recognize any excess loss account as ordinary income.[320] Excess loss accounts arise, when a member's losses utilized on a consolidated group return exceed the group's tax basis in the loss member's stock.

For a full discussion of the intercompany transaction regulations, see 756 T.M., *Consolidated Returns — Computation of Tax Liability*.

The issue is not confined to the consolidated return context. In *Book Prod. Indus., Inc. v. Commissioner*,[321] the Tax Court barred a parent corporation's use of its subsidiary's operating loss while a related creditor (not part of the "affiliated group" but controlled by the same interests) took a bad debt deduction. In a case involving the same set of taxpayers, *Am. Processing & Sales Co. v. United States*,[322] the Court of Claims allowed the bad debt deduction, noting that in such a case the excess of the subsidiary's operating losses over the parent's basis in the subsidiary's stock must eventually be accounted for, so that, at least in theory, there is no double deduction. In addition, the court noted, the IRS could use the predecessor of §482 to prevent any double deduction.

Where a taxpayer claims a bad debt deduction with respect to an obligation from a party under common control, the IRS may assert either that the debt was not worthless or that the debtor must realize cancellation of indebtedness income, because the claimed deduction shows that the creditor has decided not to pursue the claim. However, in *Zimmerman Steel Co. v. Commissioner*,[323] a debtor corporation was permitted to continue to accrue and deduct interest on a debt which had been written off and deducted by a related corporation.

4. *Debt Arising Out of Payment of Federal Income Taxes*

Under the consolidated return regulations, members of an affiliated group filing consolidated returns are severally liable for the consolidated income tax liability of the group, including any deficiencies assessed against the group for the consolidated return period.[324] Thus, one member of a group may pay for a portion of the consolidated tax liability attributable to another member. Although payment may give the member a right to reimbursement from the other member, the paying member may not deduct the payment as a bad debt if it fails to recover the advance from the other member because §275 prohibits a deduction for federal income taxes. In this situation, the right of reimbursement is directly attributable to the payment of income taxes for which the paying member is separately liable under the consolidated return regulations; therefore, §275 bars the deduction.[325]

In *Rude v. Commissioner*,[326] the Tax Court disallowed a nonbusiness bad debt deduction for a wife's worthless right of contribution from her ex-husband regarding his 50% share of an outstanding assessment for federal income taxes. The court reasoned that, because the payment of the tax itself was not deductible under §164, to grant the taxpayer a §166 deduction would result in an unwarranted circumvention of a statutory prohibition.[327] In *First Nat'l Bank of Duncanville v. United States*,[328] (discussed at III.A.1., above), the tax would have been deductible if the bank had paid it directly, which distinguishes that case from *Rude*. In Rev. Rul. 69-411 (discussed at III.A.5.b., above), the legatee was not directly liable for the estate tax, which distinguishes the ruling from *Rude*.

5. *Illegality*

A debt may be illegal in the sense that it is unenforceable (e.g., as usurious) and losses on such debts cannot qualify

[317] *See Ilfeld v. Hernandez*, 292 U.S. 62 (1934); *Katzinger Co. v. Commissioner*, 129 F.2d 74 (7th Cir. 1942).

[318] T.D. 9442, 73 Fed. Reg. 79324 (12/29/08), offers additional guidance as to the deemed satisfied/reissuance transaction provisions of Reg. §1.1502-13(g).

[319] Reg. §1.1502-13(g)(5), *Ex. 3*.

[320] Reg. §1.1502-19(b), §1.1502-19(c)(1)(iii)(B), §1.1502-19(c)(1)(iii)(C).

[321] T.C. Memo 1965-65.

[322] 371 F.2d 842, 849–50 (Ct. Cl. 1967). *See also Velvet O'Donnell Corp. v. United States*, 1 Cl. Ct. 683 (1983) (deduction allowed for unpaid debt between affiliated corporations determined to be worthless in first consolidated return year but before actual time of affiliation).

[323] 130 F.2d 1011 (8th Cir. 1942), *rev'g* 45 B.T.A. 1041 (1941).

[324] Reg. §1.1502-6(a). There is a limited exception to this rule for the liability of a subsidiary that has ceased to be a member of the group as a result of bona fide sale or exchange of the subsidiary. Reg. §1.1502-6(b), as amended by T.D. 10018, 89 Fed. Reg. 106,848 (Dec. 30, 2024).

[325] *Globe Prods. Corp. v. Commissioner*, 72 T.C. 609 (1979); *Merit Tank & Body, Inc. v. Commissioner*, T.C. Memo 1980-175.

[326] 48 T.C. 165 (1967).

[327] *Accord Globe Prods. Corp. v. Commissioner*, 72 T.C. 609, 619–20 (1979) (worthless right of contribution from member of affiliated group to pay share of joint and several obligation for consolidated income taxes); *Merit Tank & Body, Inc. v. Commissioner*, T.C. Memo 1980-175. *Cf. Arrigoni v. Commissioner*, 73 T.C. 792, 801 n.9 (1980) (§6672 penalty).

[328] 481 F. Supp. 633 (N.D. Tex. 1979).

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under §166.[329] They might nevertheless qualify as losses under §165.[330]

[329] Reg. §1.166-1(c). *But see Travis v. Commissioner*, 406 F.2d 987 (6th Cir. 1969).

[330] *Tharp v. Commissioner*, T.C. Memo 1972-10. See discussion at III.A.3., above.

Can a deduction for a bad debt incurred in an illegal activity be denied on grounds of public policy? As noted in III.C.1.d., above, §280E denies a deduction for bad debts suffered by drug dealers in the course of carrying on a trade or business of a criminal nature. For other types of criminal activity, the issue is apparently an open one.

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IV. Business v. Nonbusiness Bad Debts

Note: In the case of corporate taxpayers other than S corporations, the Code does not distinguish between business and nonbusiness bad debts. Accordingly, this discussion of the tax consequences of such characterization applies only to noncorporate taxpayers and S corporations.

A. Tax Consequences of Characterization

1. To Whom Applicable

Section 166(d)(1), which bars a deduction for partially worthless nonbusiness bad debts and classifies deductions for wholly worthless bad debts as short-term capital losses, applies "[i]n the case of a taxpayer other than a corporation."[331]

An entity classified as a partnership under Reg. §301.7701-3 is a taxpayer,[332] and not a corporation, within the meaning of the Code. If the partnership's partners include corporations, then the existence of a bad debt incurred by a partnership must be determined at the partnership level and reported on the partnership's tax return.[333] The classification of a debt as business or nonbusiness should also be made at the partnership level.[334] Although partnership level determination of these matters means that a corporation cannot obtain a deduction for a partnership nonbusiness bad debt until it becomes wholly worthless, it does not mean that a corporate partner should not be entitled to an ordinary deduction for its share of a wholly worthless partnership nonbusiness bad debt. Section 702(a) lists several items of partnership income, gain, deduction, loss, or credit which a partner must take into account separately, including any item to the extent provided in the regulations.[335] Reg. §1.702-1(a)(8)(ii) provides that each partner must take into account separately any item which if taken into account separately by any partner would result in a tax liability for that partner that was different than that which would result if that partner did not take the item into account separately. Reg. §1.702-1(b) provides that the character in the hands of a partner of any item taken into account separately shall be determined as though the item was realized directly from the source from which it was realized by the partnership.

Comment: While there do not appear to be any cases or rulings addressing the issue, it appears that a partnership's deduction for a nonbusiness bad debt should be reported as a separate item on the partnership's return (and the partners' Schedules K-1), and since there is no prohibition on a corporation claiming an ordinary deduction for a nonbusiness bad debt, a corporate partner's distributive share of the nonbusiness bad debt should be deductible against ordinary income.

Although S corporations are classified as corporations for purposes of the Code, §1363(b) provides that, with certain exceptions, an S corporation shall compute its taxable income in the same manner as an individual.[336] In Rev. Rul. 93-36, the IRS ruled that because §166 is not specifically enumerated as an exception in §1363(b), S corporations must separately state their nonbusiness bad debt as a short-term capital loss under §166(d) and can deduct the loss only in the year it becomes wholly worthless. Prior to 1997, ownership of S corporation shares was limited to individuals, their estates and certain trusts;[337] therefore, even though there is an S corporation provision[338] similar to the partnership provision that requires S corporation items to be separately stated if they would change a shareholder's tax liability, historically the consequences of an S corporation nonbusiness bad debt to a corporate shareholder has not been an issue. However, as of January 1, 1997, certain entities which, although generally tax exempt, are subject to tax as corporations on their unrelated business taxable income are permitted shareholders of S corporations.[339] Accordingly, for periods after 1996, it is possible for the issue to arise and the treatment should be the same as for a corporate partner of a partnership.

2. Timing and Character

Pursuant to the general rule of §166(a), a business bad debt is deductible against ordinary income to the extent that the underlying obligation becomes wholly or partially worthless during the tax year.[340] The amount of the deduction is limited to the taxpayer's adjusted basis in the obligation (for loss purposes) under §1011.[341] A nonbusiness bad debt is deductible only when it becomes wholly worthless and is treated as a short-term capital loss.[342]

In the case of individuals, the business bad debt is deductible in computing "adjusted gross income," unless the individual's business is that of being an employee.[343] Hence, unless the business is that of being an employee, the deduction is not subject to the limitations applicable to miscellaneous itemized deductions and is available even where the individual elects the standard deduction.

A bad debt deduction claimed in connection with a taxpayer's business as an employee is an itemized deduction;[344] because §166 is not one of the sections excluded from the definition of miscellaneous itemized deductions by §67(b), such bad debt is nondeductible for tax years beginning after 2017.[345] Bad debts are, however, business deductions, so they can contribute toward a net operating loss for the year without regard to the limitation on nonbusiness deductions imposed by §172(d)(4).

A nonbusiness bad debt is deductible as a short-term capital loss.[346] Accordingly, a taxpayer who incurs a nonbusiness

[331] §166(d)(1).

[332] *United States v. Galletti*, 541 U.S. 114 (2004).

[333] *S. Stanwood Menken v. Commissioner*, 8 B.T.A. 1062.

[334] *Cole v. Commissioner*, T.C. Memo 1962-287.

[335] §702(a)(7).

[336] *See* Reg. §301.7701-2.

[337] §1361(b)(1)(B).

[338] §1366(a)(1)(A), §1366(b).

[339] §1361(b)(1)(B), §1361(c)(6).

[340] Reg. §1.166-1(a).

[341] §166(b). Thus, a business bad debt previously reported as partially worthless, is deductible upon total worthlessness, only to the extent of its remaining basis. Reg. §1.166-3(a)(2)(iii), §1.166-3(b).

[342] §166(d)(1)(B); Reg. §1.166-5.

[343] §62(a)(1).

[344] §62(a)(1).

[345] §67(h). For tax years beginning before 2018, miscellaneous itemized deductions were subject to a 2% floor. Pre-TCJA §67(a), §67(b).

[346] §166(d)(1)(B), §1222(2).

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bad debt is subject to the rules that limit deductions for excess net short-term capital losses[347] and capital loss carryforwards.[348]

Nonbusiness bad debts will not support a deduction for partial worthlessness.[349] As discussed at VIII.A.1.b., below, it may be possible for a person to avoid the partial worthlessness prohibition by having the debtor (1) execute a new note for an amount approximately equal to what he might be expected to repay or (2) pay as much of the note as is possible and cancel the remaining unpaid balance of the note.[350] These maneuvers are designed to accelerate realization of loss for the creditor; however, if they succeed, the debtor may face an acceleration of cancellation of indebtedness income (see X., below).

In contrast to the general distinctions between business and nonbusiness bad debts described above, a bad debt evidenced by a security, i.e., a bond, note, or other evidence of indebtedness issued by a corporation or governmental unit with interest coupons, or in registered form, is subject to the rule contained in §165(g)[351] and, in the case of debt evidenced by a writing, partial payments in full satisfaction are subject to the rule in §1271(a)(1).[352] For a discussion of the capital versus ordinary loss issue under these provisions, see III.B.2.a. and III.B.3., above.

B. *Nonbusiness Bad Debt Defined*

Section 166(d)(2) defines a nonbusiness bad debt by a process of exclusion, that is, a nonbusiness bad debt is a bad debt other than:

(A) one created or acquired in connection with the taxpayer-creditor's trade or business[353] or

(B) the loss from the worthlessness of which was incurred during the operation of the taxpayer-creditor's trade or business.[354]

In order to qualify as a business bad debt (debts that are excluded from the meaning of nonbusiness bad debts) under the first rule of exclusion, the worthless debt must have been created or acquired in the trade or business of the taxpayer who is claiming the deduction.

Example 1: T, an accrual-basis taxpayer who is engaged in a retail business, holds an unpaid trade receivable against D. In Year 1, T sells his business to B and retires, but retains the claim against D, which becomes worthless in Year 2. Because T created or acquired the debt in his trade or business, the debt is a business bad debt even though T is not engaged in a trade or business in the year of worthlessness.[355]

Example 2: Same as *Example 1*, except T gives his claim in Year 1 to his son, S, a full-time student. S's worthless claim against D in Year 2 is a nonbusiness bad debt. The same result would arise if instead of transferring the obligation to a relative, T sold the claim to a third party who could not satisfy the trade or business requirement under the second rule of exclusion under §166(d)(2)(B).[356] This is because the holder of the obligation in the year of worthlessness did not create or acquire the obligation in connection with his trade or business, nor was the loss proximately related to the creditor's conduct of a trade or business in which he was engaged in the year of worthlessness.

To qualify as a business bad debt under the second rule, the bad debt must, at the time of worthlessness, be proximately related to the taxpayer's trade or business.[357]

Example 3: Same as *Example 1*, except T sold the claim to B in Year 1 and B continues T's retail operations in Year 2, the year of worthlessness. B is entitled to a business bad debt in Year 2 for the amount paid to T for the claim.[358] If the debt did not become worthless until a year in which B had ceased conducting T's retail business and if the worthlessness of the debt was not proximately related to any trade or business B was then conducting, the debt would be a nonbusiness bad debt.

Example 4: Same as *Example 1*, except T bequeaths the note to his daughter X, and bequeaths his trade or business to his son Y. The note becomes worthless one year after T's death. X will only be entitled to capital loss treatment on the worthlessness of the debt unless, at the time of worthlessness, she is engaged in the conduct of a trade or business to which the loss from the worthlessness of the debt obligation is proximately related. However, if the debt became worthless while T's estate was carrying on T's trade or business and prior to the distribution of the note to X, the estate would be entitled to a business bad debt because such loss would be sustained as a proximate incident to the conduct of a trade or business.[359]

Note: In the examples involving a bequest of the claim, the holder's tax basis in the claim (and thus the maximum bad debt deduction) would generally be the claim's value on T's date of death (or, if elected, the alternative valuation date).[360]

The Tax Court's decision in *Felmann v. Commissioner*[361] addressed both definitions of business bad debts contained in §166(d)(2). In *Felmann*, the taxpayer had been a 50% shareholder in a corporation engaged in a retail antique business in San Francisco. About the time the other 50% shareholder died, the corporation was informed that its lease would not be renewed. A few months later, the corporation liquidated under §331, and the liquidating distribution to the taxpayer included a

[347] §1211(b).
[348] §1212(b).
[349] Reg. §1.166-5(a)(2).
[350] *See Walsh v. Commissioner*, T.C. Memo 1961-278, *aff'd*, 313 F.2d 389 (4th Cir. 1963).
[351] §166(e). In general, this results in a capital loss if the obligation is a capital asset.
[352] §1271(a)(1). Compare with §1275(a)(1). See III.B.3., above.
[353] §166(d)(2)(A); Reg. §1.166-5(b)(1).
[354] §166(d)(2)(B); Reg. §1.166-5(b)(2).
[355] Reg. §1.166-5(d), *Ex. 1.*
[356] Reg. §1.166-5(d), *Exs. 2, 4.*
[357] Reg. §1.166-5(b) (flush language).
[358] Reg. §1.166-5(d), *Exs. 3, 5.*
[359] Reg. §1.166-5(d), *Ex. 5.*
[360] §1014(a), §2032(a).
[361] 77 T.C. 564 (1981).

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one-half interest in a trade receivable which was valued at (and thus had a tax basis in taxpayer's hands equal to) face. Following the liquidation, the taxpayer moved to Beverly Hills where he was engaged (as a sole proprietor) in the antique business at the time the trade receivable became worthless. The taxpayer claimed an ordinary deduction for a business bad debt. The IRS asserted a deficiency, claiming the obligation was a nonbusiness bad debt because it did not fall within §166(d)(2)(A) or §166(d)(2)(B).

In upholding the IRS's position, the Tax Court first held that §166(d)(2)(A) was inapplicable because the debt was created or acquired in the corporation's trade or business and not the trade or business of the taxpayer who had acquired it in his capacity as a shareholder when the corporation was liquidated. Next, the court held that requirement for a business bad debt under §166(d)(2)(B) was not met because, at the time the obligation became worthless, it was proximately related to the taxpayer's status as shareholder of his liquidated corporation (which was not a trade or business), and not proximately related to the antique business which he operated as a sole proprietor.

Comment: Unfortunately, the Tax Court's discussion as to why it did not consider the obligation to be proximately related to the taxpayer's antique business was limited to its rejecting the taxpayer's argument that his situation was not unlike that in examples (3) and (5) of Reg. §1.166-5(d) by stating "… in the examples, the business which was operating when the debt was created was operating as a sole proprietorship and was the same business currently being operated as a sole proprietorship by the son or the executor when the debt became worthless." The decision's "Findings of Fact" description of the taxpayer's antique business in Beverly Hills is limited to its location and is thus silent as to many factors which one would think might be relevant to a determination as to whether the obligation was proximate to that business. For example: (i) did the liquidating distribution to the taxpayer also include business assets, such as inventory, that the taxpayer used in the Beverly Hills business; (ii) was the obligation reflected as an asset on the books and records of the Beverly Hills business and/or financial statements provided to potential suppliers or lenders; and (iii) did the Beverly Hills business continue to service customers (or use suppliers) of the San Francisco business. The lack of discussion of such factors coupled with the court's statement that the examples involved the same business conducted (by different persons) as a sole proprietorship both at the time the obligation was created and at the time it became worthless could be read as implying that qualification as a business bad debt under §166(d)(2)(B) requires that the debt be proximately related to the same business and/or a business conducted in the same form of organization as the one in which the debt arose. Fortunately, no judicial or administrative authority has cited *Felmann* for that proposition.

The distinction between a business and nonbusiness bad debt lacks significance if there is a sale or exchange of the debt. A sale or exchange will bring the transaction within the jurisdiction of §165. The question of ordinary loss versus capital loss will generally depend on the debt's status as a capital asset (unless §165(g)(3) applies), and for there to be any kind of deduction, capital or ordinary, the taxpayer generally must demonstrate a profit motivation. In addition to actual sales or exchanges, sales are deemed to occur if a debt that becomes worthless is evidenced by a "security" to which the §165 rules apply.[362] An exchange is also deemed to occur if a debt instrument is retired within the meaning of §1271(a)(1).[363]

In determining whether a bad debt is a business or a nonbusiness obligation, the regulations focus on the relation the loss bears to the taxpayer's business. If, at the time of worthlessness, the relation is a "proximate" one, the debt qualifies as a business bad debt and may be deducted under §166. The Supreme Court has stated that "in determining whether a bad debt has a 'proximate' relation to the taxpayer's trade or business, the proper measure is that of dominant motivation."[364] In *Hough v. Commissioner*,[365] the taxpayer (a practicing attorney) deducted as bad debts amounts advanced to a radio station in which he was the sole shareholder. No promissory notes or corporate minutes reflected or described the station's liability to the taxpayer for repayment of the amounts advanced. During the taxpayer's ownership of the station, no repayments of any kind were made on the amounts advanced. The Seventh Circuit held that the taxpayer was not entitled to a bad debt deduction after concluding that the taxpayer's "dominant motivation" in advancing the sums to the radio station was to protect his investment as a shareholder, which was a nonbusiness purpose.

In *Fincher v. Commissioner*,[366] the Tax Court applied a cost-benefit analysis in holding that an official of a defunct savings and loan association (S&L) was not entitled to a §166 bad debt deduction for the nearly $500,000 in personal accounts in the S&L that he was compelled to forfeit to settle a civil lawsuit brought against him by the S&L's conservators. In spite of his legal difficulties, the court observed, the officer could have removed the funds from the S&L at any time before it was forced into conservatorship. The court, therefore, rejected the executive's assertion that his dominant motivation for placing almost half a million after-tax dollars at risk was to preserve his position as an officer of the lending institution, for which the S&L paid him an annual salary of only $72,000. Nor was it deductible as a nonbusiness bad debt, because the taxpayers failed to provide sufficient evidence of worthlessness during the years in issue.

In *Litwin v. United States*,[367] the taxpayer, whose advanced age made him generally unemployable, formed a corporation to sell alternative energy systems. He wanted to continue to be active, draw a salary, and provide a useful service. He served actively as CEO and chairman of the board. Because of cash flow problems, he guaranteed lines of credit, made personal loans, and chose to forgo salary from the new corporation of which

[362] §165(g)(1).

[363] See the discussion of §1271 at III.B.3., above.

[364] *United States v. Generes*, 405 U.S. 93, 103 (1972).

[365] 882 F.2d 1271 (7th Cir. 1989), *aff'g* T.C. Memo 1986-229. *See also Baggao v. Commissioner*, T.C. Memo 1992-225 (amount loaned by shareholders to their corporation for attorney fees, which corporation did not repay, was a nonbusiness bad debt because loan was made to protect the shareholders' investment in corporation).

[366] 105 T.C. 126 (1995).

[367] 91-1 USTC ¶50,229 (D. Kan. 1991), *aff'd*, 983 F.2d 997 (10th Cir. 1993). *See Rosenberg v. United States*, 96-2 USTC ¶50,583 (N.D. Ill. 1996) (applying dominant motive test of *United States v. Generes*, 405 U.S. 93 (1972), retaining taxpayer's business as employee held dominant motive in guaranteeing his corporation's debts, thus escaping nonbusiness bad debt classification).

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he owned 62% of the stock. He also incurred legal fees in a suit related to the loan guarantees. When the corporation went bankrupt, the taxpayer claimed as business bad debts the losses incurred from the guarantees, the personal loans, and the legal fees. Citing *United States v. Generes*, the district court held that the taxpayer's losses were business bad debts, explaining that his motives were to: (1) further his business interest in remaining employed and meaningfully serving in a managerial capacity with a company in which he believed, (2) obtain a salary to meet his financial demands, and (3) protect his business reputation. The court noted that the taxpayer's loans and guarantees were more than three times his investment, suggesting that the taxpayer was primarily motivated by concerns other than protecting his investment.

The Tax Court came to a similar conclusion in *Lagoy v. Commissioner*,[368] where it held that an accountant's loans to two client corporations, which were made to assist the corporations in acquiring another company, qualified as business bad debts. The court found that the accountant's predominant motivation in making the loans was to broaden his client base.

In *Smartt v. Commissioner*,[369] the taxpayer was engaged in a highly leveraged real estate development business in which a good reputation and credit rating were necessary to maintain the business. A partnership in which the taxpayer was the general partner with a 40% interest built a truckstop and leased it to an unrelated corporation which operated the truckstop. The taxpayer advanced funds to the lessee when it fell behind on the rent and paid funds to a bank to prevent the enforcement of a lien on the truckstop's equipment. The Tax Court held that the advances to the lessee and the bank were business bad debts because the taxpayer's dominant motivation in making them was the preservation of his business.

More typical is *Garner v. Commissioner*,[370] where the guarantor of a corporation's debt was also the sole shareholder and an employee. The shareholder/employee guarantor could not deduct payments under the guarantee as business bad debts because the guarantor's dominant motivation was held to be the protection of his investment. Similarly, in *Silberstein v. United States*,[371] a stockholder's personal loan guarantee was a nonbusiness bad debt where his motive for guaranteeing the loan was protection of his 25% interest in the business.

The Tax Court, in *Nicholson v. Commissioner*,[372] applied another rule to distinguish between business and nonbusiness debts: whether the activity resembles an investment by the taxpayer, rather than a trade or business. The degree to which the taxpayer is active is relevant to this distinction. In *Nicholson*, the taxpayer's bad debt arose from "net leasing" activities, under which the taxpayer, as lessor, was not responsible for repairs, insurance, utility services, real property taxes, and similar fees. Therefore, the court classified the arrangement as an investment, rather than a trade or business. In this situation, the taxpayer's leasing activity consisted of little more than collecting a check each rental period.

[368] T.C. Memo 1992-213.

[369] T.C. Memo 1993-65.

[370] 987 F.2d 267 (5th Cir. 1993).

[371] 93-1 USTC ¶50,242 (E.D. Mo. 1993).

[372] T.C. Memo 1993-183.

In PLR 200714008, the IRS concluded that the dominant motive of a taxpayer engaged in a consulting business for making loans to a client whom the consultant was advising in connection with the proposed acquisition of a business was to increase the likelihood that the taxpayer would be paid a consulting fee and the taxpayer was therefore entitled to a business bad debt deduction when the loans were discharged in the client's bankruptcy. The IRS based its conclusion on the following findings: (1) based on the facts submitted, the proposed business venture continually experienced significant cash flow problems, and as a result, the taxpayer was required to lend the debtor money in order for the taxpayer to be paid his consulting fee; (2) similar to *Litwin v. United States*, the size and magnitude of the taxpayer's employment compensation package supported the finding that the loan had a business purpose, and therefore, the loan was created in connection with the taxpayer's consulting business; and (3) providing venture capital to the debtor was consistent with the taxpayer's past business practices and was in furtherance of the taxpayer's consulting business.

C. Taxpayer's Trade or Business

1. General Principles

A business bad debt deduction is unavailable unless the taxpayer-creditor can establish that (1) he was engaged in a trade or business and (2) the acquisition or worthlessness of the debt was proximately related to the conduct of such trade or business.

The concept of a trade or business is narrower than that of an activity engaged in for the production of income.[373] This distinction led to the enactment of what is now §212 by the Revenue Act of 1942, which also established the nonbusiness bad debt category under §166(d).[374] In *Higgins v. Commissioner*,[375] the Supreme Court, in holding that a taxpayer who managed a large investment portfolio was not "carrying on a trade or business," stated that in order to determine whether the activities of a taxpayer constitute the carrying on of a trade or business, the trial court must examine all relevant facts and circumstances present in each case and focus on whether the fre-

[373] *See Nicholson v. Commissioner*, T.C. Memo 1993-183 (worthless debts arising from net leases, which are considered to be investment activities, are nonbusiness bad debts and thus short-term capital losses).

[374] The distinction between a trade or business and an investment activity is also pertinent in determining whether certain deductions incurred with respect thereto are deductible from gross income or adjusted gross income and whether certain operating expenses of a noncorporate taxpayer may be carried over to other tax years. *See* §62(a)(1), §172(d)(4). Also, investment activities must be distinguished from personal expenditures and hobby activities in qualifying certain expenses, depreciation and credits for income tax purposes. *See* §212, §183, §167, §168, and §263; Reg. §1.48-1.

[375] 312 U.S. 212, 217–218 (1941). *Accord City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941) (trusts established to collect interest and make reinvestments not trade or business); *United States v. Pyne*, 313 U.S. 127 (1941) (estate, by marshalling and collecting assets of the deceased as a conduit for ultimate distribution to beneficiaries, not engaged in a trade or business). *See Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979), adopting trial judge's opinion per curiam (taxpayer engaged full time in directing the management of purchasing and selling on his own account held to be engaged in trade or business as trader; business bad debt deduction from worthless loan made to business colleague still disallowed based on failure to prove business motive for loan or that worthlessness arose in year claimed); *Hunsaker v. Commissioner*, 615 F.2d 1253 (9th Cir. 1980).

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quency and level of activity constitute a trade or business. Despite the Supreme Court's endorsement of a facts and circumstances test, some subsequent decisions added a threshold requirement, i.e., that a taxpayer engaged in a trade or business must also hold himself out to others as selling goods or services. This "goods-and-services" test had its genesis in Justice Frankfurter's concurring opinion in *Deputy v. DuPont*,[376] decided prior to the *Higgins* decision, in which the majority opinion did not consider the meaning of a trade or business.

In a 1987 case, *Groetzinger v. Commissioner*,[377] the Supreme Court formally rejected Justice Frankfurter's suggestion that carrying on a trade or business requires one's holding oneself out to others as selling goods or services. The Court reiterated that whether a trade or business exists requires an examination of the facts of each case, and refused to attempt any all-purpose definition in view of the fact that the Code uses the term "trade or business" in various contexts. For a full discussion of *Groetzinger*, see 527 T.M., *Loss Deductions*.

In order to establish a business debt, it is not necessary that a taxpayer be in the business of lending money,[378] although the making of loans may be so extensive as to characterize the taxpayer as being in such business.[379]

Furthermore, the debt does not have to be a receivable from the sale of inventory, although the examples in the regulations are of this type.[380]

When a trade or business is deemed to commence may be critical. Investigation, promotion, or preparation for entering into a new trade or business is not the conduct of a trade or business.[381] For example, in *Ward v. Commissioner*,[382] the taxpayer incurred expenses immediately after leaving one business but before the incorporation of a second business. Interim period expenses were held not to be expenses of an existing trade or business and were not deductible for tax purposes. However, in *Malmstedt v. Commissioner*,[383] the Fourth Circuit (reversing the Tax Court) held that expenses incurred by a taxpayer in developing a new commercial real estate venture were still part of the existing trade or business conducted by the taxpayer, even though the previous activities had been restricted to developing residential property. Moreover, it is also possible that a taxpayer may be engaged in two or more trades or businesses at the same time.[384]

Syracuse v. Commissioner[385] considered the issue of whether a taxpayer was engaged in an existing trade or business for purposes of §166. The taxpayer-creditor was held to be engaged in a landfill business when the debt was created. In establishing his trade or business, the taxpayer presented evidence that he had purchased property specifically for use in the business, attended numerous meetings in an effort to secure business for his landfill, continuously held himself out to the public and third persons as being engaged in the business, and owned and operated machinery in connection therewith. Accordingly, a loan made by the taxpayer in an effort to secure business for his landfill operations was held to be deductible as a business bad debt in the year of worthlessness.

If the taxpayer's dominant motive in lending funds to a third party is to help a member of his family or a personal friend, and the loan becomes worthless, it will normally (assuming it qualifies as debt for tax purposes) constitute a nonbusiness bad debt.[386] Such a finding was made in *Hunsaker v. Commissioner*,[387] where a son's sizeable advance of money to his father's corporation was held to be a nonbusiness bad debt upon worthlessness. A similar finding was made in *Levin v. United States*,[388] where the taxpayer established that he was engaged in a trade or business, but failed to prove business motives for the loans made to a personal friend. The court noted that the advances were not handled by the taxpayer in a businesslike manner, e.g., the note was not executed until more than a year after the first advance of funds, and the debtor believed that the only reason for executing a note was to allow the taxpayer to recover from his estate in the event of the debtor's death. In recharacterizing the worthless obligations as nonbusiness bad debts, the court stated that the taxpayer's casual attitude in making the advances strongly indicated that the loans were primarily personal in nature.

The courts have long recognized that the business of a shareholder normally is not the same as the business of his corporation, even though he may have controlling stock ownership, and regard them as the same.[389] Indeed, advances (direct or indirect) to corporations by stockholders provide the most common examples of nonbusiness debts to be found in the case law.[390]

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[376] 308 U.S. 488, 499 (1940).

[377] 480 U.S. 23 (1987).

[378] *Giblin v. Commissioner*, 227 F.2d 692 (5th Cir. 1955); *Milgroom v. Commissioner*, T.C. Memo 1962-88; *Hickerson v. Commissioner*, 229 F.2d 631 (2d Cir. 1956); *Estate of Byers v. Commissioner*, 57 T.C. 568 (1972), *aff'd per curiam*, 472 F.2d 590 (6th Cir. 1973).

[379] *See Owens v. Commissioner*, T.C. Memo 2017-157; *Ruppel v. Commissioner*, T.C. Memo 1987-248 (trade or business found despite fact that loan activity tailed off; curtailed lending was result of default by largest debtor); *Bush v. Commissioner*, T.C. Memo 1968-39. *See also Magee v. Commissioner*, T.C. Memo 1993-305 (taxpayer's loan-making activities not extensive or continuous enough to qualify as business; therefore, loan is deductible only as nonbusiness bad debt); FSA 199911003 (taxpayer whose business consists of making loans and purchasing obligations from other lenders is in trade or business of moneylending, and can take business bad debt deduction).

[380] *Bart v. Commissioner*, 21 T.C. 880 (1954), *acq.*, 1954-1 C.B. 3.

[381] *Westervelt v. Commissioner*, 8 T.C. 1248 (1947); *Koons v. Commissioner*, 35 T.C. 1092 (1961); *Haskins v. Commissioner*, T.C. Memo 1982-730.

[382] 20 T.C. 332 (1953), *aff'd*, 224 F.2d 547 (9th Cir. 1955). *See Petersburg Television Corp. v. Commissioner*, T.C. Memo 1961-49.

[383] 578 F.2d 520 (4th Cir. 1978), *rem'g* T.C. Memo 1976-46.

[384] *Curphey v. Commissioner*, 73 T.C. 766 (1980); *Achong v. Commissioner*, 246 F.2d 445 (9th Cir. 1957); *Sherman v. Commissioner*, 16 T.C. 332 (1951).

[385] T.C. Memo 1981-340.

[386] *Estate of Broadhead v. Commissioner*, 391 F.2d 841 (5th Cir. 1968); *Goldman v. Commissioner*, T.C. Memo 1962-36; *O'Malley v. Commissioner*, T.C. Memo 1980-95.

[387] 615 F.2d 1253 (9th Cir. 1980).

[388] 597 F.2d 760 (Ct. Cl. 1979). *See also Henderson v. United States*, 403 F. Supp. 665 (D. Cal. 1986) (attorney not allowed business bad debt deduction for loan to friend for starting business, although friend promised to give him legal work; court allowed only nonbusiness bad debt deduction because attorney's dominant reason for making loan was not to benefit his legal practice because he never did any legal work for friend and mutual friend was investor in business).

[389] *Burnet v. Clark*, 287 U.S. 410 (1932); *Dalton v. Bowers*, 287 U.S. 404 (1932). *See Tibbals v. United States*, 362 F.2d 266, 271 (Ct. Cl. 1966).

[390] *Knight v. Commissioner*, 538 F.2d 310 (2d Cir. 1976); *Bomaha Nat'l Bank v. Commissioner*, 183 F.2d 899 (8th Cir. 1950); *Van Pelt v. Commissioner*, 191 F.2d 861 (6th Cir. 1951); *Towers v. Commissioner*, 247 F.2d 233 (2d Cir. 1957). *See also Blauner v. Commissioner*, T.C. Memo 1967-156 (indirect loan). However, a taxpayer other than a corporation, trust, or estate, may

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Is the same true of loans by a partner to a partnership? Probably; however, years ago the Tax Court held in *Butler v. Commissioner*,[391] that a loan by a partner to or for the benefit of a partnership may be deductible as a business bad debt on the theory that a partnership is but an instrumentality for carrying on the taxpayer's trade or business. In that case, where the creditor-limited partner was permitted to treat a worthless partnership obligation to the partners as a business bad debt, the decision was predicated on an aggregate theory of partnership taxation whereby the trade or business of the partnership was attributed to each partner, including the creditor-limited partner.[392] The *Butler* decision related to years prior to the 1954 enactment of §707(a), which provides that certain transactions between a partner and a partnership are to be treated as occurring between the partnership and one who is not a partner. Reg. §1.707-1(a) expressly indicates that this concept applies to a loan of money or property between a partner and the partnership. Because §707(a) adopts an entity theory approach, a court reviewing fact patterns similar to *Butler* may consider it necessary to examine a creditor-partner's individual activities and motives in loaning funds to his partnership in determining whether the obligation is a business or nonbusiness debt, instead of merely adopting the aggregate theory standard used in *Butler*. In other words, it is arguable that loans made by a partner (especially a limited partner) to a partnership should generally be considered an investment activity by focusing solely at the partner level.[393]

Comment: Where a proposed loan would be a business loan if made by the partnership, a partner willing to fund the loan should be able to avoid the need to attribute the partnership's business to the partner by contributing capital to the partnership which makes the loan and specially allocates items of income and loss associated with the loan to the partner. To minimize the risk of the IRS's disregarding the partnership's role as maker and owner of the loan, it would be advisable for a second partner to have at least a minimal percentage interest in the items associated with the loan.

In *Smith v. Commissioner*,[394] the trade or business of the partnership was attributed to the partners. The context was not a loan from the partners to the partnership but rather a loan from the partnership to a related corporation. In *Smith*, the two (general) partners in a construction partnership were allowed a business bad debt deduction for payments by the partnership to discharge their guarantees of a construction loan made to a corporation in which they each held a 30% interest. The partnership was performing the construction work for the corporation, and the court found that (i) the partners were engaged in the construction business through the partnership and (ii) the making of the guarantee was primarily motivated by their desire to obtain the construction contract.

In *Dagres v. Commissioner*,[395] the trade or business of the partnership was attributed to a partner in the context of a loan by a venture capitalist who was a partner in several partnerships that were in the trade or business of advising venture capital funds. The taxpayer lent $5 million to another individual who was the chief executive officer of a public company in financial difficulty. The purpose of the loan was to gain favor with the borrower in hopes that the borrower would refer business leads to the taxpayer and the funds the taxpayer advised. After some of the principal and interest had been paid, the remainder of the loan became worthless and was forgiven by the taxpayer. The court established that the partnerships were engaged in a trade or business and then attributed the trade or business of the partnerships to the individual partner-taxpayer.

Partners often advance funds to partnerships on the understanding that available partnership funds will be used to pay back the advance, with an agreed yield, before anything is distributed to the other partners. The parties have a choice between structuring the advance as a loan or as a contribution to partnership capital. Any tax considerations aside, a lending partner will presumably prefer structuring the advance as a loan, which (subject to any applicable contractual or equitable subordination) will be *pari passu* with other creditors, rather than as a capital advance which is only paid after all creditors are provided for; however, the other partners may prefer a capital advance which does not require a fixed payment date. The tax consequences may also be a significant consideration in choosing the legal form of the advance.

If the yield on the advance is payable periodically without reference to the partnership's income or cash flow, the yield will be ordinary income,[396] to the lending partner at the time partnership deducts or capitalizes the payment (subject to adjustment for differences between the tax years of the partner and the partnership) whether the advance is a loan or a capital advance.[397] In the case of a capital advance where the obligation to pay the yield is dependent on income or cash flow, the lending partner will receive an allocation of partnership income (which may include capital gain or tax-exempt income).

Allocations of a partnership's income or loss among its partners are governed by regulations promulgated under §704(b). The underlying principle of these regulations is that a partnership's income or loss should be allocated to those partners who would receive the benefit of the income or bear the burden of the loss if the partnership converted its assets to cash without recognizing any additional gain (other than certain gain attributable to nonrecourse debt in excess of basis) or loss and liquidated. The principal portion of a partner loan or a capital advance which is entitled to a repayment priority over other capital will not affect the partnership's allocations of income

take an ordinary loss upon the worthlessness, sale, or exchange of stock from a qualifying small business corporation in the manner prescribed in §1244.

[391] 36 T.C. 1097 (1961), *acq.*, 1962-1 C.B. 3. *Accord Stanchfield v. Commissioner*, T.C. Memo 1965-305 (decided under 1954 Code).

[392] The trade or business of a partnership may also be attributed to its partners under certain provisions of the Code. *See, e.g.*, §§875, 1402(a).

[393] *But see Stanchfield v. Commissioner*, T.C. Memo 1965-305 (§707 not raised).

[394] T.C. Memo 1994-640.

[395] 136 T.C. 263 (2011). *See* Jackel and Maddrey, "'*Dagres*': New Law or Just More of the Same?" *BNA Daily Tax Rpt.* (Apr. 25, 2011) (79 DTR J-1) (calling into question the court's conclusion on trade or business attribution issue).

[396] In the case of a loan, the lender partner's ordinary income (and partnership's payment or accrual) will be interest for all purposes of the Code. In the case of a capital advance, the yield will be treated the same as interest for some, but not necessarily, all purposes. *E.g.*, Reg. §§1.469-2(e)(2)(ii), 1.263A-9(c)(2)(iii).

[397] §707(c) (yield on capital). §§267(a)(2), (e), 1272(a)(1); Reg. §1.267(a)-2T(b) (yield on loan).

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or loss unless and until all the partners have had their nonpriority capital reduced to zero (through the allocation of losses or distributions in excess of income). Thereafter, losses (up to the amount of the loan or priority capital) will generally be allocated to those partners who will be liable (at least to the extent of their negative capital accounts) for repayment of the advance. If no partner will be personally liable (i.e., the right to repayment is limited to the assets of the partnership), such losses are allocable to the partner(s) who have made the loan or advanced the priority capital.

If no partners are personally liable for repayment and the partnership cannot repay the advance, the partner who made the advance will eventually be allocated losses equal to his nonpriority capital and the unpaid portion of the advance (whether it was a loan or priority capital). If the advance was priority capital, the partner will have a zero capital account balance and that is clearly the end of it. If the advance was a loan, the partner will have a negative capital account and a receivable, each equal to the unpaid amount. What happens if the partners just abandon their partnership at that point? The partner-creditor has had a tax loss that matches his economic loss, which as far as it goes is the proper result. But the partner-creditor still has a basis in his loan, equal to its unpaid principal balance. As a theoretical matter, the basis in the bad debt and the negative capital account should not be simply ignored. There is no authority on the proper analysis, but a reasonable approach would be to say that the partner-creditor is deemed to contribute cash to the partnership sufficient for the partnership to pay off the loan.[398] This will eliminate both the negative capital account and the loan. Faced with this situation, a partner-creditor might consider contributing money to the partnership so that it can pay off the loan.[399] If there are other creditors, the matter becomes more complex. For example, an actual cash contribution might have to be shared with the other creditors.[400]

The alternative analysis is to say that the partnership has cancellation of indebtedness income, allocable to the partner-creditor's capital account, and the partner-creditor has a bad debt. The cancellation of indebtedness income will be ordinary income, while the bad debt deduction might be a nonbusiness bad debt, and thus a capital loss. This analysis yields tax results that satisfy theory just as well as the first analysis — income for tax purposes matches economics, everything balances (except for mismatches between capital losses and ordinary income), and no basis disappears. But the ultimate rationale for treating cancellation of indebtedness as income is that it improves the debtor's overall net worth, which is hardly the case with the partner-creditor in question. Deeming the partner-creditor to have made a contribution to capital that is used to pay off the loan seems to be the better approach.

Section 108(e)(8) provides that, if a partnership issues an interest in partnership capital to a creditor in satisfaction of a debt, the partnership is treated as satisfying the indebtedness for an amount of money equal to the fair market value of the partnership interest. If one imputed the issuance of a partnership interest to the partner with the negative capital account, would the value of the imputed interest be zero or the amount by which his negative capital account was reduced?[401]

Under Reg. §1.1001-2, the amount of any nonrecourse debt secured by property is treated as sales proceeds if there is a disposition of the property. Accordingly, if a partner makes a nonrecourse loan secured by property (within the meaning of Reg. §1.1001-2) to the partnership, he will, when the partnership assets securing the loan are sold or otherwise disposed of, be allocated gain equal to the lesser of (i) the unpaid portion of his loan or (ii) the losses previously allocated to him based on the loan. He will also have a bad debt deduction, which could be a business bad debt, but would often be a nonbusiness bad debt, deductible only as capital loss. Depending on the nature of the partnership property and the nature of the debt, there can easily be a mismatch of capital loss against ordinary gain or vice versa.

Note: A loan that is "nonrecourse" within the meaning of the §704(b) regulations may not be a nonrecourse loan secured by property for purposes of Reg. §1.1001-2.[402]

If one or more partners are liable for repayment of the advance and it is a loan, the lender partner will be entitled to a bad debt deduction only when and to the extent that he is able to establish that neither the partnership nor the partners with liability are able to pay. Similarly, if other partners are liable for the repayment of an advance of priority capital, the advancing partner will end up with a positive capital account equal to any unrepaid amount and, provided that the obligation of the partners with liability has become fixed under applicable law, should be entitled to a bad debt deduction if the partners with liability are unable to pay.

For example, in PLR 8006009, solvent partners began contributing capital to the partnership in Year 1 to repay the partnership's third-party creditors. In Year 4, the partnership completed the sale of assets, ceased doing business, and paid the third-party creditors. This left the insolvent partners who had not contributed their proportionate shares of the excess of third-party liabilities over the partnership's assets (exclusive of the solvent partners' contributions) with negative capital accounts and the contributing partners with positive capitals in an aggregate amount equal to the noncontributors' negative capital accounts. In Year 4, the partnership settled its claims against all but one of the partners with negative capital accounts. It settled with the final negative-account partner in Year 5. The IRS determined that, under state law, the partners' obligations to repay negative capital account balances did not become a legally binding obligation to pay a fixed amount by a date certain un-

[398] *Cf.* §108(e)(6) (if creditor contributes indebtedness to corporate debtor, corporation is treated as satisfying debt for amount equal to creditor's tax basis for debt).

[399] *But see Monahan v. Commissioner*, T.C. Memo 1994-201, *aff'd*, 86 F.3d 1162 (9th Cir. 1996) (where repayment of deficit in partnership held sham because partner effectively controlled funds involved in transaction).

[400] If the partner/creditor is a limited partner or a member of a limited liability company, the other creditors probably have no claim against his negative capital account but would presumably have a claim against any cash transferred to the partnership.

[401] *See* Prop. Reg. §§1.108(e)(8), 1.721-1(d); preamble (REG-164370-05, 73 Fed. Reg. 64903 10/31/08) (if certain conditions met, fair market value equals increase in liquidation value (generally increase in capital account), otherwise fair market value determined based on all facts and circumstances; §721 precludes creditor recognizing loss on excess of basis in debt over value of partnership interest received; basis in debt becomes basis in partnership interest).

[402] *See* Reg. §§1.704-2(b)(3), 1.752-1(a)(2).

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til the partnership ceased active business in Year 4. Therefore, Year 4 was the earliest year that a bad debt deduction could be claimed. The IRS allowed the partnership (and thus the contributing partners) a business bad debt deduction in Year 4 equal to the excess of the negative capital account of each partner with whom a settlement was reached in Year 4 over the amount of the settlement. A business bad debt deduction for the shortfall attributable to the partner with whom settlement was reached in Year 5 was allowed in Year 5.[403]

Comment: By allowing a business bad debt deduction for the unpaid negative capital account (and presumably requiring the noncontributing partners to recognize cancellation of indebtedness income) the IRS's approach in PLR 8006009 would usually place the partners in the position (except for timing differences and a possible income exclusion for insolvency) they would have been in under the §704(b) regulations had it been known that the noncontributing partners would not actually bear the economic loss associated with the unrepaid negative capital accounts.

For detailed discussions of the partnership allocation rules, see 712 T.M., *Partnership — Taxable Income; Allocation of Distributive Shares; Capital Accounts*, and 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules.*

2. Promoters; The Whipple Case

Noncorporate taxpayers who extensively promote, invest, manage, and lend funds to various corporations have frequently sought business bad debt treatment on worthless obligations of corporations in which they are shareholders.

The landmark Supreme Court decision of *Whipple v. Commissioner*[404] established the relevant rule. Although remanding the case for additional findings, the Supreme Court adopted the Commissioner's view that a taxpayer who furnishes management or other services to one or more corporations which he controls or in which he has an interest (for the purpose of profit or gain) is not engaged in an independent trade or business.

Comment: Though such efforts may produce income in the form of dividends or appreciation, this type of return is characteristic of investment income rather than profits from the active conduct of a trade or business. Therefore, if all the taxpayer can establish is that he was engaged in investing in corporations, the worthlessness of a corporate obligation generally constitutes a nonbusiness bad debt. However, if the shareholder-lender is regularly engaged in promoting corporations for a fee or commission, his involvement may constitute a trade or business. Accordingly, if a lender can establish that the worthlessness from a bad debt was proximately related to his trade or business as a promoter, a business bad debt deduction is allowed.

Another way of analyzing the *Whipple* decision is that taxpayers who want to claim a business bad debt should be prepared to establish that they are engaged in the business of lending money by demonstrating that they possessed as many as possible of the usual indicia of a business — books of account, an employee, a business name, etc.[405] This approach is usually unsuccessful for individuals making a limited number of loans, except for shareholders making loans to corporations in which they have a substantial proprietary interest. In this situation, the overriding factor is not the extent of activities or number of loans made by the shareholder-creditor, but the general relationship between the taxpayer and the corporation.[406]

The *Whipple* decision has had a severe impact on promoter cases under §166. For example, in *Estate of Campbell v. Commissioner*,[407] the Second Circuit denied a business bad debt deduction claimed by a taxpayer-attorney with a record of 40 or more business ventures. The same result occurred in *Schwartz v. Commissioner*,[408] wherein a builder, who was involved in several corporations, had a history of seeking a return as an investor rather than as a promoter. In *Townshend v. United States*,[409] the Court of Claims conceded that the taxpayer could be classified as a "promoter" in the corporate or securities-law sense of the word, but that for federal income tax purposes, he had not undertaken corporate promotion "for fees and commissions with a view to an early and profitable sale thereof after the business has become established."

On the other hand, the Tax Court stated in *Farrar v. Commissioner*,[410] that "to blindly refuse to acknowledge that a taxpayer is in the trade or business of promoting would be to adopt a per se rule that is not supported by [*Whipple*] or its progeny." In *Farrar*, the Tax Court held that a taxpayer, who "bought and sold at least 31 banks and insurance companies, as well as other businesses and income producing real estate,"[411] was engaged in the trade or business of developing and promoting businesses. The court rejected the IRS's suggestion that a taxpayer must earn some sort of fee or commission to be engaged in the business of promoting, observing that buying and selling businesses for profit may constitute a trade or business even though a promoter does not receive a fee, commission, or other "non-investor" compensation. The court relied on its opinions in *Whipple* and *Deely v. Commissioner*[412] Upon holding that the taxpayer was in the promotion business, the court found that the taxpayer's now-worthless loans and guaranty payments to or on behalf of three separate entities were related proximately to that promotion business. The court explained that the taxpayer acquired his interests in two of the entities with the intention of developing their businesses and selling his interests at a profit

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[403] PLR 8006009 did not address the tax consequences to the noncontributing partners. Presumably they had cancellation of indebtedness income in the settlement year. If they did not have cancellation of indebtedness income, they would have a §752 deemed cash distribution in excess of basis. Since the TAM indicates that many of them were insolvent, they presumably would have preferred cancellation of indebtedness income (excludable to extent of insolvency) to §752 distribution resulting in capital gain equal to their negative capital accounts.

[404] 373 U.S. 193 (1963).

[405] *See United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967), *rev'g* 64-2 USTC ¶9691 (E.D. Tex. 1964). *See also Davis v. Commissioner*, T.C. Memo 1965-134 (holding against taxpayer); *Bush v. Commissioner*, T.C. Memo 1968-39 (same).

[406] *See Bettinger v. Commissioner*, T.C. Memo 1970-18. *But cf. Knight v. Commissioner*, T.C. Memo 1970-1 (one-time performance of duties as administrator of estate not business).

[407] 343 F.2d 462 (2d Cir. 1965), *aff'g per curiam*, T.C. Memo 1964-53.

[408] T.C. Memo 1964-247.

[409] 384 F.2d 1008 (Ct. Cl. 1967).

[410] T.C. Memo 1988-385.

[411] *Id.*

[412] 73 T.C. 1081 (1980).

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(although the taxpayer held no interest in the third entity, which was the sole general partner of one of the other two entities). Accordingly, the court held the loans and guarantee payments were deductible as §166 business bad debts.

Similarly, the Tax Court held in *Newman v. Commissioner*,[413] that a taxpayer had established that he was in the trade or business of promoting (i.e., he had a reputation in the community for promoting, organizing, financing, and selling businesses), and that his losses proximately related to this business were bad debts.

On the other hand, in *Bell v. Commissioner*,[414] the Eighth Circuit upheld the Tax Court's denial of a taxpayer's business bad debt deduction, holding that worthless loans that the taxpayer made to two corporations that he owned did not relate to a trade or business of buying, rehabilitating, and reselling corporations because the taxpayer contributed working capital (in the form of loans), rather than personal services, to rehabilitate the businesses.

3. *Where Loans to Corporations Are Not Denied Business Status Under the Whipple Doctrine*

A person (e.g., a stockholder) may be able to establish that a loan to a corporation is a business loan in (at least) three situations: (1) promoter cases, (2) loans made in furtherance of the lender's trade or business, or (3) where the loan is related to the lender's business of being an employee.

a. *Where Taxpayer Is a True Promoter*

The activities required of a promoter are so extensive (following *Whipple*, discussed at IV.C.2., above)[415] that this category is applied only in "exceptional situations,"[416] e.g., where the taxpayer acquired, rehabilitated, and disposed of formerly distressed businesses.[417]

b. *Loans in Furtherance of Separate Business*

This exception can perhaps best be explained by describing the holdings of some cases, several of which involved professionals. For example, a business bad debt deduction was permitted for a physician, who, in exchange for notes, transferred his equipment to a corporation formed to hold medical equipment for a group practice of which he was a member.[418] The same result occurred in a case where the notes represented the sale of a stock exchange membership by a stockbroker.[419] In *Garlove v. Commissioner*,[420] a lawyer lent funds to permit a client to stay in business. The business nexus for the loans was evidenced by the substantial fees he received from the client-debtor.[421]

In *Smith v. Commissioner*,[422] the two taxpayers owned 60% of a corporation and 100% of a partnership which was to perform construction work for the corporation. The construction lender required each of the corporation's four shareholders to execute the construction loan note as both makers and guarantors and required a $250,000 deposit as collateral. The collateral was provided by the partnership. Eventually, the partnership paid $227,000 to the construction lender. The court found that the partnership had made the payments to the lender to satisfy the taxpayers' guarantees and that the taxpayers' rights to subrogation were worthless at the time the payments were made. The court further found that the taxpayers were engaged (through their partnership) in the construction business and that the guarantees were primarily motivated by the desire to obtain the construction contract. In determining the guarantors' motivation, the court noted that their anticipated profits from the partnership's performance of the construction contract were substantially greater than their projected profits from the corporation's development and sale of the project and that the transaction was entered into at a time when the partnership's construction business was slow and it needed work in order to retain key employees.

Some taxpayers, however, have not fared as well as those mentioned above. For example, in *Gustin v. Commissioner*,[423] the taxpayer failed to show that the loans were made to obtain or retain the debtors as clients or that the taxpayer ever obtained subsequent business from them. In *Hogue v. Commissioner*,[424] the taxpayer, an accountant, was unable to prove the relationship of the loans to the obtaining of new clients.

The notion that loans to finance an important customer may be proximately related to the lender's trade or business appears to be generally accepted. In *Maloney v. Spencer*,[425] the leading stockholder was held to be in the business of leasing property to the corporations formed by him. (This case was favorably cited in *Whipple*.)[426]

Similarly, in *Morrow v. Commissioner*,[427] an individual engaged in the construction business lent money to his primary customer to aid the latter indirectly in obtaining the financing for its purchases from the taxpayer.[428] Favorable results were al-

[413] T.C. Memo 1989-63. *See also In re Farrington*, 111 Bankr. 342 (Bankr. N.D. Okla. 1990).

[414] 200 F.3d 545 (8th Cir. 2000), *aff'g* T.C. Memo 1998-136.

[415] Pre-*Whipple* cases include *Commissioner v. Smith*, 203 F.2d 310 (2d Cir. 1953), *rev'g* 17 T.C. 135 (1951); *Gamble v. Commissioner*, T.C. Memo 1960-238; *Funk v. Commissioner*, 35 T.C. 42 (1960), *acq.*, 1961-2 C.B. 4; *Allen v. Commissioner*, 283 F.2d 785 (7th Cir. 1960).

[416] *See Salomone v. Commissioner*, 27 T.C. 663, 670 (1957). *See also Ingram v. Commissioner*, T.C. Memo 1961-277, *rem'd*, 63-2 USTC ¶9516 (5th Cir. 1963). *But compare Elliott v. United States*, 268 F. Supp. 521 (D. Ore. 1967); *Farrar v. Commissioner*, T.C. Memo 1988-385.

[417] *Vreeland v. Commissioner*, 31 T.C. 78 (1958). *See also Farrington v. United States*, 111 Bankr. 342 (Bankr. N.D. Okla. 1990); *Newman v. Commissioner*, T.C. Memo 1989-63.

[418] *Bernstein v. Commissioner*, T.C. Memo 1960-213.

[419] *Cluett v. Commissioner*, 8 T.C. 1178 (1947), *acq.*, 1947-2 C.B. 2.

[420] T.C. Memo 1965-201, *appeal dismissed* (6th Cir. 1965). *But see Canelo v. Commissioner*, 53 T.C. 217, 223–225 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971).

[421] *Cf. Steadman v. Commissioner*, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir. 1970).

[422] T.C. Memo 1994-640.

[423] T.C. Memo 1968-42, *aff'd per curiam*, 412 F.2d 803 (6th Cir. 1969).

[424] 459 F.2d 932 (10th Cir. 1972), *aff'g* T.C. Memo 1971-75. *See also Hough v. Commissioner*, 882 F.2d 1271 (7th Cir. 1989) (court rejected theory that loans to taxpayer/attorney's wholly owned radio station were made to generate legal fees from station/client, noting that taxpayer had never billed station for fees generated during period of ownership; in any event, amount of loans were totally disproportionate to amount of legal fees taxpayer could reasonably expect to generate).

[425] 172 F.2d 638 (9th Cir. 1949).

[426] *Accord Commissioner v. Moffat*, 373 F.2d 844 (3d Cir. 1967), *aff'g* T.C. Memo 1965-183.

[427] T.C. Memo 1965-45.

[428] *Accord Lundgren v. Commissioner*, 376 F.2d 623 (9th Cir. 1967), *rev'g* T.C. Memo 1965-314. *But cf. Hirsch v. Commissioner*, T.C. Memo 1971-235; *Gulledge v. Commissioner*, 249 F.2d 225 (4th Cir. 1957).

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so obtained in *Rubin v. Commissioner*,[429] where the lender was the distributor for the debtor-manufacturer, and in *Lundgren v. Commissioner*,[430] where the lender sold products of the debtor corporation.

Another favorable decision in this area is *Bowers v. Commissioner*,[431] where the sole shareholder of a corporation engaged in real estate sales was allowed a business bad debt deduction for a worthless loan made to an important corporate customer. Although the loan was made directly to the customer's controlling shareholder, the customer's business dealings contributed significantly to corporate profits, which were, in effect, received by the lender in the form of compensation. Under the facts, the Fourth Circuit reversed the trial court and held that the loans were predominately and "solely" made to maintain the corporation's enhanced level of profitability and not primarily for personal reasons.

In *Harvey v. Commissioner*,[432] however, a shareholder made loans to the lessee of property owned by his corporation. A business bad debt was subsequently denied on the basis that the lessor-corporation could easily have obtained other tenants and thus the loan was unnecessary.

It has generally been considered that loans made to attract future customers may not lay the basis for a business bad debt deduction.[433] However, in *Adelson v. United States*,[434] the trial court allowed a financial consultant business bad debt deductions for loans made to six newly formed companies that could not qualify for bank financing for which he agreed to serve as a consultant and in which he held minority equity interests. On appeal, the Federal Circuit remanded for further consideration of the taxpayer's dominant motive in making the loan, i.e., whether the advances were made to further the taxpayer's business or equity interest in the debtor-companies.[435] On remand, the Claims Court determined that the taxpayer had met his burden of proof that loans to three of the companies were business bad debts (i.e., that his predominant motive in making the loans related to his business interests (as a financial consultant) rather than his nonbusiness interests (as an investor)), but had failed to meet his burden of proof with respect to loans to the other three companies.[436]

The business relationship for supporting a business debt is not restricted to direct customers of the taxpayer's business. In *Wade v. Commissioner*,[437] a 50% stockholder was allowed a business bad debt deduction on loans to his corporation which was formed to sell time for radio and television stations and thereby to complement the taxpayer's advertising business. In *Myers v. Commissioner*,[438] a construction partnership was allowed a business bad debt deduction on loans to a thinly capitalized land-owning corporation, owned in part by the partnership, which was virtually a co-venturer with the latter. In *Estate of Saperstein v. Commissioner*,[439] the deceased, a sports promoter and owner of the Harlem Globetrotters, was allowed a bad debt deduction for advances to a new professional basketball league, created to provide teams to compete with the Globetrotters. In *Schafer v. United States*,[440] advances to an oil drilling company by a one-third shareholder were held to give rise to a business bad debt, because the loans were made in connection with the taxpayer's general oil business of which the corporation represented only one of many aspects.[441]

These results should be compared to the case where a taxpayer who was engaged in a trade or business in Seattle, advanced funds to establish a similar business in Toronto. A business bad debt deduction was denied because the establishment of the new business did not directly benefit the established business.[442]

In *Moffat v. Commissioner*,[443] the court allowed a business bad debt deduction where the debtor corporation was organized to accommodate key employees.[444] Similarly, the Tax Court sustained a business bad debt in *Dorminey v. Commissioner*,[445] where a major shareholder formed a corporation to import bananas and made loans to it in order to assure his produce business a source of supply.

It has been held, however, that advances must be "necessary" to obtain a source of supply.[446] The basis of the "necessary" requirement under §166 has not been satisfactorily explained. It lacks statutory support: §166 does not contain the word "necessary," or any equivalent, or any cross reference to §162.[447] It is possible that "necessity" has been used as a means of distinguishing a business-related loan from an investment. In addition, "necessity" might distinguish the concept of "preservation" from that of "expansion" expenditures and advances, the latter constituting capital payments.[448] However, it is uncertain whether the application of this last distinction (which was developed in the area of business expenses) would, per se, require a bad debt to fall within the nonbusiness category.

Along similar lines, the Tax Court has recognized as having a business purpose loans made to protect the taxpayer's rep-

[429] T.C. Memo 1963-218.

[430] 376 F.2d 623 (9th Cir. 1967).

[431] 716 F.2d 1047 (4th Cir. 1983), *rev'g* T.C. Memo 1982-635.

[432] 35 T.C. 108 (1960). *See also Schneiderman v. Commissioner*, T.C. Memo 1987-551 (taxpayers who guaranteed loan to their corporation were entitled to only nonbusiness bad debt deduction after corporation defaulted on loan).

[433] *See, e.g., Haley v. Commissioner*, T.C. Memo 1959-29.

[434] 553 F. Supp. 1082 (Ct. Cl. 1982).

[435] *Adelson v. United States*, 737 F.2d 1569 (Fed. Cir. 1984).

[436] *Adelson v. United States*, 87-1 USTC ¶9282 (Cl. Ct. 1987).

[437] T.C. Memo 1963-50.

[438] 42 T.C. 195 (1964), *acq. in result only*, 1964-2 C.B. 6.

[439] T.C. Memo 1970-209.

[440] 68-1 USTC ¶9306 (W.D. Okla. 1968).

[441] *See also Tibbals v. United States*, 362 F.2d 266, 271 (Ct. Cl. 1966).

[442] *United States v. Keeler*, 308 F.2d 424 (9th Cir. 1962). *Accord Allen v. Commissioner*, 283 F.2d 785 (7th Cir. 1960). *See also McCurdy v. United States*, 328 F. Supp. 1068 (S.D. Ohio 1970), *aff'd and rev'd*, 467 F.2d 285 (6th Cir. 1972).

[443] T.C. Memo 1965-183.

[444] *See also Cluett v. Commissioner*, 8 T.C. 1178 (1947), *acq.*, 1947-2 C.B. 2.

[445] 26 T.C. 940 (1956), *acq.*, 1957-1 C.B. 4. *See, e.g., Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962).

[446] *See Spillers v. Commissioner*, T.C. Memo 1967-216, *aff'd*, 407 F.2d 530 (5th Cir. 1969). *Cf. Koppelman v. Commissioner*, 27 T.C. 382 (1956).

[447] *See Steadman v. Commissioner*, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir. 1970); *McCurdy v. United States*, 328 F. Supp. 1068 (S.D. Ohio 1970), *aff'd and rev'd*, 467 F.2d 285 (6th Cir. 1972).

[448] *Funk v. Commissioner*, 35 T.C. 42 (1960), *acq.*, 1961-2 C.B. 4. *See White v. Commissioner*, 15 B.T.A. 1375 (1929), *nonacq.*, IX-1 C.B. 77. *Cf. also Crowder v. Commissioner*, 19 T.C. 329 (1952), *acq.*, 1953-1 C.B. 3, in which the payment of another's debt was allowed as an ordinary and necessary business expense.

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utation in the business community,[449] or payments made to protect an employee-stockholder's credit standing.[450] In *Milbank v. Commissioner*,[451] the Tax Court categorized advances made by an investment banker to a corporation in which he was a shareholder as primarily made to preserve his relations with his clients rather than to protect his investments in the corporation. In *Estate of Capell v. Commissioner*,[452] the Tax Court held that direct advances made by a shareholder-creditor to a corporation were proximately related to the lender's trade or business. However, a physician who paid the debts of his incorporated pet shop could not justify a business deduction on the ground of protection of his business reputation.[453] In *Spillers v. Commissioner*,[454] the taxpayer failed to prove that financial collapse of the debtor-supplier would have impaired the creditworthiness of his controlled corporation even though both corporations served the same customers.

c. Loans by Employees

It is well established that being an employee may be a trade or business for purposes of §166. An employee may be required, or may consider it necessary, to loan money to the corporation in order to obtain or maintain his employment. Under these circumstances, an employee is considered as having made the loan in the trade or business of being an employee for purposes of §166.[455]

Note: Deductions attributable to a trade or business which consists of the taxpayer's performance of services as an employee are miscellaneous itemized deductions, and thus, a bad debt deduction treated as a business bad debt incurred in connection with the taxpayer's employment is not deductible for tax years beginning after 2017.[456] Additionally, it would not be deductible for purposes of the alternative minimum tax.[457] However, the deduction may be reduced by 2/37 of the lesser of: (i) itemized deduction amount; or (ii) amount of taxable income over $600,000 (adjusted annually for inflation after 2018).[458]

Clearly, a taxpayer cannot be within the loan in connection with employment rule by making an ad hoc arrangement with the debtor to be paid "compensation," unless the taxpayer actually renders services.[459] In addition, the debt must be proximately related to the taxpayer's employment interest, rather than an interest only as investment as a stockholder in the corporation. One factor tending to favor the presence of an employment interest is where the advances are substantially in excess of investment interest.[460]

Finally, the taxpayer has an evidentiary problem: the taxpayer must establish that there was a proximate relationship between the loan he made, as a condition of the taxpayer's employment, and the taxpayer's "business" of being an employee.

The test for determining whether a particular debt bears a proximate relationship to the taxpayer's trade or business was set forth by the Supreme Court in *United States v. Generes*.[461] In *Generes*, the Court stated that: "[I]n determining whether a bad debt has a 'proximate' relation to the taxpayer's trade or business, as the [r]egulations specify, and thus qualifies as a business bad debt, the proper measure is that of dominant motivation, and that only significant motivation is not sufficient."[462]

Therefore, a taxpayer may establish the requisite "nexus" by proof that his dominant motivation in incurring the debt was to protect his employment.[463] The determination of the taxpayer's dominant motive is essentially a factual inquiry, and the burden of proof is on the taxpayer.[464] Moreover, the taxpayer's testimony regarding his dominant motive for making the loans to his employer must be examined objectively in light of the overall facts and circumstances of record.

Note: In *Generes*, the Supreme Court — instead of ordering a new trial — ordered a judgment notwithstanding the verdict for the government. In so ordering, the Court made much of the fact that the taxpayer's stock investment (made with after-tax dollars) was more than five times his net after-tax annual salary, the protection of which was alleged to have partially motivated the loan. The Court, in the last part of its opinion, strongly suggested that a taxpayer cannot prevail where his annual after-tax salary is substantially smaller than the amount of his original equity investment in the corporation.

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[449] *Lutz v. Commissioner*, 282 F.2d 614 (5th Cir. 1960), *dist'g Welch v. Helvering*, 290 U.S. 111 (1933), *aff'g* 63 F.2d 976 (8th Cir. 1933).

[450] *Milbank v. Commissioner*, 51 T.C. 805 (1969).

[451] 51 T.C. 805 (1969).

[452] T.C. Memo 1977-413.

[453] *Graumann v. Commissioner*, T.C. Memo 1964-226, *aff'd*, 357 F.2d 504 (9th Cir. 1966). *See also LaStaiti v. Commissioner*, T.C. Memo 1980-547.

[454] T.C. Memo 1967-216, *aff'd*, 407 F.2d 530 (5th Cir. 1969).

[455] *See Trent v. Commissioner*, 291 F.2d 669 (2d Cir. 1961), disavowing dicta to the contrary in *Wheeler v. Commissioner*, 241 F.2d 883 (2d Cir. 1957).

[456] §67(h). For tax years beginning before 2018, a bad debt deduction treated as a business bad debt incurred in connection with the taxpayer's employment would be miscellaneous itemized deductions were subject to a 2% floor on miscellaneous itemized deductions. Pre-TCJA §67(a), §67(b).

[457] §56(b)(1)(A)(i).

[458] §68(a) (referencing §1(j)), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111(a). For the inflation-adjusted amounts, see Tables, Charts & Lists, *Tax Rate Schedules*.

[459] *Teakle v. Commissioner*, T.C. Memo 1977-380 (shareholder-employee of closely held corporation must prove level of activity and salaries earned from corporation to justify finding that employment constituted trade or business in claiming business bad debt deduction); *Fitch v. Commissioner*, T.C. Memo 1960-268.

[460] *See Smith v. Commissioner*, 55 T.C. 260 (1970) (reviewed), *rev'd and rem'd*, 457 F.2d 797 (5th Cir. 1972), on remand, 60 T.C. 316 (1973), *acq.*, 1973-2 C.B. 3. *But compare Commercial Bank of Daytona Beach v. United States*, 71-2 USTC ¶9668 (M.D. Fla. 1971).

[461] 405 U.S. 93 (1972).

[462] 405 U.S. at 103.

[463] *Shinefeld v. Commissioner*, 65 T.C. 1092 (1976).

[464] *Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984) (taxpayer has burden of refuting IRS's characterization of debt by proving that he sustained bad debts proximately related to his trade or business); *B. B. Rider Corp. v. Commissioner*, 725 F.2d 945 (3d Cir. 1984) (relationship between debt and taxpayer's trade or business is question of fact). *See also Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976).

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Other courts have followed the "dominant motivation" test enunciated by the Supreme Court in *Generes*. These courts include the Fourth,[465] Sixth,[466] Seventh,[467] and Eighth Circuits;[468] the Tax Court;[469] and the Court of Federal Claims.[470]

Note: Before *Generes*, the courts struggled to define what standard to use in allowing business bad debt deductions claimed by employees for loans made to their employers. For example, in *Worrell v. United States*,[471] the district court allowed the taxpayer a business bad debt deduction when he satisfied obligations of his employer-corporation (of which he owned 50%), pursuant to an indemnification contract that was entered into so that the corporation could obtain performance and payment bonds necessary for it to enter into certain construction contracts. The Fifth Circuit reversed on the ground that the payment, which obviously benefited the corporation, was not required of the taxpayer as a condition for his continued employment. The taxpayer's defeat in this case may be explained on the ground that insufficient evidence was produced at trial to substantiate his claims.

The burden of persuasion was satisfied in *Jaffe v. Commissioner*,[472] where the taxpayers (commissioned salesmen for a printing firm in which they advanced funds and acquired stock in a map-making corporation) made the advances with the expectation that the debtor corporation would be a captive customer of the printing firm, thereby increasing their commissions as salesmen for the firm. Based on the record, the Tax Court held that the taxpayers were entitled to a business bad debt deduction. Dominant motive is determined at the time the taxpayer makes the loan to his employer or guarantees a loan.[473] When the creditor or guarantor of a corporation's debt is a shareholder/investor and an employee, there can be mixed motives for the loan or guarantee. In such cases, the critical issue becomes identification of the dominant motive.[474] One method the courts have applied in determining the taxpayer's dominant motive has been to examine the nature of being a shareholder versus that of being an employee. Under this test, returns from investing — as a shareholder — are "expectative," i.e., the rewards result from appreciation and earnings on the investment rather than from personal effort or labor.[475] On the other hand, the nature of an employee's role or status is derived from his efforts and labor in exchange for a salary.[476]

Another way of deciding the taxpayer's dominant motive is to examine how the taxpayer would have benefited from the loan or guarantee had the loan not gone bad. For instance, if the returns on the debt would have produced increased share prices (i.e., capital gains), the loan was a personal nonbusiness investment. If, on the other hand, the returns on the debt would have increased the taxpayer's salary, it was a business debt. If both would have resulted, the *Generes* approach — i.e., a consideration of all of the relevant facts, emphasizing the objective factors, and not giving controlling weight to any single factor — is used.[477]

Note: Because the *Generes* standard is intended to provide a guideline of certainty for the trier of fact,[478] it is important to examine the specific circumstances of each case. In *Litwin v. United States*,[479] the district court found that the loans and guarantees made by an 83-year-old shareholder outstripped his expected annual salary and exceeded his financial risk by more than three times. Therefore, the court held that the taxpayer had not willingly risked these funds for an anticipated return on investment; instead, the court found that all of his actions evidenced a desire to continue to use his managerial skills to run the business. In other words, the taxpayer made the loans and guarantees because he wanted to be actively employed in responsible positions and to enjoy the rewards of his work (i.e., salary and personal achievement). On appeal, the Tenth Circuit affirmed the district court in *Litwin*, concluding that the district court had substantial evidence of the taxpayer's business purpose in making the loans and guarantees. In *Jaffe v. Commissioner*,[480] worthless loans by two employees who owned all the

[465] *Gantt v. United States*, 528 F.2d 354 (4th Cir. 1975) (dominant motivation test applied; bank loan guaranteed by employee-taxpayer not to protect his status as employee).

[466] *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570 (6th Cir. 1982) (insufficient evidence to support employees' claim that their loan guarantee was for preservation of their wages).

[467] *Hough v. Commissioner*, 882 F.2d 1271 (7th Cir. 1989) (taxpayer's loan to corporation not business bad debt because he failed to prove that his dominant motivation in making the loan was business related).

[468] *Alsobrook v. United States*, 566 F.2d 628 (8th Cir. 1977).

[469] *Fincher v. Commissioner*, 105 T.C. 126 (1995) ($72,000 salary not sufficient motivation for S&L executive to place $500,000 in personal savings accounts at risk); *Scifo v. Commissioner*, 68 T.C. 714 (1977), *acq.*, 1978-2 C.B. 2; *Estate of Durante v. Commissioner*, T.C. Memo 1988-60 (taxpayer's guarantee of financing for the purchase of townhome models actually made only so guarantor could purchase stock of company purchasing homes; thus, taxpayer was investor and his involvement in other construction and development activities not enough to create proximate relation to trade or business); *McMonagle v. Commissioner*, T.C. Memo 1988-370 (taxpayers failed to convince Tax Court that potential risks to husband's employment or salary was dominant motivation for taxpayers' investment); *Maloney v. Commissioner*, T.C. Memo 1975-286; *Orrell v. Commissioner*, T.C. Memo 1979-129; *Sussman v. Commissioner*, T.C. Memo 1980-228.

[470] *Adelson v. United States*, 12 Cl. Ct. 231 (1987). *See also Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979).

[471] 269 F. Supp. 897 (S.D. Ga. 1967), *rev'd*, 398 F.2d 427 (5th Cir. 1968).

[472] T.C. Memo 1967-134. *See also Artstein v. Commissioner*, T.C. Memo 1970-220 (loans made by shoe designer-employer to his corporation, to protect his professional reputation and employment, held business bad debt on worthlessness).

[473] *Harsha v. United States*, 590 F.2d 884 (10th Cir. 1979). *See also B. B. Rider Corp. v. Commissioner*, 725 F.2d 945 (3d Cir. 1984) (loss from direct loan and from loan guarantee are evaluated under same dominant-motive test).

[474] *United States v. Generes*, 405 U.S. 93 (1972); *Whipple v. Commissioner*, 373 U.S. 193 (1963).

[475] *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570, 575 (6th Cir. 1982); *Litwin v. United States*, 91-1 USTC ¶50,229 (D. Kan. 1991), *aff'd*, 93-1 USTC ¶50,041 (10th Cir. 1993). *See also Mills v. United States*, 96-1 USTC ¶50,054 (Bankr. W.D. Tenn. 1995) (shareholder/employee's loan to corporation held nonbusiness bad debt because evidence that shareholder's salary was relatively small compared to his outstanding loan amount indicated that this dominant motivation was investor, not employee).

[476] *Litwin v. United States*, 91-1 USTC ¶50,229 (D. Kan. 1991), *aff'd*, 983 F.2d 997 (10th Cir. 1993). *See also Burwell v. Commissioner*, T.C. Memo 1988-495 (no salary paid to shareholder/employee is one factor used to determine taxpayer's dominant motive for making loans to employer; although court found that loans were advanced not to protect employment, there is no rule that taxpayer must receive salary for loans to relate to employment).

[477] *Litwin v. United States*, 91-1 USTC ¶50,229, fn. 5 (D. Kan. 1991), *aff'd*, 983 F.2d 997 (10th Cir. 1993) (Supreme Court in *Generes* offered tool for evaluating credibility of taxpayer's professed dominant motive when multiple motives were present).

[478] *United States v. Generes*, 405 U.S. 93 (1972).

[479] 91-1 USTC ¶50,229 (D. Kan. 1991), *aff'd*, 983 F.2d 997 (10th Cir. 1993).

[480] T.C. Memo 1967-215. *See also Carter v. Commissioner*, T.C. Memo 1979-447.

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stock of the corporation were deductible as business bad debts, because the loans were made in order to protect their jobs. One employee was 70 years old and would have been unemployable if he had lost his job with the debtor.[481]

In *Niblock v. Commissioner*,[482] the taxpayer failed to show that he had an unusual disability (e.g., age) which would have made him insecure about future employment. The court found that the debt was not proximately related to the taxpayer's trade or business of being an employee.

In *Estate of Avery v. Commissioner*,[483] the taxpayer prevailed where he formed the debtor corporation as a means of exploiting his own talents. The decisive factor was that his personality prevented him from working under any other arrangement. A taxpayer also succeeded in a case where the advances were made to protect and enhance his established reputation as a designer and salesman of shoes, even though he probably could have obtained other employment.[484] Thus, where a taxpayer has an established profession or line of work, a business bad debt deduction may be obtained not only for advances to keep a particular employment, but also to acquire a job or to boost his employability.[485]

D. Is a Profit Motive Required?

Under §166, business bad debts are fully deductible from ordinary income. Worthless nonbusiness debts are treated as a short-term capital loss. Nonbusiness debts are defined by §166(d)(2) in the negative; they are debts other than debts (a) created or acquired in connection with the taxpayer's trade or business, or (b) whose worthlessness gave rise to a loss incurred during the operation of the creditor's trade or business. On the face of the statute, a bad debt is deductible (as a capital loss) even if the taxpayer had no profit motive in advancing the money. There is no requirement that the loan be entered into for profit, and it is reasonably clear that a nonbusiness bad debt is a capital loss deduction even if strictly personal reasons motivated the loan.[486]

From 1913[487] until 1942,[488] the statute required that a debt be "charged off" to be deductible. This requirement implies that the taxpayer keeps books of account, which in turn would support an argument that Congress contemplated that the deduction would be used only in connection with business and investment activities. The courts have not accepted this argument:

> The phrase was apparently introduced to prevent a taxpayer from reserving a loss at his option until his income was large and his surtax high, but it was not meant to limit deductions to persons whose affairs were formally managed.[489]

The argument that Congress intended to require a profit motive is undercut, if not destroyed, by the legislative history of the Revenue Act of 1942, which introduced the distinction between business and nonbusiness bad debts.[490] The Ways and Means report states that "[a]n example of a nonbusiness bad debt would be an unrepaid loan to a friend or relative … ."[491] Although in context this does not (quite) purport to define "nonbusiness" debt as a statutory term, the legislative history clearly indicates that Congress sought to draw the line between business and nonbusiness, not between profit-motivated and personal.

A bad debt deduction is not necessarily precluded by a lack of profit motive, even where the loan obviously fails normal commercial standards and would not have been made but for family feeling, if at the outset there was a genuine expectation of repayment and intent to enforce collection.[492] Nevertheless, the Tax Court held without significant discussion in *Sheldon v. Commissioner*,[493] that a quasi-contractual debt arising from advances to locate a deceased relative was nondeductible because it was motivated by personal and family reasons.

Section 166 is not rendered inapplicable merely because the loan was from one family member to another. Section 267 disallows losses on sales or exchanges between related parties, but a bad debt is not such a loss.[494] If a related creditor can establish that there was a bona fide debt, then a bad debt deduction in the year of worthlessness will be sustained.[495] In practice, however, the presence of personal motivations will cast doubt on whether there was a bona fide expectation of repayment, and therefore on the status as bona fide debt. The analysis of whether an advance that purports to be a loan constitutes bona fide debt is discussed in III.A., above.

Courts have subjected intrafamily bad debt deduction claims to close scrutiny in order to determine whether the advance was in substance a gift,[496] or a contribution to capital.[497] Indeed, the Tax Court has frequently stated that a purported

[481] *See also Fitzpatrick v. Commissioner*, T.C. Memo 1967-1.

[482] T.C. Memo 1968-260, *aff'd*, 417 F.2d 1185 (7th Cir. 1969).

[483] T.C. Memo 1969-64.

[484] *Artstein v. Commissioner*, T.C. Memo 1970-220.

[485] *See Pierce v. Commissioner*, T.C. Memo 1986-552.

[486] *See* §165(c); *Redfield v. Eaton*, 53 F.2d 693, 694 (D. Conn. 1931).

[487] Act of 1913, 38 Stat. 114, §11(B).

[488] Revenue Act of 1942, 56 Stat. 798, §124(a).

[489] *Shiman v. Commissioner*, 60 F.2d 65, 67 (2d Cir. 1932) (citation omitted).

[490] Revenue Act of 1942, 56 Stat. 798, §124(a) (amending §23(k) of the 1939 Code).

[491] H.R. Rep. No. 2333, 77th Cong., 2d Sess. 45 (1942). *But see Putnam v. Commissioner*, 352 U.S. 82, 92 (1956) (purpose was to put nonbusiness investments in form of loans on footing with other nonbusiness investments).

[492] *See, e.g., Oatman v. Commissioner*, T.C. Memo 1982-684 (incarcerated brother); *Sooy v. Commissioner*, 10 B.T.A. 493 (1928) (dying brother), *aff'd on other grounds*, 40 F.2d 634 (9th Cir. 1930).

Reg. §1.262-1(c)(4) states that bad debts of a personal or family nature are deductible to the extent expressly provided under §166 and the regulations thereunder, but neither §166 nor the regulations thereunder directly address loans to family members.

[493] T.C. Memo 1961-44 (alternative holding), *aff'd on other grounds*, 299 F.2d 48 (7th Cir. 1962).

[494] Section 166(d) provides that the loss from a nonbusiness debt's becoming worthless "shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year." It does not provide that it shall be considered a loss from the sale or exchange with the debtor.

[495] *See Andrew v. Commissioner*, 54 T.C. 239 (1970), *acq.*, 1970-2 C.B. xviii; *White v. Commissioner*, T.C. Memo 1971-13.

[496] *Rude v. Commissioner*, 48 T.C. 165 (1967); *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951). Loans between related persons may also require consideration of certain gift tax, estate tax, and income tax questions. *See* §2511 §2512, §2043, §7872, §1272, and §1274.

[497] *United States v. Henderson*, 375 F.2d 36 (5th Cir. 1967), *rev'g* 64-2 USTC ¶9691 (E.D. Tex. 1964); *Vaughters v. Commissioner*, T.C. Memo 1988-276 (advances to son's farming operation).

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loan to a family member is presumed to be a gift for tax purposes.[498] Even if there is a contemporaneous promissory note, the court may conclude that it was not a genuine debt.[499] Therefore, a deduction is denied unless the taxpayer shows that his conduct has been less like that of a donor (or equity investor) than a creditor.[500] Moreover, a taxpayer who refuses to collect a loan because of family ties cannot sustain the deduction.[501]

Planning Point: Loans between related parties should be fully documented and consistently treated by the parties as bona fide debts.[502] Furthermore, where the loan is made to a friend or a family member, the taxpayer should be prepared to produce positive evidence showing that the loan was made with a profit motive. The statute may not technically require a profit motive. However, the IRS may be expected to challenge a bad debt deduction between family members as a nondeductible gift.

The Joint Committee on Taxation's General Explanation of the 1976 TRA supports the argument for requiring a profit motive, in the context of a discussion of the repeal of former §166(g). Former §166(g) had allowed a guarantor to treat payments made upon the default of a family member's primary obligation as a business bad debt if the borrowed funds were used in the debtor's trade or business. This provision was repealed in 1976 because it had the effect of favoring related party guarantees over direct loans to family members which were still nonbusiness bad debts losses which were deductible only as short-term capital losses. The General Explanation comes very close to saying that a profit motive was required for loans or guarantees between related persons, but does not quite do so:

> Generally, in the case of a direct loan, the transaction is entered into for profit by the lender, who hopes to realize interest on the loan. However, this may not be true in the case of loans made between friends or family members, and in these cases the Internal Revenue Service will generally treat any loss resulting from such a "loan" as a gift, with respect to which no bad debt deduction is available.
>
> The Congress believes that a bad debt deduction should be available in the case of a guaranty related to the taxpayer's trade or business, or a guaranty transaction entered into for profit. However, no deduction should be available for a "gift" type situation.[503]

Carrying out the most straightforward reading of the subsequent discussion in the legislative history, the regulations governing losses of guarantors and the like provide that "reasonable" consideration in cash or property is necessary for a guarantor's promise if the payor is a spouse or a person described in §152(a) (persons eligible to be claimed as a dependent). As to other persons, cash or property is not required provided it can be demonstrated that the guaranty was made for a good-faith business purpose or was consistent with normal business practice.[504]

Comment: The regulations require a guarantor's fee or the equivalent only where the taxpayer guarantees a debt of his spouse or dependent: those to whom the requirement applies will meet it only if fanatically devoted to tax planning.

In light of the foregoing, when structuring loans between friends and family members, the lender, in order to obtain a bad debt deduction in the event of worthlessness, should: (1) document the loan transaction carefully, (2) have the debt instrument provide for a reasonable rate of interest,[505] and (3) collect or make reasonable efforts to collect the debt in accordance with the schedule of payments provided in the instrument.

For a guaranty of a family member's debt, in order to comply with the regulations, the borrower should pay the guarantor with cash or property, more than nominal in amount, in exchange for the guaranty.

Caution: A guarantee of a family member's debts may have unexpected gift or estate tax consequences.[506]

As with family members, common ownership (stockholder-controlled corporations or brother-sister corporations) subjects the transaction to close scrutiny in order to prove the existence of a bona fide debt.[507] For example, in *Leuthold v. Com-*

[498] *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201 (1970); *Rude v. Commissioner*, 48 T.C. 165 (1967); *Mercil v. Commissioner*, 24 T.C. 1150 (1955); *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951); *Clark v. Commissioner*, 18 T.C. 780, 783 (1952); *Grossman v. Commissioner*, 9 B.T.A. 643, 644 (1927); *Boneparte v. Commissioner*, T.C. Memo 2015-128. *See also Caligiuri v. Commissioner*, 549 F.2d 1155, 1157 (8th Cir. 1977) (a purported loan between family members is always subject to close scrutiny).

[499] *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949) (purported debt arising from transaction between husband and wife evidenced by promissory note), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951); *VHC, Inc. v. Commissioner*, T.C. Memo 2017-220 (purported loans to founder's son and related companies evidenced by promissory notes), *aff'd*, No. 18-3717, 2020 BL 296123 (7th Cir. Aug. 6, 2020).

[500] *See, e.g., Alpert v. Commissioner*, T.C. Memo 2014-70 (nonbusiness bad debt deduction denied because no bona fide debt existed where taxpayer made multiple transfers to trusts to benefit his sons and, despite promissory notes, no documents supported purported revolving line of credit, no repayment schedule existed, and no collection action was taken against purported debtors); *White v. Commissioner*, T.C. Memo 1971-13; *Wincorn v. United States*, 61-1 USTC ¶9212 (N.D. Tex. 1961); *Cogan v. Commissioner*, T.C. Memo 1971-230; *Tanner v. Commissioner*, T.C. Memo 1962-123; *Kraus v. Commissioner*, T.C. Memo 1967-217. *Compare Smyth v. Barneson*, 181 F.2d 143 (9th Cir. 1950), *with Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951); *Qureshi v. Commissioner*, T.C. Memo 1987-153, *aff'd*, 843 F.2d 1388 (4th Cir. 1988) (no bona fide debt where taxpayer knew he would not be repaid). *But see Ewing v. Commissioner*, 213 F.2d 438 (2d Cir. 1954).

[501] *Thom v. Burnet*, 55 F.2d 1039 (D.C. Cir. 1932). *See also* PLR 9033036 (§166 nonbusiness bad debt deduction disallowed where no true debtor-creditor relationship existed; funds paid to son-in-law were gifts rather than bona fide debt as required by Reg. §1.166-1(c)). *But see Shirar v. Commissioner*, T.C. Memo 1987-492, *rev'd as to other issues*, 916 F.2d 1414 (9th Cir. 1990) (taxpayer's failure to take formal collection action did not preclude bad debt deduction, because he had ascertained that his brother had no assets and legal action would have produced no results).

[502] *Caligiuri v. Commissioner*, 549 F.2d 1155 (8th Cir. 1977), *aff'g* T.C. Memo 1975-319. *See also Mellen v. Commissioner*, T.C. Memo 1968-94, and *Cole v. Commissioner*, T.C. Memo 1954-224 (debtor but not creditor acted as if debt existed).

[503] General Explanation of the 1976 TRA, prepared by the Staff of the Joint Committee on Taxation at 157–158. See Worksheets, below.

[504] Reg. §1.166-9(e)(1).

[505] *See* §§1272, 2511, 2512, 7872.

[506] *See* PLR 9409018, *modifying and withdrawing* PLR 9113009.

[507] *George E. Warren Corp. v. United States*, 141 F. Supp. 935 (Ct. Cl. 1956); *Irbco Corp. v. Commissioner*, T.C. Memo 1966-67, 25 T.C.M. 359 (1966); *Brown Corp. of Ionia, Inc. v. Commissioner*, T.C. Memo 1982-683. *Cf. General Aggregates Corp. v. Commissioner*, 313 F.2d 25 (1st Cir. 1963), *rev'g on this issue* T.C. Memo 1962-27. See III.C.1.a., above, for disallowance of deductions where the debtor is created by the taxpayer for such purpose. For

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missioner,[508] the Tax Court denied a bad debt deduction for advances made by a shareholder to companies in which he held substantial interests. In support of its holding, the court stated that: (1) the taxpayer failed to execute promissory notes, with respect to the advances; (2) the alleged loans did not provide for maturity dates, security, or collateral; (3) the taxpayer never received any interest payments on any of the advances that were repaid; (4) the corporations were thinly capitalized at all relevant times, with stockholders' equity actually being negative; and (5) the corporations were unable to obtain financing from other sources.[509] But this type of issue does not usually involve any serious question of the taxpayer's profit motive. Rather, it is a species of the debt-equity issue. The substantive aspects of this problem in the context of §166 are considered at III., above.

an analysis of the rule governing bad debts between members of an affiliated group, see Reg. §1.1502-13(g)(3) and Rev. Rul. 76-430.

[508] T.C. Memo 1987-610.

[509] *Leuthold v. Commissioner*, T.C. Memo 1987-610.

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V. Guarantee Obligations

Note: The analysis of the tax consequences of guarantee obligations in this chapter applies only to payments made by the guarantor in partial or full satisfaction of the primary debtor's obligation to the guaranteed creditor. Different tax treatment applies to payments made by a guarantor for a release from, or modification of, his obligations which do not reduce the underlying debt. See III.B.2.f., above.

A. General Principles

Payments made by guarantors pursuant to agreements made after 1975 are governed by Reg. §1.166-9. The regulations apply not only to guarantors in the narrow sense, but also endorsers, indemnitors, and others secondarily liable on a debt obligation, all of whom, are for convenience referred to herein as "guarantors."[510]

One can search the current statute in vain for any hint of how to treat guarantors. The authority for Reg. §1.166-9 is in a sense nonstatutory: the 1976 TRA repealed former §166(f), which focused on how to treat guarantors, and the legislative history set forth how Congress expected guarantors to be treated thereafter.[511]

The basic holdings of *Putnam v. Commissioner*,[512] the leading case involving guarantee obligations, are left intact under Reg. §1.166-9. In *Putnam*, the taxpayer guarantor argued that because the subrogation rights he acquired against the debtor by satisfying his guarantee obligation were worthless at the time he made the payment to the primary creditor, his loss should be treated as incurred in a transaction entered into for profit (i.e., result in an ordinary loss under the predecessor to §165) rather than as a nonbusiness bad debt governed by the predecessor to §166. In rejecting the taxpayer's position, the Supreme Court stated:

> … the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps into the creditor's shoes. Thus, the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt.[513] [Citations omitted.]

Putnam did not address the tax treatment of a loss from a guarantee where payment of the guarantee did not give the guarantor subrogation rights against the primary debtor; however, as discussed V.D., below, its holding was subsequently applied to such losses.

B. Business v. Nonbusiness Guarantee

In holding that Putnam's loss was governed by the bad debt provisions, the Supreme Court relied to some extent upon legislative history indicating a congressional desire to put nonbusiness bad debts on the same footing as other nonbusiness investments. In *Putnam*, it was stipulated that if the loss was governed by the bad debt provisions, it was a nonbusiness bad debt. Thus, while *Putnam* established that §166, rather than §165, has jurisdiction over payments made on guarantees, it did not hold that a bad debt resulting from a guarantor's payment of the guarantee is automatically a nonbusiness bad debt. Testing direct obligations and guarantee obligations in the same manner makes sense because a guarantee is merely an indirect method of financing.[514] Thus, if the guarantee agreement arises out of the guarantor's trade or business, the guarantor is permitted to deduct the loss resulting from the transaction as a business bad debt.[515] If the guarantee agreement is a transaction entered into for profit by the guarantor (but not as part of his trade or business), he is allowed to deduct the resulting loss as a nonbusiness bad debt.[516]

C. Necessity of a Profit Motive

In the case of a guarantee agreement that is not entered into as part of the guarantor's trade or business or as a transaction for profit, it appears that no deduction is available in the event of payment under the guarantee. The regulations and the "Blue Book" are clear that a profit motive is essential where the agreement is not entered into as part of the guarantor's trade or business.[517] In this respect, the treatment of guarantors' losses differs from the treatment of bad debts generally.[518]

A guarantee agreement is considered to have a profit motive if the guarantor can substantiate that he received reasonable consideration for giving the guaranty.[519] For this purpose, consideration includes indirect consideration.[520] For example, where the taxpayer can substantiate that the guaranty was given in accordance with normal business practice, or for a bona fide business purpose, the taxpayer is entitled to a nonbusiness bad debt deduction even if he received no monetary consideration. However, in cases of guarantees of loans to a spouse or persons eligible to be claimed as dependents, indirect consideration is

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[510] Reg. §1.166-9(a), §1.166-9(b). Former §166(f) and Reg. §1.166-8 apply to payments made pursuant to agreements made before 1976.

[511] Pub. L. No. 94-455, §605(a), 90 Stat. 1525, 1575, 1976 C.B. (Vol. 1) 51 General Explanation of the Tax Reform Act of 1976, at 156. See the Worksheets, below.

[512] 352 U.S. 82 (1956). *See also Ferguson v. Commissioner*, 253 F.2d 403 (4th Cir. 1958); *Holtz v. Commissioner*, 256 F.2d 865 (9th Cir. 1958).

[513] 352 U.S. 82, 85.

[514] *See Putnam v. Commissioner*, 352 U.S. 82, 90–93 (1956); *Gillespie v. Commissioner*, 54 T.C. 1025 (1970), *aff'd*, 72-2 USTC ¶9472 (9th Cir. 1972); *In re United States v. Vaughan*, 82-2 USTC ¶9573 (E.D. Ky. 1982).

[515] Reg. §1.166-9(a); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 157–158 (See the Worksheets, below). *Ripson Est. v. Commissioner*, 39 T.C.M. 224, 231 (1979); *Justice Steel, Inc. v. Commissioner*, 41 T.C.M. 209 (1980); *Rosati v. Commissioner*, T.C. Memo 1970-343; *Commissioner v. Moffat*, 373 F.2d 844 (3d Cir. 1967), *aff'g* T.C. Memo 1965-183; Rev. Rul. 71-561. *Cf. Gardner v. United States*, 68-1 USTC ¶9164 (N.D. Ind. 1968).

[516] Reg. §1.166-9(b); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 157 (see the Worksheets, below). *See Stoltz v. Commissioner*, 410 F. Supp.2d 734 (S.D. Ind. 2006) (taxpayer fraudulently induced to act as guarantor and subsequently called to repay loan not entitled to §166 deduction because transaction was nonbusiness and lacked profit motive).

[517] *Id.*

[518] See IV.D., above.

[519] Reg. §1.166-9(e)(1); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 158 (see the Worksheets, below). *See also* PLR 9441017 (ESOP's use of acquisition loan proceeds to purchase guarantor's stock was reasonable consideration for his guarantee of acquisition loan for purposes of Reg. §1.166-9(d)).

[520] Reg. §1.166-9(e)(1).

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not sufficient to support a deduction.[521] Thus, where the taxpayer guarantees a loan to his son at the time the son is a "qualifying child" or "qualifying relative" within the meaning of §152, he is not entitled to a deduction unless he directly receives reasonable consideration.

D. Subrogation Unnecessary

When a guarantor has to make good on a guarantee, the guarantor acquires the debt by subrogation, but typically the right of subrogation is worthless. The guarantor nonetheless gets a bad debt deduction. In *Putnam v. Commissioner*,[522] where the taxpayers had guaranteed loans made to a corporation in which they were stockholders, the Court noted that in making payments pursuant to the guarantee, the taxpayers acquired the former creditors' right for repayment of the original indebtedness by subrogation and that the subsequent worthlessness of the claim was a nonbusiness bad debt even though the right might be worthless as soon as it passed to the guarantor upon payment.

For some time there was a theory that the tax consequences of a guarantor's loss hinged on whether the guarantor had a right of subrogation. This theory held that in the absence of subrogation §166 could not apply because there was never a debt obligation between the primary debtor and the guarantor. Under this theory, although a loss on a guarantee with subrogation that was not a business bad debt[523] could be deducted, if at all, only as a capital loss, a loss on a guarantee without subrogation entered into with a profit motive would give rise to an ordinary deduction under §165.[524]

This theory led to attempts on the part of some taxpayers to take themselves out of the general rules relating to guarantees of debts by taking steps to ensure that they would have no right of subrogation against the borrower if he defaulted. However, this theory was generally rejected by the courts[525] and eventually rejected by Congress.[526] Thus, losses on guarantees, regardless of the applicable state law on subrogation, are deductible (if at all) under §166.[527]

The effect of a right of subrogation on the timing of a bad debt deduction is discussed in V.G., below.

[521] Reg. §1.166-9(e)(1).

[522] 352 U.S. 82 (1956).

[523] I.e., the guarantee was not entered into as part of the guarantor's trade or business (and, prior to 1976, the proceeds of the guaranteed debt were not used in the trade or business of the noncorporate primary borrower).

[524] *See Fox v. Commissioner*, 190 F.2d 101 (2d Cir. 1951) *rev'g* 14 T.C. 1160 (1950). *Rietzke v. Commissioner*, 40 T.C. 443 (1963) appears to accept the theory; *but see Martin v. Commissioner*, 52 T.C. 140, 146–7 (1969) (court reasoned that language supporting theory was not necessary to decision in *Reitzke* case).

[525] *Stratmore v. United States*, 420 F.2d 461 (3d Cir. 1970), *rev'g* 292 F. Supp. 59 (D.N.J. 1968) (court reasoned that allowing tax result to be dependent on existence of technical right of subrogation under state law would undermine *Putnam* doctrine); *Horne v. Commissioner*, 523 F.2d 1363 (9th Cir. 1975) (court reasoned that there was no explanation for why Congress would have "intended tax consequences to flow" from mere existence of such right); *Martin v. Commissioner*, 52 T.C. 140 (1969), *aff'd per curiam*, 424 F.2d 1368 (9th Cir. 1970); *Stoody v. Commissioner*, 66 T.C. 710 (1976), *acq.*, 1977-2 C.B. 2; *United States v. Vaughan*, 82-2 USTC ¶9573 (E.D. Ky. 1982).

[526] H.R. Rep. 94-658, 94th Cong., 1st Sess. 176–77 (Nov. 12, 1975).

[527] *Id.*

E. Guarantors of Corporate Obligations

Although the 1976 repeal of §166(f) (relating to bad debts arising from noncorporate taxpayers' guarantees of loans whose proceeds were used in an unincorporated business) did not change the tax treatment of bad debts arising from guarantees of corporate obligations, Congress took the opportunity to make some of the rules applicable to bad debts arising from such guarantees clear.[528] These rules, which are now included in the regulations, were: (i) in the case of an individual guarantor of a corporate obligation, any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guarantee was made pursuant to the taxpayer's trade or business;[529] and (ii) if, under the facts of the particular case, the payment by a corporate debtor's shareholder under a guaranty constitutes a contribution to the debtor's capital, the payment increases the shareholder's basis in his shares and is not deductible.[530]

The regulation's requirement that a guarantee made pursuant to a noncorporate taxpayer's trade or business in order to qualify as a business bad debt is substantially the same as the §166(d)(2)(A) provision that treats a debt as a business debt if it is created or acquired in connection with a trade or business of the taxpayer. However, there is no rule similar to §166(d)(2)(B) (business debt treatment if the loss on worthlessness is incurred in the taxpayer's trade or business) that applies to guarantees. Where a noncorporate taxpayer is personally liable on the guarantee the lack of a provision similar to §166(d)(2)(B) will usually not matter (because on a transfer of the business either the original guarantor will remain liable or the transferee will be substituted as a guarantor); however, the lack of such a comparable provision may have significant and inconsistent consequences where the guarantee is limited to certain assets of the guarantor.

> *Example 1:* Assume that T operates a business as a sole proprietor and in Year 1 guarantees a bank loan to a major customer so that the customer can open an additional location and thus buy much more of T's output. In Year 3 when the loan is still outstanding T sells the business to M (who will also operate as a sole proprietorship). Assuming that the bank is unwilling to simply release T from the guarantee, either T will remain on the guarantee or the parties will negotiate for M to be substituted for T. If the guarantor is required to pay under the guarantee (and cannot recover from the customer), whether the guarantor is T or M, the guarantor will have made his guarantee in connection with a trade or business he was operating at the time his guarantee was entered into.

> *Example 2:* Assume the facts are the same as in *Example 1*, except that (i) T operates the business through a single

[528] H.R. Rep. 94-658, 94th Cong., 1st Sess. 177 (Nov. 12, 1975); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 158 (see Worksheets, below).

[529] Reg. §1.166-9(b).

[530] Reg. §1.166-9(c).

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member limited liability company, X, which is disregarded for federal tax purposes; (ii) X provides the guarantee (effectively limiting the bank's recourse to the assets of the business); and (iii) rather than purchasing the business assets, M purchases all of the membership interests in X. Since X is a separate legal entity for commercial law purposes, no change is made to the guarantee when M replaces T as the sole owner of X. However, because X is disregarded for federal tax purposes, for federal tax purposes M is the noncorporate taxpayer guarantor when payment under the guarantee is made and there is no recovery. Although there appears to be no authority addressing the issue, it seems that M should be treated as having entered into a guarantee when he became engaged in the trade or business by acquiring the membership interests (and was treated for tax purposes as acquiring the assets which were subject to the contingent liability under the guarantee) and thus be entitled to a business bad debt deduction.

Example 3: Assume the facts are the same as in *Example 2*, except that (i) during all of Year 1, X is owned 40% by T, 40% by B, and 20% by C; (ii) M purchases T's 40% membership interest in January of Year 2; and (iii) N purchases B's 40% membership interest in June of Year 3. X is treated as a partnership (i.e., a noncorporate taxpayer). Since X entered into the guarantee in Year 1 in connection with the trade or business it was conducting in Year 1, it is entitled to a bad debt deduction when, subsequent to Year 3, payment under the guarantee is made and there is no recovery. The deduction for the business bad debt is passed through to the partners (M, N, and C). What if both M and N had purchased their 40% interests in Year 2? Under former §708(b)(1)(B) and the regulations thereunder,[531] X would be deemed to have transferred its assets to a new partnership (which would be a new and different taxpayer) in exchange for partnership interests and to have liquidated by distributing the interests in the new partnership to M, N, and C. Although X would continue to be the same entity under state commercial laws, it no longer would be the same noncorporate taxpayer that entered into the guarantee in Year 1. As in *Example 2*, it seems the new (for tax purposes) partnership should be treated as having entered into the guarantee at the time it "acquired" the assets in the deemed transfer. However, under new §708(b)(1), applicable to partnership taxable years beginning after December 31, 2017, a partnership is treated as continuing upon a sale or exchange of 50% or more of the total interest in a partnership's capital and profits within a 12-month period, and new elections are not required or permitted unless no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in the partnership.[532]

If a guarantor is both an employee and a shareholder of the corporate debtor, the dominant motivation test established under *United States v. Generes*[533] is used to determine whether the guarantee was entered into in connection with his trade or business of being an employee.[534]

If the guarantor's claim against the corporate debtor for reimbursement of payments made on the guarantee is worthless, the corporate equity should also be worthless and the regulation's requirement that, where the payment under the guarantee is in substance a contribution to capital, it is added to stock basis, will generally not affect the timing of the deduction. One exception would be where the guarantee had been made in the noncorporate guarantor's trade or business (i.e., would be a business bad debt if respected as a debt) and the corporation has sufficient assets to eventually make a partial repayment. As a business bad debt, a bad debt deduction could have been taken based on partial worthlessness of the claim; however, as part of the taxpayer's rights as a stockholder, no deduction is available until he receives the partial repayment and his stock becomes worthless.

A worthless stock loss is treated as arising from a sale or exchange of the stock on the last day of the taxable year during which the stock became worthless.[535] If the guarantee payment would have otherwise given rise to a business bad debt, treating it as additional stock basis converts it from an ordinary deduction to a capital loss.

A nonbusiness bad debt deduction is a short-term capital loss. Where a guarantee payment is treated as a contribution to capital and the right to reimbursement does not become worthless until the following tax year, the loss will be a long-term capital loss.[536] In the case of a guarantee payment treated as a contribution to capital where the claim becomes worthless in the tax year in which payment is made, the holding period for the "shares" attributable to the payment should begin on the date of the payment and have a tax basis equal to the payment, if the guarantor has properly claimed a worthless stock deduction in a prior year. Even if the stock has not become worthless in a prior year, it seems reasonable to treat the guarantor has having acquired a separate block of stock with a basis equal to the payment, but an argument can be made that he has merely acquired additional basis in his existing shares. Should it make a difference if the corporation has multiple shareholders and the guarantee was not pro rata, so that the guarantors presumably have acquired distribution rights superior to the other shareholders?

A corporate parent's contribution to a subsidiary in the nature of a contribution to the subsidiary's capital is distinguish-

[531] Reg. §1.708-1(b).

[532] §708(b)(1), as amended by the 2017 tax act, Pub. L. No. 115-97, §13504.

[533] 405 U.S. 93 (1972), discussed at IV.C.3., above.

[534] *E.g., Rosenberg v. United States*, 96-2 USTC ¶50,583 (N.D. Ill. 1996) (retaining taxpayer's business as employee held dominant motive in guaranteeing his corporation's debts, thus permitting business bad debt deduction; court found following factors determinative: (1) taxpayer's personal loan guarantees far exceeded value of investment, (2) his salary from business prior to tax year had been substantial, and (3) his other income was insubstantial); *Brooks v. Commissioner*, T.C. Memo 1990-259; *Jerich v. Commissioner*, T.C. Memo 1992-136 (deduction denied where shareholder/employee's dominant motivation for guaranteeing corporate loan was to benefit as individual investor, rather than as employee of corporation).

[535] §165(g)(1).

[536] Because the loss is treated as arising from a sale of the stock on the last day of the taxable year in which it became worthless, the holding period includes the entire year in which the stock became worthless plus some portion of the year in which the payment was made pursuant to the guarantee.

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able from a payment that may partly discharge the parent's guarantee of the subsidiary corporation's debt, even where the payment arguably is in furtherance of a performance guarantee given by the corporate parent to a third party.[537]

In general, a payment in discharge of part of, or all of, taxpayer's agreement to act as guarantor, endorser, or indemnitor of an obligation is treated as a worthless debt only if:

- The agreement was entered into in the course of either the taxpayer's trade or business or a transaction for profit;[538]
- There was an enforceable legal duty upon the taxpayer to make the payment, although legal action did not need to have been brought against the taxpayer;[539] and
- The agreement was entered into before the obligation became fully worthless, or partially worthless in the case of an agreement entered into in the course of the taxpayer's trade or business.[540]

In *Baker Hughes*, a U.S. corporate parent made wire transfers aggregating to $52 million to a Russian corporate subsidiary whose net assets were less than the minimum level for chartered capital under Russian Federation law. Because of this capital inadequacy, the subsidiary was subject to liquidation by the Russian tax authority. The wire transfers, which mitigated the capital inadequacy and ended the risk of liquidation, were structured as "Free Financial Aid" payment under the tax code of the Russian Federation. As "Free Financial Aid," characterized in a shareholder meeting as a "free capital contribution," the transfers were not subject to a repayment expectation, and the recipient subsidiary corporation was not obligated to repay these transfers to the U.S. corporate parent.[541]

After the IRS denied the parent's §166 deduction for the Free Financial Aid payment, the taxpayer pursued refund litigation in federal district court, but lost. The district court reasoned that whether payments from a corporate parent to a corporate subsidiary are deductible in the year made depends on whether the advances are, in substance, debt (e.g., loans) or, in substance, equity (e.g., contributions to capital).[542] In order for an advance of funds to be considered a debt rather than equity, the courts have stressed that a reasonable expectation of repayment must exist, and must not depend solely on the success of the borrower's business.[543] Where there was neither a certificate evidencing a loan nor a note evidencing a loan, and no provision in documentation creating an expectation of repayment of principal or interest, and no way to enforce repayment of an advance from the corporate parent to the subsidiary, the advance was found to be in the nature equity, not debt. Accordingly, a bad debt deduction under Reg. §1.166-9(d) was not available to the corporate parent.[544]

The Fifth Circuit noted that only bona fide debt arising from a debtor-creditor relationship may give rise to a bad debt for purposes of §166.[545] The Fifth Circuit opined that the Free Financial Aid agreement did not impose any obligation on the corporate subsidiary to repay the wire transfers, that the corporate parent's obligations as guarantor did not impose an obligation on the Russian subsidiary, and that there was no debt, good or bad, at all. The Fifth Circuit also distinguished voluntary payments made while the payor knows there will not be repayment from payments that are made in compliance with a taxpayer's obligations as a contractual guarantor, noting that the former is considered a gratuity and not a deductible bad debt, while the latter is a loss that arises because the debtor is unable to repay the guarantor, thus making it a deductible bad debt. The Fifth Circuit noted that this line of reasoning is consistent with §166's implementing regulations, which state that "[a] gift or contribution to capital shall not be considered a debt for purposes of §166,"[546] and concluded that the Free Financial Aid was a contribution to the subsidiary's capital used to resolve the capitalization problem identified by the Russian Ministry of Finance, did not discharge the parent corporation's guarantor obligation, and did not qualify for a §166 bad debt deduction.[547]

F. *Interest Not Deductible as Such*

When a guarantor makes good on a guarantee, part of the payment is typically interest which accrued before the guarantor became primarily liable for the debt. The payment may also include interest which accrued after the guarantor became primarily liable. Interest accrued while the guarantor is primarily liable on the debt is deductible only as interest.[548] Accordingly, it is subject to any applicable limits under §163[549] and is deductible by an accrual method guarantor as it accrues. Interest that accrued prior to the guarantor becoming primarily liable is subject to the rules of §166; therefore, it cannot be deducted as interest under §163.[550] Further, interest accrued prior to the guarantor's becoming primarily liable cannot be deducted under §166 until it is paid[551] and, if the bad debt is a nonbusiness bad debt it will be deductible as a short-term capital loss.

[537] Reg. §1.166-9(c) (contribution to capital was not treated as worthless debt for purposes of §166); *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018), *aff'd*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019) (applying *Putnam v. Commissioner*, 352 U.S. 82, 88 (1956), to find that payment to subsidiary constituted voluntary contribution to capital that was not eligible for bad debt deduction).

[538] Reg. §1.166-9(d)(1).

[539] Reg. §1.166-9(d)(2).

[540] Reg. §1.166-9(d)(3).

[541] *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019).

[542] *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018), citing *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984).

[543] *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018), citing *American Processing and Sales Co. v. United States*, 371 F.2d 842, 856 (Ct. Cl. 1967).

[544] *Baker Hughes Inc. v. United States*, 313 F. Supp. 3d 804 (S.D. Tex. 2018), *aff'd*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019).

[545] *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019) (reference to Reg. §1.166-1(c)).

[546] *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019) (reference to Reg. §1.166-1(c)).

[547] *Baker Hughes Inc. v. United States*, No. 18-20585, 2019 BL 448909 (5th Cir. Nov. 21, 2019), citing *Commissioner v. Fink*, 483 U.S. 89, 96–97 (1987).

[548] *See Jerich v. Commissioner*, T.C. Memo 1992-136.

[549] Note that the 2017 tax act, Pub. L. No. 115-97, §13301, amended §163(j) to limit the deduction for net interest expense incurred by a business to the sum of business interest income, 30% of adjusted taxable income, and floor plan financing interest effective for taxable years beginning after December 31, 2017.

[550] Reg. §1.166-9(a) (last sentence), (b) (last sentence); *Jerich v. Commissioner*, T.C. Memo 1992-136; *Fincher v. Commissioner*, 105 T.C. 126 (1995) (principal and interest paid by loan guarantor both deductible as §166 nonbusiness bad debt).

[551] See, V.G., below.

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G. *Timing of Deduction*

A guarantor may not claim a bad debt deduction prior to making payment on the guarantee, even if the guarantor is an accrual basis taxpayer. In *Black Gold Energy Corp. v. Commissioner*,[552] the taxpayer, an accrual basis corporation, had guaranteed obligations of its 67% owned subsidiary to two creditors. The subsidiary defaulted on its obligations in 1984. In January 1985, the taxpayer settled its obligations under the guarantees by making a cash payment to one creditor and delivering a promissory note providing for monthly payments over nine years to the other creditor. The Tax Court held that the taxpayer did not sustain a bad debt loss in 1984. The Court further held that the taxpayer was entitled to bad deductions in 1985 only equal to the cash payments made to creditors during 1985.

The court explained, citing *Putnam v. Commissioner*,[553] *Martin v. Commissioner*,[554] and Reg. §1.166-9(a), that a guarantee obligation is worthless no earlier than the moment the guarantor pays the creditor, and that a guaranteed debt cannot become worthless before the guarantor's payment, even if it is indisputable that the debtor will never reimburse the guarantor, and even though the guarantor is on the accrual basis. The court also explained that delivery to a creditor of the guarantor's note cannot, until the guarantor makes payment on it, precipitate the debtor's obligation to the guarantor. Thus, the court concluded that the taxpayer's delivery of a note to a creditor did not constitute payment for purposes of §166.

In *Bolt v. United States*,[555] a guarantor of several notes made to a wholly owned corporation was denied a nonbusiness bad debt deduction in the year in which (i) the creditor of the corporation obtained a judgment against him on the guarantee and (ii) the taxpayer had irrevocably transferred property to third parties with a provision that the third parties pay his judgment creditors directly. The district court noted that because the purchasers of the property did not in fact make payment until the following year, the deduction for the prior year was denied.

If the guarantee agreement requires payment by the guarantor upon default by the borrower, and upon making the payment the guarantor has a right of subrogation or other rights against the borrower, no deduction is allowed to the guarantor until the year in which his right against the borrower becomes worthless (or partially worthless, where the guarantee was given in connection with the guarantor's trade or business).[556] If the guarantor has no right of subrogation or other right against the borrower, however, the payment under the guarantee is deductible in the year in which the payment is made.

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[552] 99 T.C. 482 (1992), *aff'd*, 33 F.3d 62 (10th Cir. 1994).

[553] 352 U.S. 82 (1956).

[554] 52 T.C. 140 (1969).

[555] 80-2 USTC ¶9713 (D. S.C. 1980).

[556] Reg. §1.166-9(e)(2); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 158 (see the Worksheets, below).

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VI. Worthlessness of a Debt

A. *Definition of Worthlessness*

Section 166(a)(1) provides that there is allowed as a deduction any debt which becomes worthless during the year. No precise test for determining worthlessness within the taxable year exists.[557]

In *Higginbotham-Bailey-Logan Co. v. Commissioner*,[558] the Board of Tax Appeals noted that the then current edition of *Webster's New International Dictionary* defined "worthless" as "destitute of worth; having no value; valueless; useless," and required the petitioner to establish that the debts were without value. In Rev. Rul. 71-577,[559] the IRS ruled that a nonbusiness bad debt deduction could be taken where the receiver in bankruptcy of the debtor bank notified depositors that it was doubtful that anything would remain for distribution except possibly one or two cents on the dollar. The IRS reasoned that because there was little or no chance of further payments of the debt as represented by the balance in the taxpayer's deposit account, the debt should be considered worthless.

"Worthlessness" is not defined in Reg. §1.166-2, but that regulation does speak of "evidence of worthlessness." The regulations further provide that where circumstances indicate that a debt is worthless and uncollectible, and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, the facts are sufficient to establish the worthlessness of a debt under §166.[560]

Debt is deemed to be worthless when its holder is justified in abandoning hope of recovery.[561] A determination as to whether a debt is worthless at a particular time is a question of fact to be determined by the evidence available from all of the surrounding circumstances.[562] The judicial standard for this determination seems to be more pragmatic than legal.[563] Many courts follow an objective standard based upon sound business judgment.[564] In using this judgment, the taxpayer must follow a rule of reason, balancing between the roles of the "incorrigible optimist"[565] and the "stygian pessimist."[566] In distilling these various notions, the Court of Claims stated that the creditor may strike a middle course between optimism and pessimism and determine debts to be worthless in the exercise of sound business judgment based upon as complete information as is readily obtainable.[567]

The deduction is allowed for any debt which becomes worthless "within the taxable year."[568] Thus, the uncertainty resulting from the lack of a meaningful or precise definition of worthlessness is exacerbated by the fact that the taxpayer must not only establish that the debt was worthless by the end of the year in which the deduction was claimed, but must also establish that it was not worthless at the end of the immediately preceding year.[569] If the claim is disallowed on these grounds, the taxpayer may claim a refund (if available) for the earlier year under a seven-year limitation period as opposed to the usual three-year limitation period. See the discussion at VIII.C., below.

Comment: In the absence of legislation or regulations setting forth objective criteria, the determination of worthlessness continues to be a highly subjective determination, dependent on the facts of the particular case. Thus, it is advisable to review the cases involving factors similar to the debt in question before taking a reporting position, and to carefully document the determination of worthlessness in order to carry the burden of proof described in VI.D., below.

B. *Factors Indicating Worthlessness*

1. *In General*

Because a taxpayer must show that the debt had value at the beginning of the taxable year and no value, or reduced value in the case of a partial write-off, at the end of the taxable year, it is essential to point to certain factors or events which took place during the taxable year that support the conclusion of worthlessness. It is also important for the taxpayer to elimi-

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[557] *Minneapolis, St. Paul & Sault Ste. Marie R.R. Co. v. United States*, 164 Ct. Cl. 226 (1964).

[558] 8 B.T.A. 566 (1927), *acq. & nonacq.*, V11-1 C.B. 14, 38.

[559] 1971-2 C.B. 129.

[560] Reg. §1.166-2(b). *See Carroll v. Commissioner*, T.C. Memo 1981-553.

[561] *Cole v. Commissioner*, 871 F.2d 64 (7th Cir. 1989).

[562] Reg. §1.166-2(a); *Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984); *Minneapolis, St. Paul & Sault Ste. Marie R.R. Co. v. United States*, 164 Ct. Cl. 226 (1964). In *Moore v. United States*, 943 F. Supp. 603 (E.D. Va. 1996), the court held that the taxpayer should not be precluded from a bad debt deduction merely because the debtor had inaccurately reported on her financial statements a net worth for which the taxpayer might have made a claim. *See also Shaw v. Commissioner*, T.C. Memo 2013-170 (in holding taxpayer failed to produce evidence debt became completely worthless, court noted worthlessness in reported year would have allowed offset to large long-term capital gain recognized that year), *aff'd on other grounds*, 623 Fed. Appx. 467 (9th Cir. 2015).

[563] *Boehm v. Commissioner*, 326 U.S. 287, 292 (1945). *See also Bank of Kirksville v. United States*, 943 F. Supp. 1191 (W.D. Mo. 1996) (IRS abused its discretion in denying bank's bad debt deductions; bank's estimates of fair market value of charged-off loans were generally sound and realistically grounded in world faced by bank at time charge-offs were made).

[564] *See Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984); *Minneapolis, St. Paul & Sault Ste. Marie R.R. Co. v. United States*, 164 Ct. Cl. 226 (1964); *Washington Inst. of Technology, Inc. v. Commissioner*, 10 T.C.M. 17, 20 (1951).

[565] *United States v. S. S. White Dental Mfg. Co., of Penna.*, 274 U.S. 398, 403 (1927).

[566] *Ruppert v. United States*, 22 F. Supp. 428, 431 (Ct. Cl. 1938). *See Halliburton Co. v. Commissioner*, 93 T.C. 758 (1989).

[567] *Minneapolis, St. Paul & Sault Ste. Marie R.R. Co. v. United States*, 164 Ct. Cl. 226, 241 (1964). The court went on to state that the possibility of collection is tested by the facts known at the time and not by hindsight. Worthlessness also means a lack of potential value as well as a lack of current liquid value, the court noted. The burden of proving worthlessness can generally be met, the court pointed out, by showing that some identifiable event occurred which effectively demonstrates the absence of potential value. Insolvency, by itself, does not establish worthlessness, the court concluded. *See LeLandais v. Commissioner*, T.C. Memo 1976-345.

[568] §166(a)(1). *See, e.g., Sarvak v. Commissioner*, No. 18-73296, 2020 BL 66774 (9th Cir. Feb. 20, 2020) (unpub. op.), *aff'g Sarvak v. Commissioner*, T.C. Memo 2018-68 (taxpayer failed to establish evidence of uncollectibility in year of deduction where taxpayer was continuing to advance funds in later tax year and prior to being told of inability to repay the "loans"); *Hynard v. IRS*, 233 F. Supp.2d 502 (S.D.N.Y. 2002), *aff'd by summary order*, 87 Fed. Appx. 220 (2d Cir. 2004) (court denied bad debt deduction taken in 1988 or 1989 for debt (which court determined was not bona fide) that would have been created in 1987 and determined worthless in 1994, neither year relating to years in which deduction taken).

[569] *Millsap v. Commissioner*, 46 T.C. 751, 762 (1966), *aff'd*, 387 F.2d 420 (8th Cir. 1968); *Moore v. United States*, 943 F. Supp. 603 (E.D. Va. 1996); *Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967).

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nate or reduce the influence of factors that suggest a continuing expectation of recovery.

Although not determinative for all cases, courts have accepted several conditions as identifiable events establishing the worthlessness of a particular debt. Among them are:

- the debtor's disappearance or departure from the country,[570]
- the debtor's death,[571]
- a decline in the debtor's business,[572]
- the worthlessness of a judgment against the debtor,[573]
- the withdrawal of financing on a real estate venture,
- the decline in value of the property secured during the debt,[574]
- the uncollectibility of a deficiency on the sale of mortgaged property,[575]
- overall business climate,
- serious financial hardship suffered by the debtor,
- debtor's earning capacity,
- events of default,
- insolvency of the debtor,
- debtor's refusal to pay,
- actions taken by the creditor to pursue collection, and
- subsequent dealings between the creditor and debtor.[576]

Secondary evidence of worthlessness is sometimes acceptable. For example, a writ of execution returned by the sheriff with the notation "no property found" or "not satisfied" has been held sufficient to establish worthlessness.[577]

By itself, evidence that the debtor is having financial difficulties does not establish worthlessness.[578] Indeed, the insolvency or adverse financial condition suffered by the debtor may only be temporary, as it may be foreseeable that its financial position will favorably change in the not-too-distant future.[579] This would tend to negate a present finding of worthlessness. Although the debtor's potential for rebounding from insolvency or threat of insolvency must be given weight in determining worthlessness, the lender need not be an "incorrigible optimist."[580]

> *Example:* L is a one-third owner and president of T Corp., a textile manufacturer. L lends T $250,000. In Year 1, T defaults on its only contract, having received only $175,000 of the total contract price of $500,000. Late in Year 1, L arranges for a $275,000 loan to T from a third party. At the end of Year 1, T has assets of $190,000 and liabilities of $850,000, and T's prospects are bleak given the loss of the contract. Despite its financial problems, T continues its operations throughout Year 1. L is not entitled to a bad debt deduction in Year 1 for its loans to T. Despite T's balance sheet insolvency and business reversal, T continued as a going concern during Year 1. Moreover, T's ability to obtain the third-party loan indicates that T's financial condition was not hopeless.

Since the running of the statute of limitations does not extinguish a debt or render it worthless (but merely provides the debtor with a defense which may be asserted in a suit instituted for collection of the debt), it is not always sufficient evidence of worthlessness to justify a bad debt deduction,[581] unless the debtor has indicated it will avail itself of the defense.[582] If, however, the taxpayer claims a bad debt deduction in a subsequent year, he must establish: (1) that the debt did not become worthless in the year in which the statute ran and (2) that he had an

[570] *Miller v. Commissioner*, T.C. Memo 1982-629 (although debtor disappeared in one year, deduction was not available until following year, when it was determined that debtor's assets were less than claims of preferred creditors); *Briant v. Commissioner*, T.C. Memo 1982-397; *Straub Distrib. Co., Inc. v. Commissioner*, T.C. Memo 1971-46; *Sims v. Commissioner*, 10 T.C.M. 608 (1951).

[571] *Estate of Avery v. Commissioner*, T.C. Memo 1969-64 (debtor's key employee); *Magus, Mabee & Reynard, Inc. v. Commissioner*, 1 B.T.A. 907 (1925) (worthless upon determination of estate's lack of assets).

[572] *Washington Inst. of Technology, Inc. v. Commissioner*, 10 T.C.M. 17 (1951); *Continental Illinois Nat'l Bank & Trust Co. v. United States*, 81-1 USTC ¶9185 (N.D. Ill. 1981). *Cf. Randall v. Commissioner*, T.C. Memo 1980-460 (worthlessness not established where business continued for another four years). *But see Fincher v. Commissioner*, 105 T.C. 126 (1995) (mere fact that government closed savings and loan (S&L) for liquidation, without evidence of S&L's assets at time it was liquidated, not sufficient to prove that deposits in S&L were worthless).

[573] *Meurer Steel Barrel v. Commissioner*, 7 B.T.A. 64 (1927), *acq.*, VII-1 C.B. 21 (1928); *Moore v. United States*, 943 F. Supp. 603 (E.D. Va. 1996).

[574] *Murchinson Nat'l Bank v. Grissom*, 50 F.2d 1056 (4th Cir. 1931). *But see Young v. Commissioner*, 6 B.T.A. 656 (1927).

[575] *LeRoy v. Commissioner*, 4 T.C. 70 (1944). *But see* Rev. Rul. 71-37 (no deduction where collateral declined in value but debtor's business still viable).

[576] *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579 (1991); *Owens v. Commissioner*, T.C. Memo 2017-157; *Cooper v. Commissioner*, T.C. Memo 2015-191.

[577] *Weiss v. Commissioner*, T.C. Memo 1965-80; *Depuy v. Commissioner*, T.C. Memo 1955-81.

[578] *Production Steel, Inc. v. Commissioner*, T.C. Memo 1979-361. *See also Kelly v. Commissioner*, T.C. Memo 1992-452 (debtor's divorce and poor financial situation did not establish worthlessness of debt). *Cf. Milenbach v. Commissioner*, 106 T.C. 184 (1996) (fact that amounts are overdue, standing alone, is not sufficient to warrant deducting them as worthless), *aff'd in part and rev'd in part on other issues*, 318 F.3d 924 (9th Cir. 2003).

[579] Rev. Rul. 71-37; *Roth Steel Tube Co. v. Commissioner*, 620 F.2d 1176 (6th Cir. 1980) (where debtor company continues to operate as going concern, its debts are not worthless for tax purposes despite fact that it is technically insolvent, particularly where taxpayer continued to extend open credit to debtor who continued to pay on account). *See also Record Wide Distrib., Inc. v. Commissioner*, T.C. Memo 1981-12; *Hawkins v. Commissioner*, T.C. Memo 1987-91 (creditor's continuing to advance new funds to the corporation which was already seriously in arrears on its existing debt to her was held to be evidence that old debt was not worthless); *Estate of Shapiro v. Commissioner*, T.C. Memo 1987-126 (corporation not allowed bad debt deduction when debtor remained employed by corporation and had escrowed stock to secure liabilities arising from his dealings with corporation).

[580] *George E. Warren Corp. v. United States*, 141 F. Supp. 935 (Ct. Cl. 1956). *See also Sollitt Constr. Co., Inc. v. United States*, 1 Cl. Ct. 333 (1983) (taxpayer was not required to postpone its claim for bad debt deduction pending efforts by HUD to arrange increase in HUD-insured mortgage where debtor was insolvent and probability of success of HUD efforts reasonably appeared to be remote at the time taxpayer claimed its bad debt deduction).

[581] *Suman v. Commissioner*, T.C. Memo 1967-84 (parent-child loan); *Spratt v. Commissioner*, 43 B.T.A. 503 (1941), *acq.*, 1941-1 C.B. 10; *Smyth v. Barneson*, 181 F.2d 143 (9th Cir. 1950) (parent-child loan); *Commissioner v. Burdette*, 69 F.2d 410 (9th Cir. 1934) (statute seemingly extended), *aff'g* 25 B.T.A. 692 (1932), *nonacq.*, XI-2 C.B. 11.

[582] *Dennison v. Commissioner*, 4 T.C. 806 (1945), *acq.*, 1945 C.B. 2.

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objective and substantial reason for believing the note eventually would be paid.[583]

Bankruptcy is generally an indication of worthlessness of at least a part of an unsecured and unpreferred debt.[584] Nevertheless, depending on the facts of the case, the debt may become worthless only when settlement in bankruptcy has been reached, or it may have become worthless in an earlier year.[585] While courts have sometimes pointed to an adjudication of bankruptcy as the identifiable event indicating the debt's worthlessness,[586] adjudication alone is not sufficient to justify the deduction; it must be clear that the net assets of the bankruptcy estate are insufficient to satisfy the debt.[587] (The concept of adjudication, eliminated when the Bankruptcy Code was enacted in 1979, was substantially the same as entering an order for relief under the Bankruptcy Code.) Furthermore, the discharge in bankruptcy may be insufficient to cause worthlessness if the debt is nondischargeable or if the taxpayer has reason to believe the debt will be paid.[588]

The fact that a debt is actually paid in a subsequent year does not bar the deduction in a prior year;[589] however, the courts take the fact into account, as suggesting that the debt then had value.[590] (For a discussion of recoveries of bad debts, see IX., below.)

2. Banks and Regulated Businesses

In the case of a bank or other corporation subject to supervision by federal or certain state authorities, the regulations provide a presumption of worthlessness to the extent that a debt is written off (1) in accordance with specific orders of the authority or (2) if, upon audit by the authority, the authority confirms that the write off would have been ordered had it not been made by the taxpayer voluntarily.[591] The "conclusive presumption" regulations recognize that sufficient similarity exists between the criteria used to classify worthless debt under §166 and the standards used by regulatory authorities to identify whether a loan should be charged off. Thus, when the standards applied by a regulatory authority are akin to those found in §166, deference is given to the regulatory authority for purposes of bad debt deductions.[592]

Note: IRS examiners have been instructed to accept charge-off amounts reported by banks and bank subsidiaries for regulatory and generally accepted accounting principles (GAAP) purposes as sufficient evidence of worthlessness.[593]

Alternatively, a bank or thrift institution[594] may, by making a "conformity election," adopt a method of tax accounting under which it claims the bad debt deduction in the year the debt is charged off pursuant to the taxpayer's method of regulatory accounting, provided that the institution's supervisory authority has made an express determination that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of the supervisory authority.[595]

To reduce the administrative complexity of the current regulations, the IRS issued proposed rules[596] under which debt held by a "regulated financial company"[597] or "a member of a regulated financial group"[598] that uses the "Allowance Charge-off Method"[599] would be conclusively presumed to have become completely or partially worthless to the extent that the amount of any charge-off[600] is claimed as a deduction under

[583] *Duffin v. Lucas*, 55 F.2d 786 (6th Cir. 1932); *Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979) (adopting trial judge's opinion per curiam).

[584] Reg. §1.166-2(c)(1). *See* TAM 200101001 (unsecured debt discharged in bankruptcy gives rise to bad debt deduction under §166).

[585] Reg. §1.166-2(c)(2). *See Owens v. Commissioner*, T.C. Memo 2017-157 (debt was worthless in 2008 — the year debtor's business doors were padlocked — even though debtor did not file for bankruptcy until 2009); *Barrett v. Commissioner*, T.C. Memo 1996-199 (taxpayer not entitled to bad debt deduction, because debtor's petition in bankruptcy is not conclusive of debt's total worthlessness); *Bledsoe v. Commissioner*, T.C. Memo 1995-521 (taxpayer's loan to company considered worthless in year government funding lost and in part to company's failure to pay banks on other obligations; bankruptcy discharge five years later led to worthlessness of remainder of debt).

[586] *E.g.*, *LaStaiti v. Commissioner*, T.C. Memo 1980-547.

[587] *Estate of Mann v. Commissioner*, 731 F.2d 267 (5th Cir. 1984); *Edgar v. Commissioner*, T.C. Memo 1979-524; *Dallmeyer v. Commissioner*, 14 T.C. 1282 (1950); *Teitelbaum v. Commissioner*, 294 F.2d 541 (7th Cir. 1961). See also *Cox v. Commissioner*, 68 F.3d 128 (5th Cir. 1995) (bankruptcy filing not enough by itself to establish worthlessness; taxpayer could have filed claim against bankrupt estate and recover part of debt); *Rendall v. Commissioner*, 535 F.3d 1221 (10th Cir. 2008).

[588] See *Garrett v. Commissioner*, 39 T.C. 316 (1962). See also *Aston v. Commissioner*, 109 T.C. 400 (1997) (nonbusiness bad debt deduction not allowed where depositor had claim pending against foreign bank still in process of liquidation).

[589] See *Olson v. Commissioner*, 10 T.C. 458 (1948).

[590] *E.g.*, *Busch v. Commissioner*, 50 F.2d 800 (5th Cir. 1931); *Hearn v. Commissioner*, 36 T.C. 672 (1961), *aff'd*, 309 F.2d 431 (9th Cir. 1962). In *Buchanan v. United States*, 87 F.3d 197 (7th Cir. 1996), the Seventh Circuit held that a nonbusiness debt was not worthless because taxpayer collected a substantial portion ($481,000 of $2.1 million loan) after debtor became insolvent, even though most of the funds used for the repayment were unlawfully diverted by the debtor from payroll taxes and his late wife's estate. The court stated that the allowance for nonbusiness debt that becomes worthless within the taxable year is unavailable if even a modest fraction of the debt can be recovered, irrespective of the source of repayment, unless the source, and therefore the repayment, is unforeseeable.

[591] Reg. §1.166-2(d)(1)(i) and§1.166-2(d)(1).

[592] Notice 2013-35.

[593] LB&I-04-1014-008 (Oct. 24, 2014). The directive does not apply to small banks that use the reserve method of accounting for loan losses under §585.

[594] The conformity election is available to "banks" as defined in §581 (which includes thrifts) and to any corporation which would be described in §581 except for the fact that it is a foreign corporation. Reg. §1.166-2(d)(4). *See Moneygram Int'l, Inc. v. Commissioner*, 144 T.C. 1 (2015) (money services business did not qualify as a bank because a substantial part of its business did not consist of receiving bank deposits or making bank loans), *vacated and remanded by* 664 Fed. App'x 386 (5th Cir. 2016) (Tax Court definition of bank requiring that deposits be held for extended time period and that interest be paid on loans is too restrictive; remand for reconsideration based on proper definition), *on remand*, 153 T.C. 185 (2019) (taxpayer was not bank for purposes of §581 and was not entitled to §582 ordinary loss deductions), *aff'd*, No. 20-60146, 2021 BL 203171 (5th Cir. June 1, 2021) (because money services business did not receive money from customers for safekeeping purposes it was not considered bank).

[595] Reg. §1.166-2(d)(3)(i), §1.166-2(d)(3)(iii)(D).

[596] See Prop. Reg. §1.166-2(d), added by REG-121010-17, 88 Fed. Reg. 89,636 (Dec. 28, 2023). The proposed rules would apply to charge-offs made by a regulated financial company or a member of a regulated financial group on its applicable financial statement that occur in tax years ending on or after the date that the proposed rules become final. A regulated financial company or member of a regulated financial group may elect to apply the proposed rules to charge-offs on its applicable financial statement that occur in tax years ending on or after December 28, 2023. *See* Prop. Reg. §1.166-2(d)(5).

[597] See Prop. Reg. §1.166-2(d)(4)(ii)(A)–§1.166-2(d)(4)(ii)(N).

[598] Defined in Prop. Reg. §1.166-2(d)(4)(iii).

[599] Defined in Prop. Reg. §1.166-2(d)(1)(i).

[600] Defined in Prop. Reg. §1.166-2(d)(4)(i).

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§166 by the respective entity on the relevant federal income tax return for the tax year in which the charge-off takes place.[601]

Under the Allowance Charge-Off Method, the debt would be charged off from the allowance for credit losses in accordance with United States Generally Accepted Accounting Principles (GAAP) and recorded in the period in which the debt is deemed uncollectible on the applicable financial statement of the regulated financial company or regulated financial group member.[602]

Note: A change to the Allowance Charge-Off Method constitutes a change in accounting method for which IRS consent is required.[603]

For certain regulated insurance companies[604] that prepare an applicable financial statement, the proposed rules would provide that the debt would be charged off pursuant to an accounting entry or set of accounting entries that reduce the debt's carrying value and result in a realized loss or a charge to the statement of operations (as opposed to recognition of an unrealized loss) that, in either case, is recorded on the regulated insurance company's annual statement.[605]

The proposed rules would further provide that if a regulated financial company or member of a regulated financial group[606] does not claim a deduction under §166 for a totally or partially worthless debt on its federal income tax return for the tax year in which the charge-off takes place, but claims the deduction for a later tax year, the charge-off in the prior taxable year would be deemed to have been involuntary and the §166 deduction would be allowed for the taxable year for which the deduction is claimed.[607]

a. General Rule — Conclusive Presumption Rules (Specific Order Method)

Although the conformity election, discussed below, is available only to banks,[608] the conclusive presumption regulations also provide a general rule that is available to both banks and other corporations which are "subject to supervision by federal authorities, or by state authorities maintaining substantially equivalent standards."[609] A regulated corporation other than a bank or, in the absence of a conformity election, a bank that wishes to rely on the presumption of worthlessness must have claimed the bad debt deduction at the time it filed the tax return for the year in which either: (1) the institution's supervisory authority specifically ordered it to charge off the debt; or (2) the institution voluntarily charged off the debt in accordance with the established policy of its supervisory authority, provided the supervisory authority later confirmed in writing that it would have ordered the taxpayer to charge off the debt if an examination had been made at the time of the charge-off.[610] The IRS has referred to this conclusive presumption rule as the "Specific Order Method."[611]

If the institution does not claim a deduction in the charge-off year but claims the deduction in a later year, the deduction is allowed in the later year provided the taxpayer demonstrates that the debt became wholly or partially worthless in that year. In that case, the taxpayer cannot rely on the conclusive presumption of worthlessness; instead, the taxpayer must produce sufficient evidence to establish the worthlessness of the debt.[612]

b. Conformity Election (Book Conformity Method)

(1) Effect of the Election

As noted above, if a bank's (which term includes thrifts for this purpose)[613] supervisory agency expressly determines that the bank maintains and applies loan loss classification standards that are consistent with those of the supervisory authority,[614] the bank may make a conformity election.[615] The IRS has referred to this conclusive presumption rule as the "Book Conformity Method."[616]

Note: The proposed rules discussed above would eliminate the conformity election.[617]

Making the conformity election results in the adoption of a method of accounting under which debts that are charged off for regulatory purposes are conclusively presumed to have become worthless during that year for tax purposes provided that the charge-off results from either a specific order of the institution's regulatory authority or corresponds to the institution's classification of the debt as a "loss asset." A debt qualifies as a loss asset if it is assigned to an asset class that corresponds to a loss asset classification under certain specified federal banking guidelines.[618] If a regulatory authority's procedures provide for the classification of loans as substandard, doubtful, or loss, a loan classified as doubtful or substandard is not a loss asset.[619] The IRS does not look behind the regulatory authority's standards; for example, the IRS Chief Counsel's Office advised that the IRS does not have the authority to question a bank's loan loss classification standards when the bank had made the conformity election and received a determi-

[601] *See* Prop. Reg. §1.166-2(d)(1).

[602] See Prop. Reg. §1.166-2(d)(1)(i). Definitions as to what constitutes an "applicable financial statement" are set forth in Prop. Reg. §1.166-2(d)(4)(viii) and §1.166-2(d)(4)(ix).

[603] *See* Prop. Reg. §1.166-2(d)(2)(i) and Prop. Reg. §1.166-2(d)(2)(ii). In 2024, the IRS issued guidance for obtaining automatic consent to change to the Allowance Charge-Off Method. *See* Rev. Proc. 2024-30.

[604] Defined in Prop. Reg. §1.166-2(d)(4)(vii)(A)–§1.166-2(d)(4)(vii)(D).

[605] Prop. Reg. §1.166-2(d)(1)(ii).

[606] A "regulated financial company" is defined in Prop. Reg. §1.166-2(d)(4)(ii) and a "member of a regulated financial group" is defined in Prop. Reg. §1.166-2(d)(4)(iii).

[607] Prop. Reg. §1.166-2(d)(3).

[608] Reg. §1.166-2(d)(3).

[609] Reg. §1.166-2(d)(1).

[610] Reg. §1.166-2(d)(1).

[611] Notice 2013-35.

[612] Reg. §1.166-2(d)(2); TAM 9122001. *See also Credit Life Ins. Co. v. United States*, 948 F.2d 723 (Fed. Cir. 1991) (conclusive presumption of worthlessness requires taxpayer to include receivable in income and then claim bad debt deduction; taxpayer not entitled to presumption if it simply excludes receivable); TAM 9248048 (bank that complied with FDIC order to amend its Call Report to reflect losses is considered to have charged off losses on its books during year of original Call Report).

[613] Reg. §1.166-2(d)(4) and §581.

[614] Reg. §1.166-2(d)(3)(iii)(D).

[615] *See* Rev. Proc. 92-84 (required form and content of such determination).

[616] Notice 2013-35.

[617] *See* Prop. Reg. §1.166-2(d).

[618] Reg. §1.166-2(d)(3)(ii)(C).

[619] *See* T.D. 8396, 1992-2 C.B. 95; T.D. 8492, 1993-2 C.B. 73; FSA 199912005.

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nation letter.[620] However, as discussed in VI.B.2.b.(2), below, grounds for IRS to revoke the election include claiming deductions substantially exceeding those that a bank exercising reasonable business judgment in applying the regulatory standards would otherwise claim.[621]

In Rev. Rul. 2001-59, a bank which had received a regulatory authority determination letter and made a conformity election erroneously classified some credit card receivables as loss assets, and thus charged them off for regulatory purposes and deducted them for income tax purposes. The total amount the bank's of wholly worthless debt deduction for the taxable year was not substantially in excess of the amount that would have been warranted by the exercise of reasonable business judgment in applying the regulatory authority's loss standards. The ruling held that the conclusive presumption of worthlessness applied to erroneously charged off credit card receivables and that they had, therefore, been properly deducted.

The conclusive presumption of worthlessness applies to a debt charged off by the bank even if its supervising regulatory authority subsequently determines the debt should have been charged off in an earlier year.[622]

A bank may have to accrue interest income for income tax purposes on a questionable loan after regulatory standards prohibit the accrual of interest (but before the loan has been classified as a loss). The IRS determined[623] that, in the year a loan is written off for regulatory financial statement purposes, a bank using a conformity method of accounting is allowed a bad debt deduction for the amount of uncollected interest that it was required to accrue with respect to the loan for income tax purposes but was not allowed to accrue for regulatory purposes.

A conformity election does not require or permit a §481 adjustment for debts that have not been deducted under the bank's prior method of accounting but would have been deducted in prior years had the conformity election been in effect.[624] Rules for determining the year, if any, in which such bad debts may be deducted are provided in Reg. §1.166-2(d)(3)(iii)(B).

(2) Making the Election

A new bank makes the election by attaching a statement to its tax return for the year in which it first adopts its method for accounting for bad debts. An already existing bank makes the election by filing a completed Form 3115, *Application for Change in Accounting Method*.[625] The election must have the words "ELECTION UNDER §1.166-2(d)(3)" typed or legibly printed on page 1 and must contain a declaration that the express determination requirement has been met.[626] The election is binding for all subsequent years unless revoked by the IRS or revoked by the taxpayers with the consent of the IRS.[627]

Further guidance for making a conformity election is provided in Elections and Compliance Statements, *Financial Institution: Conformity Election to Establish Worthlessness of Debts (§166).*

(3) Revocation of the Election

A bank's voluntary revocation of the election requires the Commissioner's consent. A request for a voluntary revocation is made by filing a properly labeled Form 3115, *Application for Change in Accounting Method*.[628] An election will be automatically revoked if, in connection with any supervisory authority examination of the bank's loan review process, the bank fails to obtain the express determination that the bank maintains and applies loan loss classification standards that are consistent with those of the supervisory authority.[629] The IRS may revoke the election if the bank fails to follow the method of accounting dictated by the election[630] or claims deductions that substantially exceed those that a bank exercising reasonable business judgment in applying the regulatory standards would claim.[631]

Once an election is revoked, the bank cannot make another election unless the IRS consents.[632]

C. Effect of Causes of Action Related to the Worthless Debt

The taxpayer may have a cause of action related to (but not arising from) the debt, so that he may recover some or all of his loss on the worthless debt. This may not preclude claiming the bad debt deduction: the precedents are in conflict.

In Rev. Rul. 80-24, the IRS ruled that the taxpayer was entitled to a §166 deduction in the year that a bankrupt debtor's unsecured note, which the taxpayer had purchased, was dishonored. The taxpayer had a cause of action against the seller of the note with a reasonable prospect of recovering the purchase price. This was ruled to have no bearing on the actual worth of the debt evidenced by the note, because the cause of action was based on the sale of the note and not on the debtor-creditor relationship between the seller and the bankrupt debtor. The ruling relied on a district court case, *Zeeman v. United States*[633]

In *Aerotron Grantor Trust v. Commissioner*,[634] a vacated Tax Court Memorandum decision, the taxpayer's suit against a third party for breach of contract and fraud in connection with

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[620] CCA 200045030 (regulatory standard classified delinquent consumer credit card and installment loans as loss assets based on passage of time).

[621] Reg. §1.166-2(d)(3)(iv)(D).

[622] Reg. §1.166-2(d)(3)(ii)(B).

[623] Rev. Rul. 2007-32.

[624] Reg. §1.166-2(d)(3)(iii)(B).

[625] Reg. §1.166-2(d)(3)(iii)(C).

[626] Reg. §1.166-2(d)(3)(iii)(C). See Reg. §1.166-2(d)(3)(iii)(E) for a transitional rule, where the bank's first examination by its supervisory authority that is after Oct. 1, 1992, has not been completed.

[627] Reg. §1.166-2(d)(3)(iii)(C).

[628] Reg. §1.166-2(d)(3)(iv)(E).

[629] Reg. §1.166-2(d)(3)(iv)(C)(1).

[630] Reg. §1.166-2(d)(3)(iv)(D).

[631] *Id.* In FSA 200018017, for example, a conformity electing institution (T) that classified loans as below average, unsatisfactory, and uncollectible for regulatory purposes had charged off as loss assets loans from the first two categories which, according to T, had become uncollectible between the time they were classified as such and the end of the year. The National Office advised the IRS to consider revoking T's conformity election in the earliest open year under examination if T was deducting bad debts for loans that had not been classified as loss assets and charged off for regulatory purposes in the same tax year. The revocation would have to be treated as a cut-off method with no attendant §481(a) adjustments with respect to loan amounts previously charged off for book purposes, the National Office stated.

[632] Reg. §1.166-2(d)(3)(iii)(C)(3), (iv)(A).

[633] 275 F. Supp. 235 (S.D.N.Y. 1967), *aff'd and rem'd*, 395 F.2d 861 (2d Cir. 1968).

[634] *Aerotron Grantor Trust v. Commissioner*, T.C. Memo 1988-556, *vac'd and rem'd by unpub. opin., on joint motion*, 927 F.2d 608 (9th Cir. 1991).

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the transaction in which the debt arose precluded a finding of worthlessness because the taxpayer had a reasonable prospect of receiving compensatory damages in an amount equal to the unpaid debt. The Tax Court cited *Exxon Corp. v. United States*[635] for the proposition that the critical factor was not the legal theory employed, but whether the taxpayer had a reasonable prospect of making his loss whole.

Comment: The Tax Court's decision in *Aerotron* is inconsistent with *Zeeman* and Rev. Rul. 80-24, which stand for the proposition that only lawsuits based directly on the debtor-creditor relationship preclude a finding of worthlessness, even though the taxpayer may recover damages that fully compensate him for the loss on the debt. In *Zeeman*, which was not cited in *Aerotron*, the taxpayer sued various parties, including the debtor, for fraud in connection with the transactions in which the debt arose. The court held that even though the damages claimed were measured by the amount of the debt, any recovery would not be on the debt. The Tax Court's reliance on *Exxon* in *Aerotron* is questionable because the fraudulent conveyance action in that case was based on the debt, despite the fact that the action was brought against the transferee of the debtor's assets.[636] The *Aerotron* holding seems realistic but technically flawed: under the statute a taxpayer is allowed a deduction if a debt becomes worthless. Even though there may be the possibility (or, in principle, even the certainty) of being made whole by a claim against someone other than the debtor, if the debt itself is worthless, that meets the statutory language of §166.

In *Thompson v. Commissioner*,[637] the Tax Court held that the presence of a pending cause of action against a surety of a construction debt precluded a finding that the underlying debt was worthless where, under local law, the creditor's rights to recover from the surety were directly related to the existence and the amount of the debt. The court reasoned that a secured debt is not worthless until the security (whether it takes the form of collateral, a guarantee, or, as was the case in *Thompson*, a statutory surety bond) becomes worthless. Rev. Rul. 80-24 and *Zeeman*, discussed above, were distinguished in *Thompson*, because, unlike *Thompson*, recoveries in the former situations were based on causes of action arising from rights other than the debt itself, such as rights of a purchaser against the seller of a note.

D. Burden of Proving Worthlessness

Under the specific write-off method of deducting bad debts, a taxpayer is allowed a deduction for each debt, without limitation as to dollar amount, that becomes partially (in the case of business debts) or wholly worthless during a taxable year.[638]

The burden of proving worthlessness is on the taxpayer and (as the regulations suggest) must be met by proving objective facts, such as those indicated above.[639] The taxpayer must exhaust all the usual reasonable means of collection to establish worthlessness.[640] The taxpayer should document all efforts to collect a debt, including demands made, discussions had with the debtor, and his reasons for not paying.[641] Failure to collect after a direct confrontation and demand for payment from the debtor is not conclusive evidence of worthlessness, however, because the efforts may be subjectively determined to be those of a lackadaisical or non-pursuing creditor, and therefore insufficient to establish worthlessness.[642] Litigation may have to be pursued until settlement or until worthlessness is firmly established.[643] Where litigation is pending in connection with a loss during the year a deduction is claimed, it may indicate that the creditor then retains some expectation of recovery, but it should be given little weight unless the expectation is objectively sound.[644]

Similar principles apply with respect to the involvement of an attorney. When a taxpayer's efforts to collect are exhausted and the taxpayer turns over the account to an attorney for collection, an opinion should be obtained from the attorney regarding when and if further legal action is necessary or likely to be productive.[645] However, mere opinions or assertions by a taxpayer's attorney have been denied decisive weight.[646]

Copies of the debtor's financial statements should be preserved;[647] however, when these show a net positive value, the taxpayer may have to show that certain assets are not worth the amount at which they appear on the books.[648] While it is not required that legal action be taken to enforce collection where there is a factual basis for concluding that a debt is worthless and uncollectible,[649] a debt is not worthless and uncollectible under §166 merely because a creditor elects not to enforce the obligations.[650]

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[635] 7 Cl. Ct. 347 (1985), *rev'd on another issue*, 785 F.2d 277 (Fed. Cir. 1986).

[636] See fn. 11 of the *Exxon* opinion.

[637] T.C. Memo 1983-81.

[638] Reg. §1.166-3(a), (b).

[639] *E.g., Rendall v. Commissioner*, 535 F.3d 1221 (10th Cir. 2008). This burden is based on an interpretation of former Rule 20 which is a predecessor to current Tax Court Rule 142(a). *See also* Reg. §1.166-3(a)(2)(iii).

[640] *Newman v. Commissioner*, T.C. Memo 1982-61; *Brewer v. Commissioner*, T.C. Memo 1992-530 (insurance agent who borrowed funds to pay insurance premiums on behalf of customer is not entitled to deduct those expenses under §166 because he did not take reasonable steps to collect on customer's promissory note).

[641] *E.g., Fox v. Commissioner*, 50 T.C. 813 (1968) (subjective good-faith opinion of petitioner is not enough). *Cf. Deauville Operating Corp. v. Commissioner*, T.C. Memo 1985-11.

[642] *Newman v. Commissioner*, T.C. Memo 1982-61; *Dean v. Commissioner*, T.C. Memo 1970-75; *Tussaud's Wax Museum v. Commissioner*, T.C. Memo 1966-211.

[643] *See H.D. Lee Mercantile Co. v. Commissioner*, 79 F.2d 391 (10th Cir. 1935); *Proesel v. Commissioner*, 77 T.C. 992, 1007 (1981). *See also Cole v. Commissioner*, T.C. Memo 1987-228, *aff'd*, 871 F.2d 64 (7th Cir. 1989) (litigation would not have been futile just because corporation, in which taxpayer controlled 15% of stock, had its assets subject to bank lien on another loan because corporation was not in default on that other loan and actually paid down balance).

[644] *Cf. Baum v. Commissioner*, 10 T.C.M. 274 (1951), *aff'd*, 199 F.2d 267 (5th Cir. 1952); *Wahl v. Commissioner*, 21 B.T.A. 822 (1930), *acq.*, X-1 C.B. 68.

[645] *Clarkston v. Commissioner*, T.C. Memo 1958-91; *Ft. Worth Warehouse & Storage v. Commissioner*, 6 B.T.A. 536 (1927), *acq.*, VI-2 C.B. 3.

[646] *Frank Guerrini Vending Mach., Inc. v. Commissioner*, T.C. Memo 1969-272.

[647] *Clements v. Commissioner*, T.C. Memo 1969-235, *aff'd per curiam*, 453 F.2d 869 (9th Cir. 1971); *Dysard v. Commissioner*, T.C. Memo 1968-21.

[648] *See, e.g., Irbco Corp. v. Commissioner*, T.C. Memo 1966-67.

[649] Reg. §1.166-2(b).

[650] *Southwestern Life Ins. Co. v. United States*, 560 F.2d 627 (5th Cir. 1977), *vac'g and rem'g, but aff'g on this issue* 75-1 USTC ¶9321 (N.D. Tex. 1975).

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Comment: Complete documentation of all efforts made to collect a debt and deliberation over various factors which culminated in a decision to write off the debt in that particular year is crucial. The number of cases each year of taxpayers who fail to sustain their burden of proving worthlessness and the correct year for worthlessness is far too high. In some cases, even though worthlessness is reasonably certain, it may be advisable to make further (documented) efforts to collect for the purpose of demonstrating to the IRS what the taxpayer already knows.

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VII. Claiming the Deductions

A. *Maximum Allowable Deduction*

1. General Rule

The allowable deduction under §166 cannot exceed the creditor's adjusted basis in the debt as determined under Regs. §1.1011-1 for determining loss from the sale or other disposition of property.[651]

Because the basis is not presumed to be the same as the face amount of the obligation,[652] the taxpayer must be able to establish the actual "cost" of the debt, under the usual rules for determining basis. Most commonly, the starting point for determining basis will be the cost under §1012, i.e., the amount advanced to the debtor if the taxpayer made the loan or the purchase price if the taxpayer purchased it from another. The basis will often include amounts taken into income with respect to the obligation; accrued but unpaid interest and an account receivable of an accrual basis taxpayer are classic examples, but there are others.

"Original issue discount"[653] is not part of a debt's basis until it has been included in the holder's gross income (and thus increased the adjusted issue price). Thus, a §166 deduction is available with respect to original issue discount only to the extent it has been included in income.

Applying the basis limitation rule in *Briesacher v. Comr.*,[654] the Tax Court held that a note issued to the petitioner for the sale of radio station assets had no ascertainable fair market value at the time of its issuance, and therefore the transaction was open for tax purposes.[655] As a result, the taxpayer's basis in the note was equal to the sum of the adjusted bases of the assets sold to the debtor in exchange for the note.

In *Swenson v. Comr.*,[656] an estranged husband who was in arrears with respect to child support payments entered into a compromise agreement. However, the wife was denied a deduction when the promise became worthless, since she had no basis in the debt. The wife contended that, by spending her money in anticipation of receipt of the support payments, she expended capital which gave rise to basis in the debt. The Tax Court rejected this position because the husband's obligation had arisen independently of the payments by virtue of the original court decree.

In *Perry v. Comr.*,[657] the Tax Court did not allow the taxpayer to deduct, as a bad debt, arrears in alimony payments from her former spouse because she did not have a basis in the debt. Further, the court held that the taxpayer's agreement (executed 10 years after the divorce), through which she agreed to guarantee payments to her children from the payments due from her former spouse, did not provide a basis in the debt because the guarantee was not in existence during the years in question and because there was no relationship between the alimony payments and the taxpayer's expenses for her children.

Citing *Swenson* and *Perry*, the IRS determined in Rev. Rul. 93-27 that a taxpayer could not claim a bad debt deduction for the amount of her ex-spouse's arrearage in child support payments because she did not have any basis in the debt.

If a guarantor gives a note to the original creditor in satisfaction of his guarantor obligation, no deduction is permitted by the guarantor until the year the note is paid.[658] This is true even though the note is secured by the guarantor's property and there is no prospect of recovery from the primary obligor.

2. Effect on Basis of Prior Operating Losses of S Corporation Debtor

A stockholder of an S corporation may deduct currently his share of the S corporation's losses to the extent that they do not exceed his basis for (1) his S corporation's stock and (2) any debt owed to him by the S corporation.[659] A stockholder's share of the S corporation losses first reduces the basis of his S corporation stock.[660] Once the basis of his S corporation stock has been reduced to zero, his share of the S corporation losses reduces basis in S corporation debt held by him.[661] The stockholder's share of S corporation income increases his basis in the S corporation debt to the extent it has previously been reduced for S corporation losses and then increases his basis in his S corporation stock.[662]

S corporation losses reduce the bases of multiple debt instruments in proportion to the shareholder's tax bases in the instruments.[663] A shareholder's share of S corporation income for the taxable year is first applied to restore basis to debt instruments evidencing advances made on or after October 20, 2009 (and debt instruments evidencing pre-October 20, 2009 advances if the shareholder elects to apply the current Regulations to earlier debt) repaid (in whole or in part) during the year to the extent necessary to offset any gain that would otherwise be realized as a result of the repayment.[664] The balance of the shareholder's share of income is applied to restore basis to all debt instruments held by the shareholder in proportion to the amount that the basis of each outstanding debt instrument

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[651] §166(b); Regs. §1.166-1(d)(1). This rule did not apply in the case of a deduction for a reasonable addition to the reserve.

[652] Regs. §1.166-1(d)(2). The regulations specify certain cases where the amount of the deduction will not equal the face amount of the debt: (1) if a taxpayer in computing taxable income values his notes or accounts receivable at fair market value, then the amount of the bad debt deduction is limited to fair market value; (2) where a taxpayer purchases receivables, a bad debt deduction is limited to cost; and (3) where a taxpayer has a claim in bankruptcy or a claim against a decedent's estate, a bad debt deduction is limited to the difference between the amount received and the amount claimed.

[653] §1271, et seq.

[654] T.C. Memo 1982-618.

[655] *See Burnet v. Logan*, 283 U.S. 404 (1931).

[656] 43 T.C. 897 (1965). Followed in *Williford v. Comr.*, T.C. Memo 1975-65.

[657] 92 T.C. 470 (1989), *aff'd*, 912 F.2d 1466 (5th Cir. 1990); *See also Beshear v. Comr.*, T.C. Memo 1990-544 (taxpayer denied bad debt deduction for unpaid alimony payments, for lack of tax basis, and for failing to include amounts in income in year for which deduction was claimed).

[658] *Perry v. Comr.*, 49 T.C. 508 (1968), *acq.*, 1968-2 C.B. 2; *Halle v. Comr.*, T.C. Memo 1983-760 (cash-basis taxpayer was not entitled to bad debt deduction when he substituted his personal note in satisfaction of his liability as guarantor for loan incurred by his corporation); *Reed v. Comr.*, T.C. Memo 1971-77. *Black Gold Energy Corp. v. Comr.*, 99 T.C. 482 (1992), *aff'd*, 33 F.3d 62 (10th Cir. 1994) (accrual-basis taxpayer).

[659] §1366(a), (d).

[660] §1367(a)(2). For a discussion of shareholder basis in S corporations, see 731 T.M., *S Corporations: Operations*.

[661] §1367(a)(2), (b)(2).

[662] §1367(b)(2)(B), (a)(1).

[663] Regs. §1.1367-2(b)(3).

[664] Regs. §§1.1367-2(c)(2), 1.1367-3.

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has been reduced and not previously restored.[665] If a shareholder holds multiple open accounts (i.e. debt not evidenced by a written instrument), their treatment for purposes of reduction and restoration of basis can vary depending on when the advances were made and whether the shareholder opts to apply the current Regulations to advances made before October 20, 2009, and not repaid prior to that date. If the shareholder chooses to apply the current Regulations to the pre-October 20, 2009 open accounts, each open account with unpaid balance in excess of $25,000 at the end of any taxable year ending on or after October 20, 2009, is treated as a separate written instrument (for the current and all subsequent taxable years) and all other open accounts are aggregated and treated as single written instrument.[666] If the shareholder does not choose to apply the current Regulations to the pre-October 20, 2009 open accounts, each open account representing post-October 19, 2009 advances with an outstanding balance in excess of $25,000 at the end of any taxable year ending after October 19, 2009 is treated as a separate written instrument (for the current and all subsequent taxable years) and all other open accounts are aggregated and treated as single written instrument.[667]

The determination of a stockholder's share of S corporation items of income and loss and the resulting adjustments to basis is made prior to determining the stockholder's bad debt deduction with respect to any S corporation debt which became worthless during the taxable year.[668]

The effect of these rules on the stockholder's bad debt deduction is illustrated by the following:

> *Example:* Assume that X, an S corporation, is formed on Jan. 1, Year 1. At formation, X issues one-half of its outstanding stock to B for $100 and the other one-half to D for $100. In addition, B lends X $200. During Year 1, X breaks even. In Year 2, X loses $400 and abandons its business.
>
> B's share of the Year 2 loss is $200 (an ordinary loss to B unless the loss resulted from a disposition of capital assets by X). B's share of the loss reduces B's basis in his X stock to zero and his basis in the X debt from $200 to $100. B is entitled to a bad debt deduction equal to his $100 basis in the $200 debt owed him by X. If the debt is a nonbusiness bad debt, the loss is a short-term capital loss. D is also allocated $200 of the Year 2 loss, but, subject to the cancellation of debt discussion below, can deduct only $100 of the loss.

The factors which justify a creditor-stockholder's claiming a bad debt deduction with respect to an S corporation's debt may also require a finding that he has released the S corporation from the debt or otherwise cancelled it.

S corporations may exclude from their gross income amounts which would otherwise be includible as discharge of indebtedness income if the S corporation is insolvent or in bankruptcy, without including any amount excluded under §108(a).[669] The S corporation is required to reduce its tax attributes (e.g., losses and credits which have not been allowed to its shareholders due to a lack of basis and tax basis of corporate assets) by an amount equal to the unrecognized discharge of indebtedness income.[670] However, the reduction of tax attributes does not occur until the first day of the tax year following the discharge of debt.

In the case of discharges of debt prior to October 12, 2001, the cancellation of indebtedness income was an item which increased the S corporation's shareholders' basis in their stock.[671] This increase in basis allowed the S corporation shareholders to deduct losses of the S corporations (which they had not been able to claim previously because of a lack of basis) in the tax year in which the debt cancellation occurred, i.e., before the losses were reduced pursuant to §108(b).[672]

To the extent the S corporation is solvent, the cancellation of the debt (unless it is a capital contribution) results in ordinary income which must be recognized by the S corporation. The creditor-stockholder must recognize his share of that ordinary income which, in turn, increases his basis in the debt, to the extent it has previously been reduced by his share of S corporation losses. Thus, the effect of the cancellation of indebtedness income would be an increase in ordinary income to the S corporation's stockholders with a dollar-for-dollar increase in the creditor-stockholder's bad debt deduction (which, if a nonbusiness debt, is short-term capital loss). Of course, if the S corporation is solvent, it may be difficult for creditor-stockholder to establish his entitlement to a bad debt deduction.

If a corporation's own debt is contributed to its capital, the corporation is treated as having satisfied the debt for an amount of cash equal to the transferor's basis in the debt determined without regard to any adjustments for S corporation income or loss.[673]

Comment: Therefore, if a creditor-stockholder originally had a basis in the debt equal to face and the only adjustments to that basis have been to reflect income or loss of the S corporation, there is no cancellation of indebtedness on the contribution of the debt to the S corporation; on the other hand, no bad debt deduction is available for any portion of the debt contributed to the debtor's capital and the shareholder's basis in the contributed debt (which reflects reductions for prior S corporation losses) is added to the contributing shareholder's basis for her stock.

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[665] Regs. §1.1367-2(c)(2).

[666] Regs. §1.1367-2(a).

[667] Regs. §§1.1367-2(a), 1.1367-3, 1.1367-2(a) (prior to amendment by T.D. 9428, 73 Fed. Reg. 62199 (10/20/08), *corrected by* 73 Fed. Reg. 67388 (11/14/08)). For a discussion of shareholder basis in S corporations, see 731 T.M., *S Corporations: Operations.*

[668] §1367(b)(3).

[669] §108(d)(7), as amended by the 2002 Job Creation and Worker Assistance Act (JCWAA), Pub. L. 107-147, §402. The JCWAA effectively superseded *U.S. v. Gitlitz*, 531 U.S. 206 (2001) for discharges after Oct. 11, 2001 (with exception for certain discharges prior to Mar. 1, 2002). *See, e.g.*, TAM 201321019 (determining that cancellation occurred before Oct. 11, 2001, where IRS argued for later date).

[670] §108(b), (d)(7).

[671] *U.S. v. Gitlitz*, 531 U.S. 206 (2001), *rev'g* 182 F.3d 1143 (10th Cir. 1999). The Court's decision resolved a split of authority among the circuit courts.

[672] Before amendment of §108(d)(7), some shareholders of insolvent S corporations who had suspended losses would have benefited from the corporation having cancellation of indebtedness income. *See, e.g.*, *Ellinger v. U.S.*, 94 AFTR2d 2004-5786 (M.D. Fla. 2004), *aff'd*, 470 F.3d 1325 (11th Cir. 2006) (shareholders' argument that corporation had income rejected).

[673] §108(e)(6), (d)(7)(C).

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3. Effect on Basis of Prior Operating Losses of Debtor Taken on Consolidated Return

Under the consolidated return regulations, the fact that members of the consolidated group have utilized the debtor member's operating losses does not reduce the group member creditors' basis in the debt or member's obligations. However, under the post-July 11, 1995, regulations, claiming the bad debt deduction will generally result in either (i) the debtor member recognizing cancellation of indebtedness income or (ii) the group members who are shareholders of the debtor member recapturing excess loss accounts as ordinary income.[674]

4. Effect on Basis of Deduction for Partially Worthless Debt in a Prior Year

When a deduction is taken for a partially worthless business bad debt, the basis of the debt must be reduced by the amount deducted.[675] The rule applies even though the charge-off does not result in a tax benefit.[676]

This reduction in basis limits future bad debt deductions with respect to the obligation and reduces the amount of loss which will be recognized if the obligation is sold or exchanged. However, if amounts received with respect to the obligation eventually exceed the reduced basis of the debt, the tax benefit principles of §111 will generally allow the creditor to avoid recognizing income or gain to the extent the recovery in excess of the reduced basis does not exceed the amount of the deduction which did not result in a tax benefit.[677] See IX.A., below, for a discussion of the tax benefit rule.

Example: Creditor makes a loan of $1,000 and receives a debt obligation with a face value and initial tax basis of $1,000. The debt is written down to $200, but only $500 of the $800 deduction results in a tax benefit. If, as part of a subsequent bankruptcy settlement, the creditor receives nothing, he has an additional deduction of $200. If he receives from $200 to $500, he has no income by virtue of the §111(a) exclusion rule. To the extent he receives more than $500, he has taxable income or gain.

The impact of the rule reducing basis by the full amount of any partially worthless bad debt deduction is mitigated by the taxpayer's leeway in taking the deductions. See VIII.A.2.c., below.

B. Amount Deductible and Gain or Loss Recognition in Foreclosures and Repossessions

1. General Rule

A foreclosure or repossession conveniently indicates the time that debt becomes worthless (unless a deficiency judgment may be obtained and satisfied).

If the debt is one described in §1271(a), the receipt of the collateral or the foreclosure proceeds may constitute a "retirement" of the debt which is treated as a sale or exchange of the debt instrument and, if the debt is a capital asset in the hands of the creditor, the resulting loss is a capital loss. See the discussion of retirements under §1271 at III.B.3., above.

If the debt is one to which §1271 does not apply, such as a debt obligation issued by a natural person before June 9, 1997, which was not purchased on or after that date, and the creditor receives either money or property in the transaction, the nature of the deduction is affected. The taxpayer is entitled to a bad debt deduction equal to the basis of the debt in the hands of the taxpayer less the fair market value of the property received.[678]

However, §1271 applies quite generally. It applies to all "debt instruments," as very broadly defined by §1275(a)(1), regardless of their form. The major exception is that §1271 does not apply to a debt instrument issued by a natural person before June 9, 1997, unless it was purchased on or after that date. Thus, generally, if the effect of the foreclosure under the documentation and local law is to extinguish the underlying debt, §1271 will apply (subject to the relevant grandfather provisions of §1271(b)(2) and (c)) and the foreclosure of the mortgage will be treated as an exchange, as provided in §1271(a)(1). See III.B.3., above. The mortgagee will realize some value on the foreclosure, unless the security is literally worthless.[679] If the mortgage is a capital asset, the loss (or gain) realized on this exchange will be a capital loss (or gain). A mortgagee will often suffer an economic loss on foreclosure, and for the loss to be treated as a capital loss would usually make the loss even more painful.

Note: In these circumstances, it is possible to argue for a bad debt deduction, which may yield an ordinary deduction, because Regs. §1.166-6 flatly states that the mortgagee gets a bad debt deduction, without any reference to §1271 or its predecessors as possible exceptions. The author believes the better argument is that §1271 applies according to its terms; a regulation cannot override a statute. Of course, if the holder is a corporation (or the mortgage is a business bad debt), the holder may claim a bad debt deduction for partial worthlessness prior to the foreclosure.

Section 582(c) provides that the sale of an evidence of indebtedness by a bank, a financial institution referred to in §591 (e.g., savings and loans), a small business investment company, or any business development corporation shall not be treated as the sale or exchange of a capital asset.

Evidence of mortgage debt held by a taxpayer which is not described in §582(c), will be a capital asset unless the debt is described in §1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business) or §1221(a)(4) (receivables arising in the ordinary course of business from the rendering of services or the sale of property described in §1221(a)(1)). Unless a taxpayer is a dealer in securities, evidence of a mortgage debt is unlikely to be described

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[674] Regs. §1.1502-13(g)(3), (5) *Ex.* 3. Regs. §1.1502-19(b), (c)(iii).

[675] *Motor Prod. Corp. v. Comr.*, 47 B.T.A. 983 (1942), *acq.*, 1943 C.B. 17, *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944).

[676] *Bank of Newberry v. Comr.*, 1 T.C. 374 (1942), *acq.*, 1943 C.B. 2.

[677] *Bank of Newberry v. Comr.*, 1 T.C. 374 (1942), *acq.*, 1943 C.B. 2; *First Nat'l Bank of Farmingdale, N.Y. v. Comr.*, 2 T.C.M. 734 (1943).

[678] *See, generally*, Regs. §1.166-6 (sale of mortgaged or pledged property; accrued interest may be included as part of deduction to extent it was included in income).

[679] If the mortgage is a "security" within the meaning of §165(g) — not a common situation — the rules of §165(g) will govern, preempting §166. §166(e).

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in §1221(a)(1). Evidence of a mortgage debt will be described in §1221(a)(4), if the mortgage secures purchase money debt received by the taxpayer with respect to property as to which he is dealer. As the following discussion indicates, §1221(a)(4) may also apply to less obvious situations. Specifically, taxpayers engaged in the business of making loans but not governed by §582 may nevertheless, in the absence of regulatory action by the IRS or Treasury, treat loans they originate as assets described in §1221(a)(4).

In *Burbank Liquidating Corporation, et al. v. Comr.*[680] (a case decided prior to the 1969 enactment of §582(c)), the Tax Court held that the business of a savings and loan association could properly be described as "rendering the service" of making loans and that loans originated by the association were, therefore, described in §1221(a)(4) and not capital assets. Rev. Rul. 72-238 and Rev. Rul. 73-558 relied on *Burbank* in finding that a mortgage loan held by a bank or savings and loan which originated the loan was an asset described in §1221(a)(4). Neither ruling noted that under §582(c) such taxpayers would recognize ordinary income or loss on the sale of a loan whether or not the loan was described in §1221(a)(4). Rev. Rul. 80-56 and Rev. Rul. 80-57 found that, pursuant to the holding in *Burbank*, mortgage loans held by an originating REIT were §1221(a)(4) assets in the hands of the REIT.

In *Federal National Mortgage Association v. Comr.*,[681] the Court found that mortgages purchased by the taxpayer ("FNMA") in the secondary market to further its statutory purpose (to provide stability to the secondary market for home mortgages and liquidity for originating lenders) were §1221(a)(4) assets in FNMA's hands because FNMA was providing a service to the mortgage lending business and the members thereof by acquiring the mortgages for its portfolio.

In 2006, IRS issued a proposed regulation[682] which "clarifies that an account or note receivable is not described in [§]1221(a)(4), if in exchange for the account or note receivable, the taxpayer provides more than de minimis consideration other than services or property described in [§]1221(a)(1), or if the account or note receivable is not issued by the party acquiring the services or property described in [§]1221(a)(1)." The preamble to the proposed regulations declared Rev. Rul. 72-238 and Rev. Rul. 73-558 obsolete because their holdings had been superseded by §582(c) for years after 1969. The preamble also stated that the IRS would determine whether to declare Rev. Rul. 80-56 and Rev. Rul. 80-57 obsolete when the proposed regulations became final. The proposed regulations were withdrawn on April 23, 2008.[683] In withdrawing the proposed regulations, the IRS stated:

> The IRS will not challenge return reporting positions of taxpayers under [§]1221(a)(4) that apply existing law, including *Burbank Liquidating*; *Federal National Mortgage Association*; and *Bieldfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000), *cert. denied*, 534 U.S. 813 (2001). *See also* Rev. Rul. 80-56, and Rev. Rul. 80-57. The IRS and the Treasury Department will continue to study this area and may issue guidance in the future.[684]

2. Repossessions

In a repossession, the creditor takes possession of the secured property in partial or full satisfaction of the debt. Section 1038 provides special rules for repossessions of real property pursuant to purchase money debt held by the seller, as discussed in VII.B.4., below. In the case of a repossession to which neither §1271 nor §1038 applies, the amount of the bad debt-deduction is the excess of the taxpayer's basis in the debt over the fair market value of the repossessed property.[685] If the fair market value of the repossessed property exceeds the taxpayer's basis in the debt, gain results. In either case, the taxpayer's basis in the repossessed property becomes the fair market value of the property.[686] Special rules applied to repossessions by Thrifts in taxable years beginning before 1996.[687]

3. Mortgage Foreclosures

a. Deduction on Foreclosure

A foreclosure differs from a repossession to the extent that the creditor gets cash in partial or full satisfaction of the debt. This is so even when the creditor is the one who successfully bids for the property because he is deemed to receive cash equal to the bid price that is then used to acquire the property. Where the mortgaged or pledged property is foreclosed (under any of the methods that are available under local law) for less than the amount of the debt, and the debt is one to which §1271 does not apply, the difference between the basis of the debt and the sale or bid price is deductible as a bad debt, where the difference is uncollectible.[688] Accrued but unpaid interest that had previously been included in income may be added to the bad debt deduction.[689]

For example, in *Community Bank v. Comr.*,[690] the taxpayer made loans to its customers and secured the loans with real property. When the customers defaulted, the taxpayer foreclosed in accordance with state law. The taxpayer was permitted a bad debt deduction equal to the excess of the unpaid balance of the debt over the bid price.

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[680] 39 T.C. 999 (1963), *aff'd in part & rev'd in part*, 335 F.2d 125 (9th Cir. 1964).

[681] 100 T.C. 451 (1993).

[682] REG-109367-06, 71 Fed. Reg. 44600 (Aug. 7, 2006). The proposed regulations would have effectively overruled *Burbank* and its progeny.

[683] Announcement 2008-41.

[684] *Id.*

[685] *E.g.*, Rev. Rul. 68-523.

[686] *See Shaheen v. Comr.*, T.C. Memo 1982-445.

[687] They recognized no gain or loss and were not entitled to a bad debt deduction. The repossessed property took on the tax basis and character (for purposes of §§166 and 1221) of the debt. Section 1038 did not apply to the repossession. §595, enacted by Pub. L. 87-34 §6(b), repealed by Pub. L. 104-188, §1616(b)(8); §1038(f), enacted by Pub. L. 88-570 §2(a), repealed by Pub. L. 104-188, §1616(b)(12).

[688] Regs. §1.166-6(a).

[689] Regs. §1.166-6(a)(2). *See also* §1274. *See Federal Home Loan Mortgage Corp. v. Comr.*, 121 T.C. 279 (2003) (taxpayer not entitled to increase basis in foreclosed mortgages for unpaid interest that accrued during period taxpayer was tax-exempt).

[690] 62 T.C. 503 (1974), *acq.*, 1975-1 C.B. 1. *See also Community Bank v. Comr.*, 79 T.C. 789 (1982), *aff'd*, 819 F.2d 940 (9th Cir. 1987), where the court held that Regs. §1.166-6 permits the IRS to introduce evidence of the actual market value of property to rebut the presumptive value of its bid in a foreclosure sale.

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If a portion of the balance is collectible, the creditor would have a partially worthless bad debt. This would preclude a current deduction if the debt was a nonbusiness debt.

b. Gain or Loss on Foreclosure

If §1271 does apply, the creditor will recognize loss to the extent the tax basis in the debt exceeds the bid price. To the extent, if any, that the bid price exceeds the tax basis in the debt, the creditor will recognize gain. Whether or not §1271 applies, a creditor who acquires the property realizes (and recognizes), in addition to any bad debt deduction or gain or loss attributable to the difference between the bid price and tax basis, a gain (or loss) to the extent of the excess (shortfall) of the fair market value of the property over the amount of debt applied to the bid price on acquisition of the property.[691]

The gain or loss recognized on foreclosure is treated as being from a sale or exchange of the loan.[692] Accordingly the character of any loss depends on whether the loan is a capital asset in the hands of the holder. To the extent bad debt deductions have been taken, the tax treatment of any gain will be governed by the tax benefit rule.[693] Further, if the holder is a cash-method taxpayer, gain will be ordinary income to the extent of any accrued but unpaid interest.[694] The character of the balance of any gain depends on whether the loan is a capital asset in the hands of the holder. (See, VII.B.1., above, for a discussion of when a mortgage note is not a capital asset.)

There is a rebuttable presumption that the fair market value of the property acquired on foreclosure is equal to the bid price. This presumption is overcome only upon clear and convincing proof that the property's fair market value is not equal to the bid price.[695]

In *Community Bank* (discussed in VII.B.3.a., above), the primary issue before the Tax Court was whether the fair market value of the properties received by the taxpayer as a result of the foreclosure was greater than, less than, or equal to the bid price for purposes of determining if the taxpayer realized gain or loss on the acquisition. The taxpayer contended that the property's fair market value was equal to the bid price, thus he did not have to recognize any gain on the acquisition. The IRS argued that the property's fair market value exceeded the bid price, and therefore there was a realization of gain by the taxpayer which had to be recognized.

The Tax Court explained that for purposes of determining gain or loss on the acquisition of property through foreclosure, it is presumed under Regs. §1.166-6(b)(2) that the fair market value of the property is equal to the bid price "absent clear and convincing proof to the contrary." The IRS had argued that such a rule would allow a taxpayer to arbitrarily choose the amount of gain or loss it wished to report by adjusting the bid price. The court rejected this argument and stated that pursuant to the standards set forth in the regulations, the IRS could present clear and convincing proof to rebut such a presumption. Because the IRS did not present clear and convincing evidence of a fair market value different from the bid price, the court concluded that Community Bank did not have to recognize any gain from the foreclosure proceedings.

Generally speaking, the taxable event associated with a mortgage foreclosure occurs when the suit (if any) on the deficiency judgment is resolved or settled and the mortgagor's equity of redemption expires or is acquired by the mortgagee.[696] However, only the amount of the deficiency needs to be partially or wholly worthless.[697]

Example: (Assume the deficiency, if any, is uncollectible).

Property	X	Y	Z
Mortgage Indebtedness (basis)	$1,000	$1,000	$1,000
Price bid by Creditor	$1,000	$ 400	$ 900
Bad Debt Deduction	None	$ 600	$ 100
Debt Applied to Bid Price	$1,000	$ 400	$ 900
Fair Market Value of Property	$ 500	$ 700	$1,500
Gain (or Loss)	($ 500)	$ 300	$ 600

Expenditures involved in disposing of foreclosed property are not deductible as business expenses. These expenses are taken into account in computing the gain or loss resulting from the disposition of the foreclosed property.[698] Note that in the case of gain upon a subsequent sale of foreclosure property, a bank must treat as ordinary income, rather than as a credit to bad debt reserves, the portion of the gain on the sale of the foreclosure property attributable to unpaid interest on the original mortgage loan.[699]

4. Reacquisition of Real Property; §1038

a. In General

Where the property was repossessed (whether by foreclosure or a deed in lieu) the general rules stated above proved to be unsatisfactory in two respects:

(1) The determination of the property's fair market value at the time of repossession or foreclosure is difficult in the case of real property. The theoretical legal test presumes a willing buyer and a willing seller, whereas in the real world the likely reason for the repossession would be the unavailability of any willing buyer at a price the owner and his creditor are willing to accept.

(2) The taxpayer repossessing the property may be treated as recognizing gain at a time when he has not received cash with which to pay the tax.[700]

Congress enacted §1038[701] to eliminate these problems in connection with a seller's reacquisition of real property in par-

[691] Regs. §1.166-6(b).
[692] Rev. Rul. 80-56.
[693] *Id.*
[694] *Helvering v. Midland Ins., Co.*, 300 U.S. 216 (1937).
[695] Regs. §1.166-6(b)(2).

[696] *Belcher v. Comr.*, T.C. Memo 1965-1.
[697] Regs. §1.166-6(a).
[698] Rev. Rul. 73-116.
[699] *See Security Bank S.S.B. v. Comr.*, 116 F.3d 302 (7th Cir. 1997), *aff'g* 105 T.C. 101 (1995).
[700] This was likely to occur where the debt was purchase money debt and the creditor was reporting his gain from the sale on the installment method.
[701] Pub. L. 88-570, §2(a).

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tial or full satisfaction of the debt arising from the sale of the property. Section 1038(a) provides that, as a general rule, no gain or loss is recognized if (i) the sale of real property gives rise to indebtedness secured by the real property and (ii) the seller reacquires the property in full or partial satisfaction of such indebtedness. The exceptions to the general rule are in §1038(b) and §1038(d). The provision applies even if the seller reacquires the property from the buyer's assignee or transferee, provided the indebtedness which is satisfied (or partially satisfied) by the reacquisition arose in the original sale.[702]

In order for §1038 to apply, the debt satisfied (or partially satisfied) must be seller financing. Thus, §1038 does not apply where the debt satisfied (or partially satisfied) by the repossession was provided by a party other than the seller, even though the sole purpose of the loan was for the purchase of the property and the debt was secured by the property; nor does §1038 apply where the property is conveyed to a person who has acquired the debt (in a bona fide transaction) from the original seller.[703] The provisions of §1038 are not elective.

Section 1038 applies regardless of the passing of title and regardless of the personal liability of the buyer.[704] Similarly, §1038 applies: (1) even though the seller must assume obligations at the time of reacquisition (a construction loan, for example) or make payments to the buyer and (2) to repossessions as well as repurchases.[705] Moreover, §1038 applies whether or not the reacquisition occurs when the debt is worthless. However, it generally does not apply if: (1) the seller makes payment to the buyer at the time of the reacquisition, (2) such payments were not provided for in the original contract, (3) the buyer has not defaulted in his obligations, and (4) no default is imminent.[706]

If the conditions to §1038 are met, the purchaser's debt to the seller is not considered to have become worthless or partially worthless as a result of the reacquisition.[707] Further, assuming the creditor has not previously claimed any deduction for total or partial worthlessness of the debt,[708] gain is recognized only to the extent, if any, of the lesser of: (1) the excess of the amount of any payments received by the seller before the reacquisition, whether in cash or property (with obligations of the purchaser received with respect to the original sale not being considered property), over the amount of gain previously reported; or (2) the amount of gain realized on the original sale in excess of the sum of (i) gain recognized in periods before the reacquisition and (ii) the amount of any payments made by the creditor in connection with the reacquisition.[709]

Any amounts previously written off under §166(a) must be "restored" to the basis of the debt upon reacquisition of the underlying property and are taxed under the tax benefit provisions.[710] See IX., below, for a discussion of §111.

Thereafter, the basis of the property reacquired is the basis of the debt at the date of reacquisition increased by (a) any gain recognized on the reacquisition, and (b) any amounts paid by the creditor (other than amounts which reduced the amount of gain recognized) in connection with the reacquisition.[711]

Comment: Section 1038 is usually thought of as a relief provision because a taxpayer who is reporting gain a sale on the installment method does not have to recognize the balance of his gain on a repossession of the property. However, where the taxpayer was ineligible to utilize the installment method, or elected not to, he may have a loss, in which case the inability to recognize a loss on the repossession and the requirement that any previously claimed bad debt deductions be recaptured can be make the application of §1038 burdensome. Such a taxpayer should be able to avoid the adverse tax consequences by transferring the note prior to taking action to repossess the property.[712] Where the note is contributed to a partnership, §704(c) and the regulations thereunder would presumably cause substantially all of the loss on the reacquisition to be allocated to the taxpayer as built in loss.

In *Rose v. Comr.*,[713] the taxpayer sold property in exchange for a note, and later assigned the note and mortgage with the agreement that he would guarantee the buyer's performance and repurchase the note and mortgage if the buyer defaulted. When the buyer defaulted, the assignee purchased the property at foreclosure, but the taxpayer refused to repurchase the note and mortgage pursuant to his agreement with the assignee. The assignee sued, and the court ordered the taxpayer to pay the amount due under the contract, after which the assignee conveyed the property to the taxpayer. The taxpayer argued that he did not regain title to the property in satisfaction of the debt for purposes of §1038 because the assignee's purchase of the property at foreclosure extinguished his rights in the property. The Second Circuit affirmed the Tax Court's holding that §1038 applied, reasoning that the taxpayer was required under the contract to purchase the property; his choice of litigation rather than fulfillment of his contractual obligation did not alter the fact that his reacquisition of the property was in satisfaction of the debt.

Special provisions address the sale of a principal residence.[714] Generally, the effect is to make §121 applicable without regard to the reacquisition if the property is resold within one year.

b. Section 1038 and the Single Property Partnership

Section 1038 only applies if a sale of real property has given rise to indebtedness to the seller secured by the real property sold.[715] Therefore, if X and Y, who are the only members of XYLLC, whose sole asset is an office building, sell their membership interests to C and D (a common device to avoid transfer and recordation taxes in jurisdictions which only apply such taxes to direct transfers of real estate), §1038 should not apply

[702] Regs. §1.1038-1(a)(4).
[703] *See* Rev. Rul. 68-523.
[704] Regs. §1.1038-1(a)(2).
[705] Regs. §1.1038-1(a)(3).
[706] Regs. §1.1038-1(a)(3)(i).
[707] §1038(a); Regs. §1.1038-1(f)(1).
[708] §1038(d).
[709] §1038(b)(1), (2).
[710] *See* Regs. §1.1038-1(f)(2)(i) (reference to Regs. §1.111-1).
[711] §1038(c). *See also* Regs. §1.1038-2 for the reacquisition and resale of property used as a principal residence.
[712] Since the transferee would not be the seller, §1038 would not apply to the reacquisition.
[713] 855 F.2d 65 (2d Cir. 1988), *aff'g* T.C. Memo 1987-19.
[714] *See* §1038(e). *See also Debough v. Shulman*, 799 F.3d 1210 (8th Cir. 2015) (interaction of §1038 and §121 capital gain exclusion after reacquisition of personal residence on default of installment sale when not resold within one year).
[715] §1038(a)(1).

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to X & Y's reacquisition of the XYLLC real property even if the reacquisition is pursuant to the purchasers' default on purchase money notes issued in exchange for the XYLLC membership interests and secured by XYLLC's real property.[716]

Suppose that instead of selling their membership interest to C and D, X and Y sell the interests to CDLLC (a transaction that causes XYLLC to become a disregarded entity for tax purposes)? Rev. Rul. 99-6 provides that where all of the interests in an entity classified as a partnership are sold to a single buyer (a) the sellers (X and Y) must report gain or loss, if any, resulting from the sale of their partnership interests in accordance with §741[717] and (b) for purposes of classifying the acquisition by the seller (CDLLC), the partnership sold (XYLLC) is deemed to make a liquidating distribution of its assets to the sellers (A and B) and immediately following such distribution, CDLLC is deemed to acquire, by purchase, all of the former partnership's (XYLLC's) assets.[718] Rev. Rul. 99-6 and Regs. §1.741-1(b) only address the tax treatment of the sellers for purposes of §741. Although there is no administrative or judicial authority directly addressing the question, it seems unlikely that X and Y could argue against the form of the transaction and successfully treat the transaction as a terminating distribution of the real estate to X and Y followed by a sale (by X & Y) of the real estate to CDLLC for purposes of §1038.

Section 1038 does not apply unless the seller reacquires the property in partial or full satisfaction of the indebtedness.[719] Suppose that XYLLC sells its real estate to CDLLC in exchange for cash and a purchase money note secured by the real estate and that XYLLC then liquidates by distributing the cash and note to X and Y, *pro rata* in proportion to their interests in XYLLC. If X and Y subsequently acquire the real estate upon a default by CDLLC, does §1038 apply? In Rev. Rul. 86-120, the IRS held that where a corporation liquidating under section 337 (as in effect prior to 1987) sold its real estate and distributed the purchaser's notes (secured by the real estate) to the shareholders,[720] §1038 did not apply to the shareholders' reacquisition of the real estate because the corporation not the shareholders was the seller of the property. In reaching this result, the IRS noted:

> "… a transfer of the real estate from the liquidating corporation directly to the shareholder would be taxable to the shareholder under section 331. Accordingly, permitting nonrecognition treatment under [§]1038 when the shareholder acquires the property indirectly from the corporation's defaulting installment purchaser would put the shareholder in a better tax position than if the property were acquired directly from the corporation. There is no indication that Congress intended such a result."

With certain exceptions which are not relevant here, neither a partnership nor its partners recognize gain or loss when the partnership distributes non-cash assets in liquidation. While the quoted language points out a significant factual difference between a partnership liquidating distribution and the corporate distribution addressed in the ruling, the quoted language was not crucial to the ruling's holding and could be regarded as dictum. Further, the position that the partners are not to be treated as the party selling or exchanging the real estate is consistent with the authorities that require that the replacement property be acquired by the partnership when partnership property is relinquished in a §1031 exchange[721] or suffers a casualty or condemnation described in §1033.[722]

If X and Y reacquire the property and operate it, in the absence of an election to be treated as a corporation their unincorporated ownership and operation of the office building will be classified as a partnership for federal income tax purposes even if they own and operate the building as co-owners under state law.[723] Could this "new" partnership be treated as resulting from a merger of XYLLC into the new partnership with the new partnership being treated as a continuation of XYLLC (and therefore as the original seller)?[724] Is such an argument significantly strengthened if X & Y transfer the note to a new unincorporated state law entity which undertakes the repossession of the property?

Note that it should be possible to avoid all of the forgoing issues by having XYLLC sell the property, retain the note, distribute any amounts collected to X and Y and file a Form 1065, *U.S. Return of Partnership Income*, each year.[725]

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[716] *Cf.*, *Held v. U.S.*, 75-2 USTC ¶ 9678 (N.D. Ala. 1975) (section 1038 did not apply where taxpayers had received note secured by stock of corporation when they sold stock and mortgage on corporation's real property had been substituted as security when purchaser liquidated corporation).

[717] The application of §741 to the sellers is mandated by Regs. §1.741-1(b).

[718] This treatment of the purchaser follows the holding in *McCauslen v. Comr.*, 45 T.C. 588, 592 (1966).

[719] §1038(a)(2).

[720] §453(h) excepted the distribution of such an installment obligation in a §337 liquidation from the general rule that the transfer of an installment obligation causes the gain to recognized.

[721] *E.g.*, *Chase v. Comr.*, 92 T.C. 874 (1989).

[722] *E.g.*, *McManus v. Comr.*, 65 T.C. 197 (1975), *aff'd*, 583 F.2d 443 (9th Cir. 1978), *cert. denied*, 440 U.S. 959 (1979).

[723] *See* §761(a); Regs. §§1.761(a), 301.7701-1(a)(2), -2(a), -3(a), -3(b)(1); *compare* Rev. Proc. 2002-22 (conditions under which IRS will consider request for ruling that undivided fractional interest in rental real property is not interest in business entity, within meaning of Regs. §301.7701-2(a)).

[724] *Compare* Regs. §1.708-1(c)(1) (if two partnerships merge, resulting partnership is continuation of merging partnership in which members of resulting partnership owned 50% or more of interests in capital and profits; if members of resulting partnership owned such interest in both of merged partnerships, resulting partnership is continuation of partnership with contribution of assets having greatest fair market value (net of liabilities)) and Regs. §1.708-1(c)(5) *Ex. 3* (liquidating distribution of partnership assets to partners followed by partners contribution of the assets to another partnership in exchange for partnership interests is treated as a merger). *But cf.*, former §708(b)(1)(B), Regs. §1.708-1(b). Note that, for taxable years beginning after December 31, 2017, the 2017 tax act repealed the rule for technical termination of partnerships so that a partnership is treated as continuing upon a sale or exchange of 50% or more of the total interest in a partnership's capital and profits within a 12-month period, and new elections are not required or permitted. §708(b)(1), amended by Pub. L. No. 115-97, §13504.

[725] *Compare Foxman v. Comr.*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965) (partnership which sold its business but held purchase money notes and later acquired relatively small amount of income producing assets did not terminate).

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VIII. Methods of Claiming the Deduction

A nonbusiness bad debt can be claimed as a deduction only in the year in which it becomes wholly worthless,[726] as distinguished from a business bad debt, which may be claimed as a deduction in a year in which the debt becomes either wholly or partially worthless.[727] The normal method of accounting for bad debts is referred to as the specific charge-off method because it requires the specific identification of the debt which has become worthless (or partially worthless in the case of a business debt). For tax years beginning before 1987, taxpayers could select between two methods of treating business bad debts: (a) the specific charge-off method or (b) the reserve method.[728]

A. *Specific Charge-Off Method*

1. *Wholly Worthless Debts*

a. *General Rule*

The general rule is that a deduction for a wholly worthless debt cannot be taken in a year which is before or after the year in which the debt becomes worthless.[729] It follows from this rule that a bad debt deduction must be supported by a showing that the debt has some value at the beginning of the year. In the absence of such a showing, the IRS may contend that the debt became worthless in a prior year.[730] Accordingly, the taxpayer should be prepared to show that it did not determine that the debt was worthless in some prior year,[731] although the taxpayer's determination, being somewhat subjective, should not be given conclusive weight. In other words, some change in the debtor's condition is necessary in the year of the deduction of a wholly worthless debt.

If the debtor's condition is unchanged during the year, either the debt was worthless before the year began or it continued to have value after the year ended.[732]

If there is no clearly identifiable event showing worthlessness, but rather a gradual drifting by the debtor into a hopeless condition, the creditor will have difficulty demonstrating the year of worthlessness. This is a common problem. In *Young v. Commissioner*,[733] the Second Circuit suggested that a taxpayer should claim a deduction at the earliest possible time so that the disallowance at that time can be countered by a claim in a later year. The statute of limitations for claiming refunds is extended to seven years because of the risks undertaken by a taxpayer in ascertaining the correct year in which to take the deduction.[734]

A taxpayer may not avoid the issue of prior worthlessness by "selling" the debt for a loss at a nominal price during the tax year.[735] If the debt became worthless before the time of sale, §166 preempts the application of §165 and the taxpayer can obtain a bad debt deduction only if the debt did not become worthless in a prior year.

Where a taxpayer is a guarantor, he is not entitled to a bad debt deduction before he makes payment to the original creditor.[736] Thus, a guarantor is entitled to a bad debt deduction for the later of (1) the tax year in which he makes payment to the original creditor or (2) the tax year in which the right to reimbursement from the original debtor (or any other guarantor) becomes worthless.[737]

b. *Compromises and Partial Payments Distinguished*

Because a nonbusiness bad debt cannot be deducted under the partial charge-off method, it often becomes necessary to determine whether a debt is wholly or partially worthless.

> *Example 1:* C lends D $10,000 in Year 1, in a transaction not connected with any business of C so that a partial charge-off cannot be taken. In Year 3, it becomes apparent that D has property worth only $4,000. Because the debt is a nonbusiness debt, C cannot deduct $6,000 in Year 3. In Year 4, C induces D (by legal action or otherwise) to part with the entire $4,000. The basis of C's debt is $6,000, and a deduction in that amount is available only when the debt is wholly worthless. The issue becomes more complicated where there is a voluntary compromise of a debt.

As discussed in III.B.3., above, §1271(a) (which treats the retirement of a certain debt instruments as a sale or exchange) now applies to substantially all debt instruments. (The principal exceptions are certain noncorporate obligations issued before July 2, 1982, and individual obligations issued before (and not purchased after) June 9, 1997.) If the parties significantly modify the terms of a debt instrument within the meaning of Reg. §1.1001-3, the original debt instrument is deemed to have been delivered to the issuer (i.e., retired) in exchange for a new (i.e., the modified) debt instrument.[738] See III.B.3.c., above, for a discussion of when a modified debt differs materially from the original debt.

Assuming the creditor holds the debt instrument for profit (e.g., to receive the interest income), the deemed sale or exchange on retirement of the debt instrument in which the creditor receives proceeds which are less than her basis in the debt instrument should result in a capital loss to the holder. This is

[726] Reg. §1.166-5(a).

[727] Reg. §1.166-3(a).

[728] Reg. §1.166-1(a), §1.166-1(b). Certain financial institutions are allowed to continue to use the reserve method. See the discussion at VIII.B.4.b., below.

[729] *Denver & Rio Grande W. R.R. v. Commissioner*, 32 T.C. 43 (1959), *acq.*, 1959-2 C.B. 4, *aff'd*, 279 F.2d 368 (10th Cir. 1960). This rule is derived from the language of the statute itself, which allows a deduction for "any debt which becomes worthless within the year." §166(a)(1). Identical language may be found in §23(k) of the 1939 Code (the predecessor to §166). The rule was seemingly designed to match the timing of the economic loss with the corresponding tax benefit. It has the effect of prohibiting the (subjective) selection of the timing of a deduction among tax years. *See also Bunch v. Commissioner*, T.C. Memo 2014-177 (taxpayer's nonbusiness loan not wholly worthless in tax year deducted because there was no definitive amount of the loss until the bankruptcy proceeding concluded which was after T deducted the bad debt).

[730] See VI.A., above.

[731] *Reading Co. v. Commissioner*, 132 F.2d 306 (3d Cir. 1942).

[732] *Keller v. Commissioner*, T.C. Memo 1970-79; *Pope v. Commissioner*, T.C. Memo 1962-279.

[733] 123 F.2d 597 (2d Cir. 1941).

[734] §6511(d)(1). See VIII.C., below.

[735] *See James Petroleum Corp. v. Commissioner*, 24 T.C. 509 (1955), *acq.*, 1956-1 C.B. 4, *aff'd*, 238 F.2d 678 (2d Cir. 1956) (worthless oil royalties).

[736] *Black Gold Energy Corp. v. Commissioner*, 99 T.C. 482 (1992), *aff'd*, 33 F.3d 62 (10th Cir. 1994) (accrual basis taxpayer). The delivery of the taxpayer's note to the original creditor does not constitute payment for this purpose. *Perry v. Commissioner*, 49 T.C. 508 (1968).

[737] *Black Gold Energy Corp. v. Commissioner*, 99 T.C. 482 (1992), *aff'd*, 33 F.3d 62 (10th Cir. 1994); *Sullivan v. Commissioner*, T.C. Memo 1968-111.

[738] Reg. §1.1001-1(a), §1.1001-3(b).

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true even the debt was a nonbusiness debt, the retirement occurs as a result of a modification of a debt instrument and the creditor continues to hold the modified debt instrument and the modified debt instrument is not wholly worthless (or even partly worthless). For purpose of determining the loss on the retirement, the modified debt instrument will generally be treated as having a value equal to its "issue price."[739]

The dark cloud in this silver lining is that if the creditor is not holding the debt instrument for profit, the loss is nondeductible and her basis in the modified note has been reduced. Given the broad application of §1271(a) and Reg. §1.1001-3's definition of a significant modification, very few compromises of a debt will fail to qualify as a retirement of the debt. However, it is possible.

> *Example 2:* Assume the same facts as in *Example 1* except that the debt is an unsecured account receivable and in Year 3, C and D agree that in consideration of D's actual payment of $4,000, C forgives the other $6,000.

Under the facts of *Example 2*, C may claim that the closing of the transaction eliminates the debt, and (since no debt exists) the loss provisions of §§165(a) and 165(c)(2) (ordinary loss treatment) apply and §166(d) does not apply.[740] The rationale for this position is that worthlessness cannot be established on a debt which does not exist.[741] The IRS, on the other hand, will argue that the compromise settlement has no greater effect than a partial payment (as in *Example 1*), and the compromise alone is not sufficient to establish the worthlessness of the $6,000. The rationale for the IRS's likely position is that the statutory prerequisite to a deduction is worthlessness, which is an independent inquiry regardless of the existence of a release.[742] The weight of authority supports the latter view.[743]

If the compromise involves an agreement with a debtor who is otherwise able to pay the debt, the amount of the debt forgiven is not deductible as a bad debt.[744] The above analysis should also be distinguished from compromises involving the issue of whether §165(a) (ordinary loss) or §165(f) (sale or exchange) applies.[745]

If, instead of reaching a compromise based on a partial payment, the parties enter into a new but scaled down agreement, it can be persuasively argued that a nonbusiness bad debt deduction should not be taken until the entire amount of the original debt becomes worthless.[746] The basis for this result is clear enough in the cases where (under the applicable law of contracts) the debtor has not given consideration so as to constitute a true novation of the original debt. The fact of the novation should not alter the result under §166 because the debt's basis is unaffected and the worthlessness of the debt remains a factual issue. At the same time, where the novation was induced by factors relating to the debtor's ability to pay, the loss provision would not apply because the debtor-creditor relationship persists.

The nonrecognition provisions of §351 (and perhaps §354) can supersede the finding of a retirement or of a compromise and preclude a loss deduction. In *IDI Mgmt., Inc. v. Commissioner*,[747] the taxpayer claimed a deduction for partial worthlessness of a debt based on the difference between the taxpayer's basis in certain accounts receivable and the value for the stock received in satisfaction thereof. The government had not specifically argued that §351 applied, but had contended that the accounts receivable were securities making the transaction a recapitalization within the meaning of §368(a)(1)(E). The Tax Court, passing over the issue of whether the accounts receivable were securities, held that the accounts receivable, which had been accrued in income by the taxpayer, were property within the meaning of §351, that §351 applied, and that no loss was recognized on the transfer with the taxpayer carrying over its adjusted basis in the accounts receivable to the stock received pursuant to §358.

2. Partial Charge-Off of Specific Business Bad Debts

a. General Rule for Partial Charge-Offs

Section 166 provides that any debt held by a corporation, or any business debt held by a taxpayer other than a corporation, need not be wholly worthless in order to be deductible.[748] If it can be determined that only part of the particular debt is recoverable, the worthless portion may be deducted in the year in which it is "charged off" by the taxpayer.[749] The election to claim the deduction based on partial worthlessness applies only to those debts and those tax years for which the treatment is claimed.

b. What Constitutes a "Charge-Off"?

Section 166(a)(2) allows a deduction for partial worthlessness to the extent that the debt is "charged off" within the tax year. This requirement, in essence, amounts to a partial book-tax conformity rule that prevents a taxpayer from taking a tax loss while continuing to carry the debt on his books.[750] Thus, the taxpayer must produce evidence that he regarded the debt as uncollectible in part, i.e., by eliminating the worthless portion of the debt from his books as an asset.[751] Crediting accounts

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[739] Reg. §1.1001-1(f).

[740] *Thorman v. Commissioner*, 8 T.C.M. 653 (1949); *Bowles Lunch, Inc. v. United States*, 33 F. Supp. 235 (Ct. Cl. 1940). In *West Coast Sec. Co. v. Commissioner*, 14 T.C. 947 (1950), *acq.*, 1950-2 C.B. 4, a loss deduction was allowed, but there the compromise was not motivated to any significant extent by the debtor's inability to pay. *Accord Lab Est., Inc. v. Commissioner*, 13 T.C. 811 (1949), *acq.*, 1950-1 C.B. 3. *Cf. Noll's Food Co. v. Commissioner*, T.C. Memo 1964-69 (compromise of debt was a contribution to subsidiary-debtor).

[741] *Henry v. United States*, 180 F. Supp. 597 (Ct. Cl. 1960).

[742] *Henry v. United States*, 180 F. Supp. 597 (Ct. Cl. 1960).

[743] *Raffold Process Corp. v. Commissioner*, 153 F.2d 168 (1st Cir. 1946); *Bingham v. Commissioner*, 105 F.2d 971 (2d Cir. 1939); *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936); *Haskel v. Commissioner*, T.C. Memo 1980-243. *See D'Alonzo v. Commissioner*, 10 T.C.M. 817 (1951); *Bohn v. Commissioner*, 43 B.T.A. 953 (1941), *acq.*, 1942-1 C.B. 2, *nonacq.*, 1941-1 C.B. 2, 13 *withdrawn*; *Kessel v. Commissioner*, T.C. Memo 1970-266.

[744] *See, e.g.*, *Fink v. Commissioner*, 29 T.C. 1119 (1958); *Kessel v. Commissioner*, T.C. Memo 1970-266.

[745] *See, e.g.*, *Vickers v. Commissioner*, 80 T.C. 394 (1983); *Yates Holding Corp. v. Commissioner*, T.C. Memo 1979-416.

[746] *Black v. Commissioner*, 52 T.C. 147 (1969); *Smith v. Commissioner*, 12 T.C.M. 131 (1953).

[747] T.C. Memo 1977-369.

[748] §166(a)(2), §166(d).

[749] Reg. §1.166-3(a)(2).

[750] *See Commissioner v. MacDonald Eng'g Co.*, 102 F.2d 942 (7th Cir. 1939).

[751] *Findley v. Commissioner*, 25 T.C. 311 (1955), *aff'd per curiam*, 236 F.2d 959 (3d Cir. 1956). *See, e.g.*, PLR 9338044 (foreign bank allowed bad

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receivable with the worthless amount is a proper charge-off.[752] However, simply increasing a general reserve account that represents bad debts does not constitute a charge-off.[753] For example, in FAA 20153501F, the taxpayer created a general reserve or provision in its books for anticipated future losses regarding certain real estate loans it issued. The taxpayer reported partial bad debt deductions reflecting the provision amounts listed in its books. The Chief Counsel's Office rejected the deductions because the taxpayer's books evidenced neither sustained losses nor that the amounts claimed as partial bad debts were abandoned, which are required for any §166(a)(2) charge-off.

A charge-off of the debt does not require debtor notification or complete elimination of the debt from the books as long as it does not appear as an asset.[754] In addition, the debt does not need to be cancelled or released.[755] The charge-off requirement is satisfied if the physical entries have been made in the tax year or, under certain conditions, before the tax year.[756] The physical charge-off entries may be made following the close of the tax year when the taxpayer's accountants are closing his books for the year.[757] However, the charge-off should be made before the income tax return is filed.[758]

If the tax basis exceeds book value, the excess is generally not deductible until the debt becomes totally worthless. The discussion above points out that the restructuring of a debt may be treated as an exchange of the old debt for the new (restructured) debt under regulations relating to the tax consequences of the modification of debt instruments.[759] In that case, the creditor may recognize gain, which is added to his tax basis in debt partially charged off in a prior year. However, regulatory and general accounting principles do not permit a corresponding increase in the book value of the debt, hence there is no opportunity for the taxpayer to take a new charge-off for pre-existing worthlessness.

Regulations provide relief if the significant modification of a debt instrument[760] during a tax year results in recognition of gain by a taxpayer,[761] by providing for a deemed charge-off of a portion of the indebtedness during the tax year (and thus allowing a tax deduction) if two conditions are met. The conditions are: (1) the taxpayer (or, in the case of transferred basis property, a transferor taxpayer) has claimed a deduction for partial worthlessness of the debt in a prior tax year and (2) each prior year charge-off and deduction for partial worthlessness satisfied the requirements of Reg. §1.166-3(a)(1) and (2).[762]

The amount of the deemed charge-off, if any, is the amount by which the tax basis of the debt exceeds the greater of (i) the fair market value of the debt or (ii) the amount of the debt recorded in the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses.[763] However, the amount of the charge-off may not exceed the gain recognized[764] as a result of the significant modification.[765]

c. *Timing of the Deduction*

The law requires only that the deducted worthless portion of the debt be charged off in the tax year.[766] It does not require that the portion charged off become worthless during that year. Therefore, there is some opportunity (subject to any limitations imposed by the financial accounting rules) to select the year in which to claim a deduction of this type. In addition, it is possible to wait until the year in which the debt becomes wholly worthless, at which time a deduction may be taken for a worthless debt in full.[767]

> *Example:* In Year 1, the taxpayer owned a business debt of $5,000 payable in Year 3 and partially secured by collateral unlikely to appreciate (e.g., short-term corporate debt trading at par) and worth only $1,000. Assume further that in Year 1 the debtor became hopelessly insolvent, he remained hopelessly insolvent at all times through Year 3, and during Year 3, the collateral was sold for $800 to partially satisfy the indebtedness. The taxpayer has several options: (1) at the taxpayer's election, he could have charged off the $4,000 on his books in Year 1 and deducted $4,000 on his Year 1 return as a partially worthless debt; (2) if the taxpayer's income situation were such that a deduction in Year 1 was not advantageous, he could, subject to any applicable financial accounting rules, have waited until Year 2 to charge off and deduct the $4,000; (3) alternatively, he could have charged off $2,000 in Year 1 and Year 2 respectively, in which case, he could claim a $2,000 deduction in one or both years or forgo the deduction in both years. Assuming that a $4,000 deduction was claimed before Year 3, an additional $200 can be deducted in his Year 3 return; (4) if no deduction is claimed in Year 1 or Year 2, the entire bad debt may deducted in Year 3 to the extent of $4,200, (if $2,000 was charged off in each of Year 1 and Year 2, but the deduction was claimed only in one of the two years, the Year 3 deduction would be $2,200).

The taxpayer must be able to demonstrate to the IRS's satisfaction that (i) the debt has become worthless to the extent of

debt deduction because physical removal of portion of its bad debt from its books through charge-off indicated abandonment).

[752] *Houghton & Dutton Co. v. Commissioner*, 26 B.T.A. 52 (1932).

[753] *See Int'l Proprietaries, Inc. v. Commissioner*, 18 T.C. 133 (1952); FAA 20153501F (charge-off required sustained loss, not anticipated future loss). *Cf. Brandtjen & Kluge, Inc. v. Commissioner*, 34 T.C. 416 (1960) (although account labeled "reserve," accompanying book entries clearly described actual losses versus anticipated losses).

[754] *See Hammerschmidt & Franzen Co. v. Commissioner*, 12 B.T.A. 811 (1928), *acq.*, VIII-1 C.B. 19; *O.S. Stapley Co. v. Commissioner*, 13 B.T.A. 557 (1928), *acq.*, VIII-1 C.B. 43; FAA 20123002F (removal of partially worthless portion of loans from general bad debt reserve to specific valuation allowance account qualified as charge-off).

[755] *See, e.g.*, *O.S. Stapley Co., Inc. v. Commissioner*, 13 B.T.A. 557 (1928). *See also* TAM 9253003 (corporation allowed bad debt deduction under §166 for participation loan it had charged off as partially worthless, even though it later exchanged debt for stock and other debt in workout agreement).

[756] Reg. §1.166-3(a)(2)(ii).

[757] *See Hamlen v. Welch*, 116 F.2d 413, 419 (1st Cir. 1940).

[758] *See Rio Grande Bldg. & Loan Ass'n v. Commissioner*, 36 T.C. 657, 664 (1961), *acq.*, 1962-1 C.B. 4.

[759] Reg. §1.1001-3.

[760] Within the meaning of Reg. §1.1001-3.

[761] Under Reg. §1.1001-1(a).

[762] Reg. §1.166-3(a)(3).

[763] Reg. §1.166-3(a)(3)(iii).

[764] Under Reg. §1.1001-1(a).

[765] Reg. §1.166-3(a)(3)(iii).

[766] §166(a)(2); Reg. §1.166-3(a)(2)(ii).

[767] *Meinig Co. v. Commissioner*, 9 T.C. 976, *acq.*, 1948-1 C.B. 2; *Findley v. Commissioner*, 25 T.C. 311, 318 (1955).

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the claimed deduction and (ii) the worthless portion of the debt has been charged off.[768] When challenged, the taxpayer has a heavier burden in establishing partial worthlessness than when establishing total worthlessness.[769] This heavier burden stems from the congressional grant of power in §166(a)(2) whereby the "Secretary may allow" a deduction for a partially worthless debt. As a result of this congressionally delegated power, the IRS's determination of partial worthlessness is not disturbed by the courts unless it is plainly arbitrary or unreasonable.[770] Note, however, that the IRS cannot deny the deduction where the facts clearly show the extent of partial worthlessness.[771] In LB&I-4-0712-009, the Commissioner, Large Business & International Division (LB&I), directed that LB&I examiners should not challenge an insurance company's partial worthlessness deduction under §166(a)(2) for the amount of the Statement of Statutory Accounting Principle (SSAP) 43R credit-related impairment charge-offs of eligible securities as reported on its Annual Statement.

Where a creditor, for reasons satisfactory to it, releases a debtor who is arguably able to pay, the creditor is not entitled to a bad debt deduction.[772] Similarly, if a creditor, for reasons satisfactory to it, takes actions which render the debtor unable to pay, a bad debt deduction is not allowed.[773]

In satisfying his burden of proof, the taxpayer may show that, considering all the facts and circumstances, a part of the debt is not recoverable.[774] The "sound business judgment" of the taxpayer is very persuasive in establishing partial worthlessness (presuming adequacy of evidence), and the IRS may not ignore this judgment in disallowing a deduction for partial worthlessness without risking an abuse of discretion.[775] In claiming a deduction for partial worthlessness, the amount of the partial worthlessness must be established with "reasonable certainty."[776] Where the uncollectible amount cannot be determined, a deduction is not allowed, even though the debt is considered partially worthless.[777] While subsequent events may be relevant to support the taxpayer's initial determination, the ultimate proof of worthlessness depends upon the facts and circumstances as they existed at the time the debt was claimed to have become worthless.[778]

If a deduction for partial worthlessness is claimed and is later disallowed (in whole or in part) on the grounds that sufficient partial worthlessness had not occurred before the end of the tax year in which the charge-off was made, the deduction may be claimed in the subsequent tax year in which the partial worthlessness does occur.[779]

B. *Reserve Method (Repealed)*

1. *Repeal of the Reserve Method*

The 1986 TRA repealed the reserve method of accounting for bad debts for tax years beginning after December 31, 1986.[780] All taxpayers (except certain financial institutions, see discussion at VIII.B.4.b., below) must use the specific charge-off method of accounting for bad debts for tax years beginning on or after January 1, 1987. However, as described in VIII.B.4.c., below, §448(d), enacted as part of the 1986 TRA, and significantly amended in 2002, allows certain service providers an exclusion from gross income which is economically similar to a deduction for an addition to a bad debt reserve.

2. *Description of the Reserve Method*

Most businesses which extend credit know that they will not collect 100% of what is owed them. Further, most such businesses can make a reasonably accurate prediction as to the percentage of their receivables which will go uncollected. By delaying the deduction for uncollected receivables until specific receivables can be identified as worthless (or partially worthless), the specific charge-off method arguably overstates income in the year the sale is made or the service provided (and the receivable is created) and understates income in the year the receivable is identified as a bad debt.

> *Example:* Assume that at year end an accrual-basis taxpayer has $100,000 of outstanding accounts receivable from sales generated during the year. Based on experience, the taxpayer can be reasonably certain that it will collect only $98,000 of the year-end receivable balance; however, the taxpayer cannot identify the specific accounts which will become uncollectible. Under the specific charge-off method, the taxpayer will report sale proceeds of $100,000 in the year of sale and, assuming that the uncollectible accounts become worthless in the following year, will have a $2,000 deduction in Year 2. It is arguable that reporting $98,000 of income in Year 1 and no deduction in Year 2

[768] Reg. §1.166-3(a)(2)(iii); *International Properties, Inc. v. Commissioner*, 18 T.C. 133 (1952).

[769] *Findley v. Commissioner*, 25 T.C. 311, 318 (1955), *aff'd per curiam*, 236 F.2d 959 (3d Cir. 1956).

[770] *Bullock v. Commissioner*, 26 T.C. 276 (1956), *aff'd per curiam*, 253 F.2d 715 (2d Cir. 1958). *See also PepsiAmericas, Inc. v. United States*, 52 Fed. Cl. 41 (2002).

[771] *See Portland Mfg. Co. v. Commissioner*, 56 T.C. 58 (1971), *aff'd*, 75-1 USTC ¶9449 (9th Cir. 1975).

[772] *Am. Felt Co. v. Burnet*, 58 F.2d 530 (DC Cir. 1932). See also the discussion of compromises in VIII.A.1.b., above.

[773] *See PepsiAmericas, Inc. v. United States*, 52 Fed. Cl. 41 (2002). (debtor ESOP rendered insolvent by creditor employer's decision to terminate plan (and thus terminate creditor employer's obligation to make future contributions which were to be major source of funding for repayment of debt)). *Cf. ABC Beverage Corp. vs. Commissioner*, T.C. Memo 2006-195 (taxpayer was successor in interest to creditor which had loaned money to debtor corporation (wholly owned by creditor's management) to purchase assets that debtor leased to creditor for use in creditor's business; creditor's management's minority ownership of creditor was not sufficient to cause creditor and debtor to be commonly controlled; before taxpayer's acquisition of creditor, creditor had reduced its rental payments to debtor to amount equal to interest on loan rendering debtor unable to make principal payments; Tax Court distinguished *PepsiAmericas* and allowed bad debt deduction on the grounds that in *ABC Beverage Corp.*, creditor and debtor were not under control, and although decision to pay less rent than lease required was factor in causing debt to become worthless, there were other contributing factors).

[774] *The Austin Co., Inc. v. Commissioner*, 71 T.C. 955 (1979).

[775] *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 73 (1971), *aff'd*, 75-1 USTC ¶9449 (9th Cir. 1975).

[776] *Production Steel, Inc. v. Commissioner*, T.C. Memo 1979-361.

[777] *Id.*; *First Nat'l Bank of Los Angeles v. Commissioner*, 6 B.T.A. 850 (1927), *acq.*, VI-2 C.B. 24.

[778] *George E. Warren Corp. v. United States*, 141 F. Supp. 935 (Ct. Cl. 1956) (partial worthlessness is to be determined from all facts and not merely those submitted to IRS before trial).

[779] Reg. §1.166-3(a)(2)(ii).

[780] Pub. L. No. 99-514, §805(a).

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would be a more accurate reflection of the taxpayer's income for each of the two years.

The reserve method effectively allowed the taxpayer a deduction for an estimate of the uncollectible portion of business receivables on hand at a particular date (to the extent not previously deducted). The reserve method was applied not only to trade accounts but also to loans, notes, and other evidences of business indebtedness (except securities within the meaning of former §165(g)(2)).

Before its 1986 repeal, §166(c) provided:

> (c) Reserve for bad debts. — In lieu of any deductions under subsection (a) [the deduction for the specific charge off of a worthless or partially worthless debt], there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

A reasonable addition to the reserve was the amount necessary to bring the reserve balance up to the level that could be expected to cover losses properly anticipated on debts outstanding at the end of the tax year.[781] Accordingly, in order to calculate the reasonable addition, it was necessary to determine (i) the appropriate year-end level of the reserve account and (ii) the year-end balance of the reserve account before the reasonable addition.

The year-end balance of the reserve account before the reasonable addition was the reserve account balance at the beginning of the year reduced by the actual charge-off of bad debts during the year and increased by any recoveries of bad debts previously charged off.

> *Example:* The reserve balance on Jan. 1, 1985, was $110,000. Charge-offs during 1985 amounted to $107,000 and recoveries during the same period amounted to $5,000. Net charge-offs were, therefore, $102,000. The reserve balance on Dec. 31, 1985, before the addition to the reserve would have been $8,000. Assuming a reasonable reserve balance at Dec. 31, 1985, was determined to be $109,000. The reasonable addition to the reserve for 1985 would have been $101,000 ($109,000 – $8,000).

The deduction for the reasonable addition to a reserve for bad debts was allowed "in the discretion of the Secretary." Therefore, if the IRS challenged the claimed deduction, the taxpayer had the very heavy burden of establishing that the IRS abused its discretion.[782] Thus, the taxpayer generally had to prove not only that the addition to the reserve was reasonable, but also that the Commissioner's determination was "unreasonable and arbitrary."[783]

As indicated above, the first step in determining a reasonable addition to the reserve was to determine a reasonable year-end balance for the reserve.

In 1940, the Tax Court decided *Black Motor Co. v. Commissioner*,[784] in which a six-year moving average formula was used by the IRS and accepted by the Court. Because of (i) the IRS's general acceptance of this formula, referred to as the *Black Motor* bad-debt formula, and its application of it even if the taxpayer hadn't, (ii) the heavy burden a taxpayer faced in overturning an IRS challenge to an addition to the bad debt reserve, and (iii) taxpayers' desire for certainty, the *Black Motor* bad-debt formula enjoyed near universal acceptance.[785]

Under *Black Motor*, an experience factor was first computed by dividing the accounts receivable for the six most recent years (including the current year) by the amounts actually charged-off, net of recoveries, during the same six-year period. The experience factor was then multiplied by the total balance of receivables outstanding at the end of the current year to determine the reasonable year-end balance for the reserve.

The *Black Motor* formula was criticized for its retrospectivity.[786] A taxpayer who had delayed making charge-offs in the past or whose receivables just began to deteriorate was penalized, because the current addition was computed by reference to past charge-off experience. The courts and the IRS have recognized that there are cases where the formula could lead to an arbitrary result and should be applied in a modified manner.[787]

By allowing a reserve balance equal to the product of the year-end receivables balance multiplied by the average annual write-off percentage, the *Black Motor* formula effectively allowed a reserve for the portion of the receivables expected to be charged off during the following year. In most cases, receivables are expected to be collected over a period of less than a year, if ever, and will probably be written off within a year if they have not been collected. However, certain types of receivables are to be paid over a period of years.

In *Beneficial Corp. v. United States*,[788] many of the loans made by the taxpayer, a finance company, were payable over a period of years. In determining the appropriate year-end balance for its reserve, Beneficial took into account the portion of the loans that could reasonably be expected to not be eventually repaid. The IRS found that the taxpayer's reserve level reflected an amount exceeding those bad debts reasonably expected to be written off in the following year. It then applied the *Black Motor* formula, which resulted in a denial of the deduction for the excess. The taxpayer argued that the "next-year only" focus was inconsistent with the concept of a reserve. The Federal Circuit held that a reserve may include a provision for outstanding debts expected to become worthless beyond the next succeeding tax year.

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[781] *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 546 (1979).

[782] *See Roth Steel Tube Co. v. Commissioner*, 620 F.2d 1176 (6th Cir. 1980); *Atl. Disc. Co. v. United States*, 473 F.2d 412, 414 (5th Cir. 1973); *Maverick-Clarke Litho Co. v. Commissioner*, 180 F.2d 587 (5th Cir. 1950).

[783] *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 548 (1979). *See also Edison Homes, Inc. v. Commissioner*, T.C. Memo 1988-441, *aff'd*, 903 F.2d 579 (8th Cir. 1990) (principles enunciated in *Thor Power Tool* regarding taxpayer's burden of proof under pre-1986 TRA §166(c) applied in the context of pre-1986 TRA §166(f)).

[784] 41 B.T.A. 300 (1940), *acq.*, 1940-1 C.B. 1, *aff'd on other issues*, 125 F.2d 977 (6th Cir. 1942).

[785] In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the Supreme Court applied the *Black Motor* formula and noted that the formula had been employed consistently by the courts and by the IRS and had been collaterally recognized by Congress. 439 U.S. 522, 548, fns. 28, 29, and 30.

[786] *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 548 (1979). *See also Valmont Ind., Inc. v. Commissioner*, 73 T.C. 1059 (1980).

[787] Rev. Rul. 76-363; *Westchester Dev. Co. v. Commissioner*, 63 T.C. 198, *acq.*, 1975-2 C.B. 2.

[788] 814 F.2d 1570 (Fed. Cir. 1987), *rev'g* 9 Cl. Ct. 119 (1985).

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In general, the bad-debt-reserve method did not apply to losses which might be suffered as a result of a party defaulting on an obligation the taxpayer had guaranteed. However, from 1966 through 1986, a deduction could be taken by a "dealer" for additions to a reserve for bad debts arising out of the taxpayer's liability as guarantor, endorser, or indemnitor of debt obligations attributable to the sale of property in the ordinary course of business provided conditions specified in the Code were complied with.[789] The provisions allowing for such a deduction were repealed by §805(b) of the 1986 TRA for tax years beginning after 1986.

For this purpose, the regulations (proposed in 1980 and adopted in January 1986) define a dealer as one who regularly sells property in the ordinary course of a trade or business.[790] A guaranteed debt obligation of the type covered by this former Code provision typically arose where a taxpayer (seller of goods) received a debt obligation of the purchaser in exchange for property or services and sold the debt obligation to a third party with recourse. However, a direct debtor-creditor relationship between the debtor/purchaser and the seller was not necessary.[791] Thus, where a purchaser borrowed money from a third party to make payment to the seller and the seller guaranteed the purchaser's obligation, the former Code provision applied.

3. Changing from the Reserve Method

A taxpayer that continues (or initiates) the use of the reserve method of accounting for bad debts, in a tax year beginning after 1986, is using an improper method of accounting. The IRS has granted automatic consent to taxpayers to change from the §585 reserve method to the §166 specific charge-off method.[792] If the taxpayer does not file a request to change the method of accounting, the absence of IRS consent is not grounds for preventing the imposition, or diminishing the amount, of penalties or other additions to tax related to the improper method of accounting.[793]

If a change from the taxpayer's improper method of accounting to a proper one is initiated by the IRS, the §481 amount is taken into income in the year of change, but, assuming the method has been used for at least three tax years, the increase in the taxpayer's tax liability for the year of change cannot exceed the additional tax liability the taxpayer would have incurred had one-third of the §481 amount been taken into income in the year of change and one-third of the amount included in income in each of the two preceding years.[794] Rules for changes in accounting methods initiated by the taxpayer are prescribed in Rev. Proc. 2015-13.

Under §805(d)(2) of the 1986 TRA, any taxpayer that maintained a reserve for bad debts for the taxpayer's last tax year beginning before 1987, and was required by the 1986 TRA to change the method of accounting for bad debts was treated as having initiated the change of accounting method, and the change was treated as having been made with the consent of the Secretary of the Treasury. The §481 adjustments required as a result of this change were to be taken into account ratably in each of the first four tax years beginning after 1986. The amount to be included in income is the full balance of the reserve account, without offset for any anticipated amounts that are not currently accrued as income under the rules of §448(d)(5).[795] The Conference Report states that the conferees intended that net operating loss and tax credit carryforwards are allowed to offset any positive §481 adjustment and, for purposes of determining estimated tax payments, the §481 adjustment is recognized in taxable income ratably throughout the year.[796]

4. What's Left of the Reserve Method

a. In General

Section 805 of the 1986 TRA repealed §166(c) (relating to reserve for bad debts), effective for tax years beginning after 1986. Since deductions are a matter of legislative grace and are allowed only if specifically provided for by Congress,[797] for tax years beginning after 1986, the only permissible deductions from (or reductions of) gross income by accrual basis tax payers for receivables that have not become worthless are those permitted by (i) §585, relating to reserves for losses of certain financial institutions (discussed at VIII.B.4.b., below), and (ii) §448(d)(5), relating to an exclusion for certain service providers (discussed at VIII.B.4.c., below).

b. Financial Institutions

Thrifts[798] and banks,[799] other than large commercial banks,[800] were exempted from the 1986 TRA's repeal of the reserve method and may use either the specific charge-off method or the reserve method to compute their bad debt deduction.

For tax years beginning after 1987, a bank's addition to the reserve (i.e., its deduction) is limited to the amount computed using the experience method described in §585(b)(2), which generally limits the reserve to a portion of the bank's year-end loan balance multiplied by its actual bad debts over a six-year (or shorter) period and divided by the sum of its year-end loan balances during that period.[801]

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[789] §166(g) as in effect from 1966 to 1976, §166(f) as in effect from 1976 to 1986.

[790] Reg. §1.166-10(a)(1).

[791] Reg. §1.166-10(a)(2).

[792] *See* Rev. Proc. 2025-23, §4.01 (change from reserve method or other improper method to §166 specific charge-off method for taxpayers other than banks), §25.01 (change from §585 reserve method to §166 specific charge-off method for banks); Rev. Proc. 2015-13.

[793] §446(f).

[794] *See* Reg. §1.481-1(c)(2), §1.481-1(c)(3), §1.481-1(c)(4), §1.481-2. The IRS may prescribe when the adjustments are taken into account. *See* Reg. §1.446-1(e)(3), §1.481-4. For a discussion of these rules and other changes in methods of accounting, see 572 T.M., *Accounting Methods — Adoption and Changes*.

[795] See VIII.B.4.c., below.

[796] H.R. Rep. No. 99-841, at II-316 (1986) (Conf. Rep.).

[797] *See Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943).

[798] Institutions described in §593(a). To wit: (i) domestic building and loan associations, (ii) mutual savings banks, and (iii) nonstock nonprofit cooperative banks organized for mutual purposes.

[799] Institutions defined in §581, other than thrift institutions described in §593(a).

[800] Defined in §585(c)(2); generally, assets in excess of $500,000,000.

[801] §585(b). A greater amount may be allowed if, as of the end of the last tax year preceding the bank's change to the experience method, its reserve balance was greater than the amount computed under the experience method. For tax years before 1988, §585(b) permitted banks to determine their addition to the reserve using either the experience method or a statutorily prescribed per-

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In *AmBase Corp. v. United States*,[802] plaintiff bank acquired a large savings and loan association in 1989, which was subsequently seized by the Office of Thrift Supervision (OTS) on December 4, 1992. In 2000, plaintiff sought to retroactively increase its bad debt reserves for 1992 to create a net operating loss that plaintiff wanted to carry back to 1989 (note that the maximum bad debt reserve addition as calculated in plaintiff's amended 2000 claim was substantially greater than the calculation reflected in plaintiff's original 1992 return). The U.S. District Court for the District of Connecticut, relying on Rev. Rul. 70-5,[803] held that plaintiff was allowed to retroactively increase its addition to its reserve for losses in an amount necessary to offset any net increase in taxable income, as redetermined, as a result of a subsequent adjustment. Furthermore, the court explicitly rejected plaintff's motion for entitlement to increase its bad debt deduction to the amended 2000 maximum computation.

On appeal, the Second Circuit affirmed the district court's holding that AmBase could claim a deduction to the extent it offset post-seizure income for the 1992 tax year. The court further held, however, that AmBase was entitled to its claimed deduction to the extent that it derived from post-seizure bad debts for the 1992 tax year.[804]

For post-1995 years, Thrifts are treated the same as banks. Thus, Thrifts that are "Large Banks" must use the specific charge-off method and other Thrifts may use either the specific charge-off method or the experience-based reserve method allowed to banks.

For tax years beginning before 1996, a Thrift that used the reserve method could, subject to certain limitations,[805] determine the appropriate addition to the reserve for its qualifying real property loans[806] based on actual experience or by multiplying its taxable income (as modified by §593(b)(2)(D)) by a specified percentage.[807] This §593 (i.e., percentage of taxable income) reserve method of accounting for bad debts by thrift institutions was repealed effective for tax years beginning after 1995.[808]

centage of the year-end loan balance. (For years after 1982, the percentage was 0.6%.)

[802] 834 F. Supp. 2d 71 (D. Conn. 2011).

[803] In Rev. Rul. 70-5, the IRS concluded, pursuant to the provisions of then-applicable Reg. §1.593-5(b)(2) and §1.593-6(a), that the taxpayer may increase its addition to its reserve for losses on qualifying real property loans in an amount sufficient to offset taxable income as redetermined by the subsequent adjustment.

[804] *AmBase Corp. v. United States*, 731 F.3d 109 (2d Cir. 2013).

[805] §593(b)(1)(B)(ii). *See also* TAM 9122001 (building and loan association's §166 debt deduction may be allowed to extent it can establish debt's worthlessness to satisfaction of district director, based on all pertinent evidence).

[806] See §593(d)(1) for a definition of "qualifying real property loans."

[807] §593(b)(1)(B), §593(b)(2). For years after 1986, the percentage was 8%.

[808] §593(f). This change in law also eliminated (subject to some transitional rules) the use of the following provisions which were available only to thrift institutions to which §593 applied: (1) the denial of a portion of certain tax credits to a thrift institution under §50(d)(1); (2) special rules under former §595 with respect to the foreclosure of property securing loans of a thrift institution, (3) the reduction in the dividends received deduction of a thrift institution under former §596, and (4) the ability of a thrift institution to use a net operating loss to offset its income from a residual interest in a REMIC under former §860E(a)(2). Provisions (1) and (3) are effective for tax years beginning after 1995. Provision (2) applies to property acquired in tax years beginning after 1995. Provision (4) applies to any residual interest held by a taxpayer if such interest has been held by such taxpayer at all times after Oct. 31, 1995.

c. *Certain Accrual Method Service Providers*

As enacted in 1986, §448(d)(5) allowed accrual method service providers an exclusion from income which was the economic equivalent of a bad debt reserve for their non-interest-bearing receivables. Specifically, an accrual-method service provider was not required to accrue any portion of amounts receivable for the performance of services which, on the basis of experience, would not be collected. A former temporary regulation[809] provided a formula for calculating the amount of the exclusion. Generally, this formula was a six-year moving-average formula substantially the same as the *Black Motor* bad-debt formula discussed in VIII.B.2., above.

The exclusion is available only with respect to amounts that are earned by a taxpayer and would otherwise be recognized in income through the performance of services by the taxpayer. For example, the exclusion is not available with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to lending money, selling goods, or acquiring accounts receivable or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those persons earned the amounts through the provision of services.[810]

In 2002, §448(d)(5) was amended to: (a) limit its applicability to taxpayers either (i) who provided services described in §448(d)(2) (i.e., services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) or (ii) whose average gross receipts have not exceeded $5 million for any three-year period (or for the period the taxpayer has been in existence, if less than three years)[811] and (b) require regulations that would allow such service providers to use methods or formulas that would, based on experience, accurately reflect the amount of income that will not be collected by such person.[812]

The changes described in (a) of the preceding paragraph greatly reduced the scope of §448(d)(5) by effectively limiting it to accrual-method service providers who either (i) were eligible to adopt the cash method of accounting or (ii) would be personal service corporations eligible to adopt the cash method but for their failure to satisfy the employee ownership test of §448(d)(2)(B).[813]

For those accrual-basis service providers who retained the right to use §448(d)(5), the 2002 amendments provided a more generous regime by requiring regulations that offered the use of methods other than the sole method allowed by the then-existing regulations; provided that, based on experience, the method actually reflects the amount which will not be collected. In response to this legislative mandate, a temporary regulation was issued,[814] which was applicable to tax years ending after March

[809] Reg. §1.448-2T(e) before amendment by T.D. 9090, 68 Fed. Reg. 52496 (Sept. 3, 2003).

[810] Reg. §1.448-3(c)(1)(ii) (unchanged from various versions of Reg. §1.448-2T(d)).

[811] The average gross receipts threshold was increased to $25 million for tax years beginning in 2018 and later. §448(c)(1).

[812] §448(d)(5), as amended by Pub. L. No. 107-147, §403(a).

[813] *See* §448(b).

[814] Reg. §1.448-2T(e), T.D. 9090, 68 Fed. Reg. 52496 (Sept. 3, 2003).

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9, 2002, and remained in effect until it was replaced by a final regulation, Reg. §1.448-3,[815] effective for tax years ending on or after August 31, 2006.

Under Reg. §1.448-3, an accrual-method service provider described in §448(d)(5) may determine the portion of receivables which, on the basis of experience, will not be collected (the "uncollectible amount") using (i) a safe-harbor method described in Reg. §1.448-3(f) or (ii) with the Commissioner's advance approval[816] and, subject to the self-testing requirement of Reg. §1.448-3(e)(2) (described below),[817] any method that clearly reflects the taxpayer's experience.[818]

Several of the safe-harbor methods in Reg. §1.448-3(f) are based on the taxpayer's experience during the "applicable period." The applicable period (chosen by the taxpayer) may consist of at least three, but not more than six, of the immediately preceding consecutive tax years. Alternatively, the applicable period may consist of the current tax year and at least two, but not more than five, of the immediately preceding consecutive tax years. A period shorter than six tax years is permissible only if the period contains the most recent preceding tax years and all of the tax years in the applicable period are consecutive.[819] Changes in the number of years in the applicable period or as to whether the current tax year is included are changes to a method of accounting.[820]

The safe-harbor methods described in Reg. §1.448-3(f) are:[821]

(1) a revenue-based moving-average method to determine the aggregate amount of uncollectible amounts receivable with the formula for determining the uncollectible amount being expressed as follows: (Bad debts sustained, adjusted by recoveries received, during the applicable period ÷ Total revenue resulting in accounts receivable during the applicable period) × Accounts receivable at end of current tax year;

(2) the actual-experience method, which applies a factor that is 105% of the taxpayer's actual experience for the applicable period determined either (A) for the entire applicable period as of a determination date no later than the return filing date or (B) as an average of each year in the period's experience determined as of a determination date no later than the return filing date for that year;

(3) a variation of the *Black Motor* formula,[822] with the formula for determining the uncollectible amount being expressed as follows: (Bad debts sustained, adjusted by recoveries received, during the applicable period ÷ Sum of accounts receivable at the end of each tax year during the applicable period) × Accounts receivable at end of current tax year – Bad debts written off during the current tax year relating to accounts receivable generated during the current tax year;

(4) a modified moving-average method, with the formula for determining the uncollectible amount being expressed as follows: (Bad debts sustained, adjusted by recoveries received, during the applicable period other than bad debts written off in same tax year accounts receivable generated ÷ Sum of accounts receivable at the beginning of each tax year during the applicable period) × Accounts receivable at end of current tax year; and

(5) an alternative experience-method, as long as that method clearly reflects the taxpayer's actual experience, provided that for the first tax year it is used the taxpayer's method results in a uncollectible amount that is equal to or less than the uncollectible amount determined under at least one of the safe harbors described in (1) through (4).[823] Further, in the third tax year that the method is used and every third year thereafter, the taxpayer must compare the uncollectible amount computed for the three-year period consisting of the current year and the two prior years. If such amount exceeds the uncollectible amount computed for the three-year period determined under at least one of the safe harbors described in (1) through (4) (the "cumulative safe-harbor uncollectible amount"), the amount excludible in the current year is limited to the excess of the cumulative safe-harbor uncollectible amount over the amounts excluded for the two prior years; and if the amount previously excluded during the three-year period exceeds the cumulative safe-harbor uncollectible amount, such excess must be included in the current (i.e., the third) year's income. If the uncollectible amount computed for the three-year period using the taxpayer's method equals or exceeds 110% of the cumulative safe-harbor uncollectible amount, the taxpayer must either (i) change to a method described in one of the five safe harbors or (ii) obtain IRS permission to use a method (which could be the method the taxpayer has been using under the safe harbor of Reg. §1.448-3(f)(5)) that clearly reflects the taxpayer's experience and satisfies the self-testing requirements of Reg. §1.448-3(e)(2) (described below).[824] Finally, in the year in which any first-year or third-year comparison test is performed, the taxpayer must document the test in its books and records (including the methodology and computations).[825]

A taxpayer using, or desiring to use, a method which is not a safe-harbor method described in Reg. §1.448-3(f) must self-test its method for its first tax year for which it uses, or desires to use, that method, and every three tax years thereafter in the manner described in Reg. §1.448-3(e)(2).[826] In summary, each self-test must be performed by comparing the uncollectible amount (under the taxpayer's method) with the taxpayer's actual experience. If the uncollectible amount determined

[815] Promulgated by T.D. 9258, 71 Fed. Reg. 23,856 (Apr. 25, 2006), and amended by T.D. 9942, 86 Fed. Reg. 254 (Jan. 5, 2021).

[816] Reg. §1.448-3(b).

[817] Reg. §1.448-3(e)(1).

[818] Reg. §1.448-3(d)(1). *Comment:* The final regulation's allowance of such a method was the major difference between it and the 2003 temporary regulation.

[819] Reg. §1.448-3(c)(2)(ii). The 2003 temporary regulation specified different applicable periods (ranging from three to six years) for different safe-harbor provisions.

[820] Reg. §1.448-3(c)(2)(i).

[821] Reg. §1.448-3(f)(1)–§1.448-3(f)(5).

[822] See VIII.B.2., above.

[823] Reg. §1.448-3(e)(3)(i), §1.448-3(e)(3)(ii).

[824] Reg. §1.448-3(e)(3)(i), §1.448-3(e)(3)(ii).

[825] Reg. §1.448-3(e)(5).

[826] Reg. §1.448-3(e)(1), §1.448-3(e)(2).

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under the desired method for the first tax year exceeds the actual experience amount, the taxpayer may not use the desired method.[827] The three-year test compares the cumulative uncollected amount for the three-year period consisting of the current year and two prior years with the taxpayer's actual experience for the three-year period (the "cumulative actual experience amount"). The consequences of failing a three-year test are basically the same as failing a three-year test under the fifth safe harbor: the exclusion is limited to the cumulative actual experience amount; any previously excluded excess must be included in current-year income; and if the excludible amount (under the taxpayer's method) equals or exceeds 110% of the cumulative test amount, the taxpayer must change to a permissible method.[828] In the year in which any first-year or third-year comparison test is performed, the taxpayer must document the test in its books and records (including the methodology and computations).[829]

The regulations are silent as to how to timely calculate a taxpayer's actual experience amount when its collection cycle for a year's receivables extends beyond the extended due date for filing its tax return.[830] The 2006 preamble acknowledges the problem and indicates that future guidance is anticipated with respect to self-testing and that such guidance may address the determination of actual experience.[831] On the other hand, it may not. In the meantime, taxpayers seeking the Commissioner's permission to adopt such an alternative method must establish that the determination of actual experience will be made in a manner which is to the Commissioner's satisfaction.[832]

Section 448(d)(5) does not apply to an amount receivable if either: (i) interest is required to be paid on the amount or (ii) there is a penalty for failure to timely pay the amount. In general, any structure which has the economic substance of imposing interest or penalties for late payment will be deemed to constitute the charging of interest or late-payment penalties. However, the offering of a discount for early payment will not be regarded as the charging of interest or late-payment penalties, provided: (i) the full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided and (ii) where the payment is received within the time required for the allowance of the discount, the discount for early payment is treated as an adjustment to gross income in the year of payment.[833]

The IRS has provided automatic consent procedures for taxpayers to change their accounting method to one of the safe-harbor methods. However, to adopt or change to a method other than one of the safe-harbor methods, a taxpayer must follow the advance-consent procedures.[834] For a full discussion, see 572 T.M., *Accounting Methods — Adoption and Changes.*

[827] Reg. §1.448-3(e)(2)(ii).

[828] Reg. §1.448-3(e)(2)(iii).

[829] Reg. §1.448-3(e)(5).

[830] *See* Reg. §1.448-3(e)(2).

[831] Preamble, T.D. 9285, 71 Fed. Reg. 52,430 (Sept. 6, 2006).

[832] Preamble, T.D. 9285.

[833] Reg. §1.448-3(c)(1)(ii)(B); former Reg. §1.448-2T(c). *See, e.g.*, Reg. §1.448-3(g) *Ex. 3*.

C. Statute of Limitations on Claiming Deduction

As a general rule, a claim for a refund of an overpayment of tax must be filed within three years of the filing of the return.[835] Where a claimed bad debt deduction is challenged on the grounds that the debt did not become worthless in the year claimed and is eventually disallowed by a court, the usual three-year period for filing a claim for refund for the year in which the debt actually became worthless is likely to have expired. Moreover, where the IRS takes the position that the debt became worthless before the year in which the deduction was claimed, the three-year period may well have expired by the time the issue is raised on audit. Section 6511(d)(1) was enacted in an effort to correct this situation and provides that a taxpayer may claim a deduction for a worthless debt (or a worthless security as defined in §165(g)(2)) at any time within seven years from the date prescribed by law for filing the return for the year with respect to which the claim is made.[836] For the seven-year limitations period under §6511(d)(1) to apply, "a debt must exist for tax purposes under the taxpayer's method of tax reporting."[837] In *Smith Elec. Co. v. United States*,[838] the Court of Claims held that the seven-year limitation period in §6511(d)(1) applied to taxpayers using the reserve method (as well as those using the specific charge-off method).

The seven-year period is computed without regard to any extension of time that may have been granted for filing the return.[839] The alternative period for filing a refund claim (two years after the tax was paid) is not affected.[840] The extended period of limitation does not apply to partially worthless debt.[841] It also does not apply to retirement of debt under §1271(a)(1) (or former §1232(a)(1)).

For further discussion, see 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation.*

[834] Rev. Proc. 2006-56 (effective for tax years ending after Aug. 30, 2006), modified and amplified by Rev. Proc. 2011-46 (nonaccrual experience (NAE) book safe harbor method of accounting added to list of acceptable safe harbors provided in Rev. Proc. 2006-56; guidance issued advising taxpayers how to obtain automatic consent (1) to change to NAE book safe harbor method, and (2) to make certain changes within NAE book safe harbor method).

[835] §6511(a).

[836] *See also* Reg. §301.6511(d)-1, §301.6511(d)-2.

[837] *See W.L. Moody Cotton Co. v. Commissioner*, 143 F.2d 712 (5th Cir. 1944); CCA 201515018 (taxpayer typically applied the cash-basis method to report income, but inadvertently reported as income the running balances of accounts receivable from the internal accounting records, overstating income and thus resulting in taxpayer's claim for a refund. The Office of Chief Counsel concluded that §6511(d)(1) did not apply to taxpayer's refund claim because as a cash-method taxpayer, the taxpayer is not entitled to a bad debt deduction since accrual of the income before the actual receipt of the income is improper. Accordingly, without an overpayment arising from a bad debt deduction, the seven-year period of limitations is inapplicable to taxpayer's refund claim).

[838] 461 F.2d 790, 793 (Ct. Cl. 1972).

[839] Reg. §301.6511(d)-1(a)(2).

[840] Reg. §301.6511(d)-1(b).

[841] Reg. §301.6511(d)-1(c).

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IX. Recovery of Bad Debts: §111

A. *Overview*

The judicially created tax benefit rule is, in a sense, an exception to a fundamental tenet of our tax law that a taxpayer's income and deductions are determined on the basis of facts available for the annual accounting period instead of on the basis of all the facts relevant to the transaction.[842] The purpose of the rule "is to approximate the results produced by a tax system based on transactional rather than annual accounting."[843] The tax benefit rule has been partially codified by §111 (which derives originally from the Revenue Act of 1942)[844] and has two essential parts.[845] The first part is a nonstatutory rule of income inclusion, which requires a taxpayer to include in gross income the recovery of a deduction (or credit) taken in an earlier year,[846] while the second part is a statutory rule of exclusion, which makes the recovery excludible from gross income to the extent the earlier deduction was not of tax benefit.[847] For example, a cash-basis taxpayer who received a refund of a prior year's state income tax that reduced his overall tax liability should include the refund in gross income in the year received, notwithstanding the fact that the year in which the deduction was taken may still be open for statute of limitation purposes.

Initially the courts found various rationales for the tax benefit rule. For example, in *Philadelphia Nat'l Bank v. Rothensies*, the court recognized that the recovery of a bad debt could not reasonably be called anything but a recovery of capital, which is normally tax-free, but reasoned that the initial deduction was a matter of legislative grace, and the price of the grace was implied consent to include recoveries in gross income.[848] At this point in history, such rationales can seem a little strained, and there is no longer any need for them, because the principle has become so thoroughly embedded in the logic of the tax law.[849]

For a full discussion of §111, see 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income.*

[842] *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) (sanctity of annual accounting periods); *Dobson v. Commissioner*, 320 U.S. 489 (1943) (tax benefit rule not applicable to exclude recovery of "losses" which were of no prior tax benefit), *reh'g denied*, 321 U.S. 231 (1944); *Putnam Nat'l Bank v. Commissioner*, 50 F.2d 158 (5th Cir. 1931); *Nat'l Bank of Commerce of Seattle v. Commissioner*, 115 F.2d 875, 877 (9th Cir. 1940).

[843] *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 381 (1983).

[844] 56 Stat. 798, §116(a) (Int. Rev. Code of 1939, §22(b)(12)).

[845] *See* Reg. §1.111-1(a)(4). See also former §58(h) for application of a tax benefit rule to items of tax preference arising in taxable years beginning before 1987 (see Pub. L. No. 101-239, §7811(d)). The tax benefit rule also applies to the recovery of a prior year's tax credits. *See* §111(b); Reg. §1.111-1(b).

[846] *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979); *Cont'l Ill. Nat'l Bank & Trust Co. v. Commissioner*, 69 T.C. 357, 370 (1977), *acq.*, 1978-2 C.B. 1; Rev. Rul. 77-67.

[847] *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967). *Cf. Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958).

[848] 43 F. Supp. 923 (E.D. Pa. 1942). *See Nat'l Bank of Commerce of Seattle v. Commissioner*, 115 F.2d 875, 877 (9th Cir. 1940) (recovery of bad debt represents replacement of profits).

[849] *See Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377–80 (1983); *Estate of Munter v. Commissioner*, 63 T.C. 663, 678 (1975) ("necessary counterweight to annual accounting principle").

B. *Judicial Rule Requiring Inclusion in Income*

One of the most common applications of the tax benefit rule arises on repayment or other recovery of a debt obligation that a creditor-taxpayer had previously written off as worthless (or treated as a capital loss under §166(d) or §165(g)).[850] A recovery for this purpose is not limited to payments made by the debtor. It extends to payments made by a person under no legal obligation to make repayment, and it extends to proceeds received from the sale of the obligation to a third party.[851] After a bad debt has been written off, its basis is zero, so that any recovery results in the realization of income.

If there is any question that the recovery is includible in gross income, the tax benefit rule has an impact. For example, in *T.O. McCamant v. Commissioner*,[852] the proceeds of life insurance on the life of the debtor were paid to the creditor after the debt was written off as worthless. The Tax Court held the proceeds to be includible in the creditor's gross income since the payments were received by the creditor by reason of the indebtedness.

The court rejected the creditor's argument that the proceeds were excludible under §101(a).[853]

However, in *Cont'l Ill. Nat'l Bank & Trust Co. of Chicago v. Commissioner*,[854] no recovery was found where a taxpayer realized gain from the sale of property previously received in complete cancellation of a partially worthless indebtedness. The gain realized in the subsequent year was considered to have been received from an independent transaction and was not subject to the tax benefit rule.[855]

Because a decedent and the decedent's estate are separate and distinct taxpayers, the tax benefit rule does not apply to the estate's recovery of bad debts reported on the decedent's tax returns. Rather the estate recognizes income or loss equal to the difference between principal amounts recovered with respect to the debt and the estate's tax basis in the debt (generally, date of death value).[856]

> *Example:* In Year 1, T, an individual not engaged in the lending business, loans $100,000 to M, a well-capitalized LLC wholly owned by his friend B. The debt is evidenced by a note; interest is payable quarterly and the principal is

[850] Until the Deficit Reduction Act of 1984 (Pub. L. No. 98-369, §171(a)), §111 was limited to recovery of "a bad debt, prior tax or delinquency amount."

[851] *Merchants Nat'l Bank of Mobile v. Commissioner*, 14 T.C. 1375 (1950), *aff'd*, 199 F.2d 657 (5th Cir. 1952); *Bear Mill Mfg. Co., Inc. v. Commissioner*, 15 T.C. 703 (1950) (court reviewed).

[852] 32 T.C. 824 (1959), *acq.*, 1960-2 C.B. 6.

[853] *McCamant v. Commissioner*, 32 T.C. 824 (1959) (without notifying taxpayers, debtor had voluntarily obtained policy which named taxpayers as beneficiaries to extent of any indebtedness he might owe them at time of his death). *Cf. Tenn. Foundry & Mach. Co. v. Commissioner*, 48 T.C. 419 (1967), *aff'd per curiam*, 399 F.2d 156 (6th Cir. 1968) (restitution of embezzled funds); *Durr Drug Co. v. United States*, 99 F.2d 757 (5th Cir. 1938).

[854] 69 T.C. 357 (1977), *acq.*, 1978-2 C.B. 1.

[855] *Cont'l Ill. Nat'l Bank & Trust Co. of Chicago v. Commissioner*, 69 T.C. 357 (1977). *Accord Allen v. Trust Co. of Ga.*, 180 F.2d 527 (5th Cir. 1950); Rev. Rul. 66-320.

[856] Amounts recovered with respect to interest are interest income. Even though the interest applicable to pre-death periods had a value for estate tax purposes, it is considered income in respect of a decedent.

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payable in Year 9. In Year 4, M's business fails and there are no funds for the payment of unsecured creditors, such as T. T claims a nonbusiness bad debt deduction on his tax return for Year 4. In Year 6, M files suit against Megacorp asserting that its unfair business practices destroyed M's business. T dies in Year 7, and his executors properly value the principal amount of the note at $45,000 (no value is assigned to the unpaid interest).

Situation (1): In Year 10, M loses at trial and the period for filing an appeal expires. In Year 10, the holder of the note (i.e., T's estate or if the estate has distributed the debt to a beneficiary, the beneficiary) is entitled to a nonbusiness bad debt deduction of $45,000.

Situation (2): In Year 10, Megacorp and M enter into a settlement agreement pursuant to which Megacorp pays M a substantial amount of damages. Also in Year 10, M pays T's estate (which is still holding the note) $135,000 ($35,000 of interest and $100,000 of principal) in full satisfaction of the note. In Year 10, the estate has $90,000 of income. Because the estate acquired the note prior to the note's maturity date and the payment was made after the maturity date, presumably all of the income is ordinary interest income (a combination of stated interest and accrued market discount).[857] Had the final payment in full satisfaction (i.e., redemption) of the note been made prior to the stated maturity date, a portion of the $55,000 excess of the principal payments over basis would not have been accrued market discount and would, therefore, qualified as capital gain from the deemed sale or exchange of the note.[858]

The results in the above example would be the same, if T had not claimed a bad debt deduction.[859]

Where an acquiring corporation recovers the previously deducted bad debts of the acquired corporation after engaging in a transaction described in §381, the acquiring corporation is treated for purposes of §111 as if it were the transferor. Thus, it must include in gross income the amounts that would have been included in gross income by the acquired corporation, but it also has the benefit of the §111 rule of exclusion.[860]

For partially worthless debts, the recovery is applied first against that portion of the debt which was not charged off and deducted. Thus, a subsequent payment equal to or less than the non-charged-off portion constitutes a return of capital and not a recovery under §111.[861] Moreover, generally any amounts recovered in excess of the creditor's original basis in the debt are not considered a "recovery."[862]

Although §111 and the regulations promulgated thereunder specifically refer to a "recovery" of a prior deduction in a subsequent year, the Supreme Court's decision in *Hillsboro Nat'l Bank v. Commissioner*[863] significantly enlarged the potential scope of the tax benefit rule by requiring its application not only where there is a technical "recovery" of a prior deduction, but also where "events occur that are fundamentally inconsistent with an earlier deduction." In explaining the principle of "fundamentally inconsistent events," the Court commented by footnote that a critical distinction must be drawn as to merely unexpected events which are not fundamentally inconsistent and those events which are inherently inconsistent.[864] In other words, the tax benefit rule applies if the event which occurred in the subsequent year would have foreclosed the deduction in the prior year.

Obviously, the recovery of a prior bad debt is always fundamentally inconsistent with the prior year's deduction for worthlessness. However, the Supreme Court acknowledged that the precise scope of the rule would have to be addressed on a case-by-case basis.[865] Thus, it is uncertain whether *Hillsboro Nat'l Bank* requires the application of the tax benefit rule where there is a recovery of a bad debt that was erroneously deducted in a prior year. However, in order for the taxpayer to gain from this limitation, a reversal of the taxpayer's prior reporting position is required. Indeed, in *Commissioner v. Liberty Bank & Trust Co.*,[866] a taxpayer was estopped from claiming that the recovery of certain bad debts that it had previously claimed as worthless and deducted in years since closed by the statute of limitations did not create income in the year of repayment. At trial the taxpayer took the position that it had in good faith, but erroneously, reported the notes to have been worthless in the barred years. In laying the foundation for applying the doctrine of estoppel, the Sixth Circuit announced that the taxpayer was under a duty to deal fairly and truthfully with the government in reporting its income tax obligation, and the government has the right to assume that the taxpayer will fulfill the duty.

Even where the elements necessary to invoke the doctrine of estoppel are not present, the Tax Court has held that a form of quasi-estoppel requires that a taxpayer treat a transaction which occurs over several annual accounting periods in a consistent manner.[867] This "duty of consistency" foreclosed a taxpayer from treating the recovery of certain amounts erroneous-

[857] *See* §§1276, 1277, 1278. For detailed discussions of the market discount rules, see New York City Bar Committee on Taxation of Business Entities, "NYC Bar Reports on Accounting for Interest on Nonperforming Loans," 120 *Tax Notes* 769 (Aug. 25, 2008); and 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments*.

[858] §1271.

[859] *Helvering v. Roth*, 115 F.2d 239 (2d Cir. 1940); *Estate of Zobel v. Commissioner*, 28 T.C. 885 (1957) (tax years in both cases predated enactment of current law provisions with respect to market discount and treating redemption of most debt instruments as a sale or exchange, so all of income (but not interest) income due to lack of sale or exchange).

[860] §381(c)(12), which overruled *Nat'l Bank of Commerce of Seattle v. Commissioner*, 12 T.C. 717 (1949). *See also* Rev. Rul. 78-278.

[861] Reg. §1.111-1(a)(2). *See, e.g.*, FAA 20144801F (upon the sale of REMIC regular interests with respect to which a partial worthlessness deduction has been taken, the taxpayer must allocate the amount received upon the sale first to the taxpayer's remaining adjusted basis, then to the amount previously deducted as partially worthless, i.e. the recovery amount, and lastly to the amount of gain, if any).

[862] Reg. §1.111-1(a)(2).

[863] 460 U.S. 370 (1983).

[864] *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 383, n. 15 (1983).

[865] 460 U.S. 370, 385 (1983).

[866] 59 F.2d 320 (6th Cir. 1932). *See also Askin & Marine Co. v. Commissioner*, 26 B.T.A. 409, *aff'd*, 66 F.2d 776 (2d Cir. 1933). Estoppel was also applied in *Mayfair Minerals, Inc. v. Commissioner*, 56 T.C. 82 (1971).

[867] *Unvert v. Commissioner*, 72 T.C. 807 (1979), *aff'd*, 656 F.2d 483 (9th Cir. 1981). *See also S. Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 559 (1980).

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ly deducted as interest on a return for a barred year as not subject to the tax benefit rule.[868] In contrast, where no switch in the prior reporting position was made by the taxpayer with respect to claiming an erroneous deduction,[869] or where an erroneous deduction was the product of a mutual mistake of law,[870] the subsequent recovery of such amounts has been held not to be subject to the tax benefit rule. Arguably, these latter exceptions are still outside of the "fundamentally inconsistent" doctrine announced in *Hillsboro Nat'l Bank*.

C. Section 111 Exclusion from Income

Section 111 prevents recovery of an item from constituting income if its deduction generated no tax benefit. The 1986 TRA amended §111 so that a taxpayer is required to include a tax benefit item in income only if the taxpayer's tax was reduced in the prior year by reason of the tax benefit item.[871] Therefore, for a taxpayer who had no taxable income in the prior year, who paid only an alternative minimum tax in the prior year, or whose tax credits in the prior year reduced tax to zero, the taxpayer need not include the tax benefit item in income in the subsequent year.[872]

The application of §111 is rather technical, and the application of regulations with respect to recoveries of partially worthless debts can become very complex.[873] In general, the total recoveries in the taxable year attributable to items deducted in a given prior year are grouped together.

The amount of the recoveries is then reduced by the "recovery exclusion" with respect to the items.[874] The difference is the amount includible in gross income by the taxpayer.

The "recovery exclusion" with respect to the items is the amount of the deductions on account of the bad debt that did not result in a reduction of the taxpayer's tax in the prior year, reduced by the recovery exclusions taken in years subsequent to the prior year up to the taxable year in question, and reduced further by any increase in net operating losses attributable to the items that were carried forward or carried back to another year.[875]

> *Example:* In 2001, Corporation Y charged off $11,000 in bad debts. Its gross income was $12,000. All other deductions amounted to $8,000. $5,000 of the $7,000 net operating loss was carried back and deducted for its 2000 taxable year. The recovery exclusion with respect to the 2001 charged-off items is $2,000 ($11,000 – [$12,000 – $8,000 + $5,000]). If in 2002, Corporation Y recovers $1,500 of the previously charged-off debts, such amount is not includible in gross income. If in 2003, an additional $5,000 is recovered, $500 is nontaxable while the balance of $4,500 is includible in gross income.

D. Bad Debt Reserves

For taxpayers who used the reserve method for deducting bad debts (generally repealed by the 1986 TRA), recoveries of debts previously charged to the reserve generally were credited to the reserve account instead of being directly included in gross income under §111.[876] This resulted in an overall decrease in the amount of the deductible addition to the reserve account for the year of the recovery. Where the taxpayer's rate of recoveries was relatively constant, there were no sharp swings in taxable income from year to year.

Despite the general rule, where a taxpayer who used the reserve method consistently followed the practice of reporting recoveries in gross income, the Tax Court, in *Ohio Loan & Discount Co. v. Commissioner*,[877] held that the practice still clearly reflected the taxpayer's income. Treating recoveries as gross income rather than a reduction of the bad debt deduction could impact items determined by reference to gross income; such as, personal holding company status and the applicability of the six-year statute of limitations where there is a 25% omission from gross income.

E. Correlation of Section 111 with Limitation of Deduction to Basis

The tax benefit rule of §111, when it apples, protects a taxpayer from recognizing income, but does not suspend the deduction for worthlessness of a debt if the deduction happens to produce no tax benefit in the year of worthlessness.

F. Alternative Minimum Tax

The tax benefit rule is applied (and the amount of any exclusion is calculated) separately for purposes of the alternative minimum tax. Specifically, §59(g) provides:

> Tax Benefit Rule. — The Secretary may prescribe regulations under which differently treated items shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's regular tax for the taxable year for which item is taken into account for any other taxable year.

The legislative history explains the enactment of §59(g) as follows:

> It is clarified that the application of the tax benefit rule to the minimum tax is within the discretion of the Secretary of the Treasury. Since the regular and minimum taxes generally are computed separately, relief from the minimum tax under the tax benefit rule is

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[868] *Unvert v. Commissioner*, 72 T.C. 807, 817 (1979).

[869] *Canelo v. Commissioner*, 53 T.C. 217, 226–27 (1969), *aff'd per curiam on other grounds*, 447 F.2d 484 (9th Cir. 1971).

[870] *Streckfus Steamers, Inc. v. Commissioner*, 19 T.C. 1 (1952) (court reviewed), *nonacq.*, 1981-2 C.B. 3.

[871] Pub. L. No. 99-514, §1812(a), 100 Stat. 2085, 2833, 1986-3 C.B. (Vol. 1) 750. This change is effective for amounts received after 1983, in taxable years ending after that date. This technical amendment to the 1984 TRA is made retroactive to the effective date of the 1984 Act for this provision. *Id.*, §1881, 100 Stat. 2833, 1986-3 C.B. (Vol. 1) 831; Pub. L. No. 98-369, §171(c).

[872] H.R. Rep. No. 99-841 at II-846, 1986-3 C.B. (Vol. 4) 846; but also see the discussion on the alternative minimum tax at IX.F., below.

[873] Reg. §1.111-1(a)(3).

[874] Reg. §1.111-1(b).

[875] Reg. §1.111-1(b)(1), (2)(ii).

[876] I.T. 1825, II-2 C.B. 114. *See* TAM 9116002 (National Office advised that taxpayer, in computing additions to its bad debt reserves under former §166(c), may take into account amounts for which credit memos were subsequently issued).

[877] 3 T.C. 849 (1944). *See also J.F. Johnson Lumber Co. v. Commissioner*, 3 T.C. 1160 (1944), *acq.*, 1945 C.B. 4.

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not appropriate solely by reason of the fact that a taxpayer has received no benefit under the regular tax with respect to a particular item.[878]

For a discussion of AMT rules, see 752 T.M., *Corporate Alternative Minimum Tax*, and 587 T.M., *Noncorporate Alternative Minimum Tax*.

[878] H.R. Rep. No. 99-841 at II-262 1986-3 C.B. (Vol. 4).

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X. Tax Consequences to the Debtor of Discharge of Indebtedness

A. General Rule

A creditor's claiming of a bad debt deduction based on worthlessness or partial worthlessness of the debt reflects the creditor's belief that he will not be able to recover what is owed; it does not, by itself, change the duty of the obligor to pay. Therefore, the claiming of the bad debt deduction does not have tax consequences to the debtor; however, the creditor's decision to claim the bad debt deduction may reflect (or eventually lead to) an event which does have significant tax consequences to the debtor. Specifically, the debtor's release from the obligation to repay will generally constitute taxable income to the debtor.[879] This is true whether the release occurs as a result of formal action taken by the creditor (such as a formal discharge or a compromise) or by operation of law (such as a discharge in bankruptcy or the expiration of the statute of limitations). As a general rule, the debtor will recognize ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market value of any property paid to the creditor.

The tax consequences to a debtor of a release from indebtedness are discussed in 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

B. Certain Statutory Exceptions to the General Rule

There are several statutory exceptions to the general rule that a debtor recognizes ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market value of any property paid to the creditor. Some of them are discussed below.

1. Gifts

Where the cancellation of the debt is a gift, the creditor is not entitled to a bad debt deduction, since the debt was not worthless.[880]

2. Insolvency or Bankruptcy

Income is generally not recognized in cases where discharge of indebtedness occurs in bankruptcy proceedings, or where the debtor is insolvent.[881] In the case of insolvency, income must be recognized to the extent the cancelled debt exceeds the amount by which the debtor was insolvent before the discharge.[882] If, as a result of the bankruptcy or insolvency exception, a taxpayer does not recognize taxable income, the taxpayer must reduce certain tax attributes (such as loss carryforwards and asset basis) as of the first day of the first taxable year following the year in which the debt discharge occurs.[883] Where the debtor is a partnership, the cancellation of indebtedness income is passed through to the partners and the availability of the bankruptcy or insolvency exception is determined at the partner level.[884]

3. Purchase-Money Debt Owed to Original Seller

In cases where the purchaser owes purchase-money debt to the original seller and the purchaser is neither bankrupt nor insolvent, the amount of discharged purchase-money debt is treated as an adjustment to the purchase price.[885] The debtor reduces its tax basis for the purchased property. If the creditor is reporting the transaction using the installment method, it adjusts its profit amount and contract price effective as of the year of the discharge. If the creditor reported the original gain or loss in the year of sale, the creditor will recognize a loss in the year of the debt reduction. To the extent the creditor previously recognized gain, the character of the loss should be the same as the previously recognized gain;[886] the character of the balance of the loss will depend on the nature of the asset sold.

4. Contribution to the Capital of the Debtor by a Shareholder of the Debtor

Where the debt is contributed to the capital of the debtor by a shareholder of the debtor, the amount of discharge of indebtedness income is the excess of the amount of the indebtedness over the shareholder's basis in the debt.[887] (A contribution to capital should preclude a current bad debt deduction[888] and should result in the corporate debtor having income, subject to exceptions for bankruptcy or insolvency, at least equal to any bad debt deduction previously claimed by the stockholder.) Where the debtor corporation is an S corporation, the shareholder's basis in the debt is, for purposes of §108(e)(6), determined without regard to adjustments under §1367(b)(2) (relating to reductions and offsetting increases to basis for the shareholder/creditor's share of losses and subsequent income).

Query: Where shareholders of a corporation make a pro rata transfer of the corporation's debt to the corporation, the issuance of additional stock to the transferors would have no economic significance. Should such a transfer be governed by §108(e)(6) (contributions to capital) or by §108(e)(8) (indebtedness satisfied by a debtor corporation's stock) (discussed in X.C., below)?

5. Qualified Real Property Business Indebtedness

A taxpayer, other than a C corporation, may elect to exclude the discharge of indebtedness from gross income to the extent it is qualified real property business indebtedness (QRPBI) discharged after 1992:[889]

> QRPBI is indebtedness which —
>
> (a) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property;
>
> (b) was incurred or assumed before 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness; and

[879] *United States v. Kirby Lumber*, 284 U.S. 1 (1931).
[880] §102.
[881] §108(a)(1).
[882] §108(a)(3).
[883] §108(b); Reg. §1.108-4(a).
[884] §108(d)(6).
[885] §108(e)(5).
[886] *See Arrowsmith v. Commissioner*, 334 U.S. 6 (1952).
[887] §108(e)(6).
[888] *Cf. Commissioner v. Fink*, 483 U.S. 89 (1987).
[889] §108(a)(1)(D).

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(c) with respect to which such taxpayer makes the required election.[890]

Qualified acquisition indebtedness means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve the property securing the debt.[891]

The amount of QRPBI that can be excluded from gross income is limited to the excess of the outstanding principal amount of all QRPBI secured by the property (immediately before the discharges) over the fair market value of the property immediately before the discharge.[892] Additionally, the amount of discharged QRPBI which may be excluded from gross income is limited to the taxpayer's basis in depreciable real property.[893]

In exchange for excluding the discharged QRPBI from gross income, the taxpayer must reduce his basis in depreciable real property.[894] In general, the basis reduction because of a QRPBI discharge is made the year after the debt is discharged.[895] However, §1017(b)(3)(F) modifies this general rule with respect to the exclusion for QRPBI, providing that basis reduction will take place immediately before the property is disposed of if earlier than the beginning of the taxable year following the taxable year of the discharge.[896]

With respect to partnerships, a taxpayer can reduce the portion of his basis in a partnership interest attributable to the partnership's depreciable real property and make a corresponding reduction in his share of the partnership's basis in the depreciable real property.[897] In the case of a partnership, the determination as to whether the discharged indebtedness is QRPBI and the amount by which the principal amount of QRPBI exceeded the fair market value of the property would have to be determined at the partnership level. However, the election to exclude discharged QRPBI is made by an individual partner.[898]

The reduction in basis is treated as additional depreciation for purposes of §1250.[899] Accordingly, unless the taxpayer dies before the earlier of (i) the disposition of the property or (ii) the date the property would have been fully depreciated, the excluded discharge of indebtedness will be offset by some combination of (1) foregone depreciation deductions, (2) ordinary income on sale or disposition,[900] and (3) reduced §1231 loss on sale.

The election to reduce basis, which is made on a completed Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* must be made on the timely filed (including extensions) income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible under §108(a).[901] If the taxpayer fails to make the election on that return, the taxpayer must request the Commissioner's consent to file a late election under Reg. §301.9100-1 through §301.9100-3.

QRPBI does not include qualified farm indebtedness.

For a detailed discussion of the tax treatment of the discharge of indebtedness, including the limitation on the exclusion from income of discharged QRPBI, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

6. Discharge of Qualified Farm Indebtedness

The discharge of qualified farm indebtedness (debt incurred directly in the operation of the trade or business of farming by a taxpayer who, for a specified three-year period, has derived at least 50% of his gross receipts from farming) may be excluded from gross income under §108(a)(1)(C).[902] The excludible amount is limited to the amount of certain tax attributes and tax attributes must be reduced by the amount of income excluded.[903]

7. Discharge of Certain Acquisition Indebtedness Secured by Taxpayer's Principal Residence

A limited amount of acquisition indebtedness secured by the taxpayer's principal residence[904] discharged in years 2007 through 2025,[905] or which is discharged subject to an arrangement that is entered into and evidenced in writing before 2026,[906] may be excluded from gross income, provided the discharge is not attributable to any factor not directly related to a decline in the value of the residence or the taxpayer's financial condition.[907] For discharges of indebtedness after December 31, 2020, the maximum amount of discharged acquisition indebtedness that is excludible from gross income as qualified principal residence indebtedness is $1,000,000 ($500,000 in the case of a married individual filing separately).[908]

Principal residence has the same meaning as for §121 (relating to the exclusion of gain from the sale of a principal residence).[909] Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving the residence

[890] §108(c)(3).

[891] §108(c)(4).

[892] *See* §108(c)(2)(A); Reg. §1.108-6(b). *See also* CCA 201623009 (limit on amount of QRPBI that may be excluded begins with fair market value of single item of real property to which discharged debt is QRPBI).

[893] §108(c)(2)(B); Reg. §1.1017-1(a).

[894] §1017(b)(3); Reg. §1.1017-1(a).

[895] §1017(a); Reg. §1.1017-1(a).

[896] *Hussey v. Commissioner*, 156 T.C. No. 12 (June 24, 2021) (because taxpayer received discharge of QRPBI and he sold such properties, bases of which were used to show he had aggregated bases that exceeded discharge amount, taxpayer had to reduce his bases in those properties as per §1017(b)(3)(F)(iii) in sale year and not following year).

[897] §1017(b)(3); Reg. §1.1017-1(a), §1.1017-1(g).

[898] §108(d)(6).

[899] §1017(d).

[900] §751, §1250.

[901] Reg. §1.108-5. Any extension of time for making the election would have to be obtained pursuant to Reg. §301.9100-2(b) or §301.9100-3. *Caution:* PLR 9701018 and earlier private letter rulings allowing the election to be made on an amended return were issued pursuant to an earlier version of Reg. §1.108-5 that had allowed a taxpayer to file an election with an amended return if the taxpayer established reasonable cause for failure to file the election with the original return.

[902] *See* §108(g).

[903] §108(g)(3).

[904] §108(h)(2). §163(h)(3)(F)(iv).

[905] §108(a)(1)(E)(i).

[906] §108(a)(1)(E)(ii).

[907] §108(h)(3).

[908] While §108(h)(2) relies on the definition of "acquisition indebtedness" under §163(h)(3)(B)(i), it is applied without the substituted amounts under §163(h)(3)(F)(i)(II), originally introduced by the TCJA and extended indefinitely by the OBBBA. *See* §163(h)(3)(B)(ii), §108(h)(2), §163(h)(3)(F)(iii), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70108(a), effective for taxable years beginning after December 31, 2025.

[909] §163(h)(3)(B). Section 121 does not contain a definition of principal residence; Reg. §1.121-1(b) requires a facts-and-circumstances determination.

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which secures it.[910] If discharged indebtedness secured by the principal residence consists of acquisition indebtedness and indebtedness which is not acquisition indebtedness, only the amount of discharged debt in excess of the amount non-acquisition indebtedness qualifies for the exclusion.[911] The taxpayer's basis for the personal residence is reduced (but not below zero) by the amount of the discharged indebtedness excluded from gross income.[912]

8. *Certain Indebtedness of Individuals Living in Specified Disaster Areas*

a. *Hurricane Katrina Disaster Area*

Subject to the conditions and limitations described in the balance of this paragraph, if indebtedness of a natural person, whose principal place of abode on August 25, 2005, was within the Hurricane Katrina disaster area, was discharged after August 24, 2005, and before 2007, by an "applicable entity" as defined in §6050P(c)(1)[913] (generally entities engaged in the lending business and certain government entities and agencies) the cancellation was excluded from gross income.[914] However, this relief provision does not apply to (i) indebtedness incurred in a trade or business or (ii) indebtedness secured by real property to the extent the indebtedness is secured by real property located outside the core disaster area.[915] In the case of a natural person whose principal place of abode on August 25, 2005, was within a Hurricane Katrina disaster area but outside of the core disaster area, the relief provision is not applicable unless the person suffered economic loss by reason of Hurricane Katrina.[916] Any amount excluded from gross income pursuant to this Hurricane Katrina relief provision is treated as an amount excluded under §108(a),[917] and, therefore, results in the same reduction of tax attributes as discharged debt excluded as a result of insolvency or bankruptcy.

b. *Midwestern Disaster Areas*

Legislation enacted in 2008[918] extended many provisions of the Katrina Emergency Tax Relief Act of 2005, including the cancellation of indebtedness relief described in X.B.8.a., above,[919] to Midwestern disaster areas with certain modifications to adjust for the later occurrence of the Midwestern disasters.

The 2008 legislation generally defines the term "Midwestern disaster area" as an area with respect to which a major disaster has been declared by the President on or after May 20, 2008, and before August 1, 2008, under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of severe storms, tornados, or flooding occurring in any of the States of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin, and which has been determined by the President to warrant individual or individual and public assistance from the Federal Government under such Act with respect to damages attributable to such severe storms, tornados, or flooding.[920] If indebtedness of a natural person, whose principal place of abode was within a Midwestern disaster area on the date of the floods, storms or tornados which caused the area to be designated a disaster area[921] (the "Applicable Disaster Date") is discharged on or after the Applicable Disaster Date and before 2010,[922] by an "applicable entity" as defined in §6050P(c)(1), the cancellation is excluded from gross income unless the debt either (i) was incurred in a trade or business or (ii) is secured by real property located outside of the disaster area. This relief from cancellation of indebtedness is also available to a natural person who suffered economic loss as a result of the disaster and would be described in the preceding sentence, but for the fact that the President determined that the area warranted public, but not individual, assistance from the federal government.[923]

As in the case of the Hurricane Katrina relief, any amount excluded from gross income pursuant to this Midwestern disaster area provision is treated as an amount excluded under §108(a),[924] and, therefore, results in the same reduction of tax attributes as discharged debt excluded as a result of insolvency or bankruptcy.

9. *Recognition Deferral for Certain Reacquired Business Debt*

If, during calendar year 2009 or 2010, a taxpayer reacquires an "applicable debt instrument" for an amount which is less than the instrument's adjusted issue price, the taxpayer may elect to include the resulting cancellation of indebtedness in taxable income ratably over five tax years beginning with the fifth subsequent taxable year in the case of debt reacquired in calendar year 2009 and with the fourth subsequent taxable year in the case of debt reacquired in calendar year 2010.[925] If the applicable debt instrument is reacquired in exchange for a new debt instrument with original issue discount, a taxpayer who elects to defer recognition of the cancellation of indebtedness income must defer deduction of the original issue discount which accrues before the commencement of the recognition period (to the extent it does not exceed the deferred can-

[910] §163(h)(3)(B) (incorporated by reference in §108(h)(2)).
[911] §108(h)(4).
[912] §108(h)(1).
[913] Katrina Emergency Tax Relief Act of 2005 (KETRA), Pub. L. No. 109-73 §401(a).
[914] KETRA §401(a), §401(e).
[915] Pub. L. No. 109-73 §401(c).
[916] Pub. L. No. 109-73 §401(b).
[917] Pub. L. No. 109-73 §401(d).
[918] Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (2008 Tax Extenders Act), Pub. L. No. 110-343, Div. C.
[919] Pub. L. No. 110-343, Div. C §702(a)(2).
[920] Pub. L. No. 110-343, Div. C §702(b)(1).
[921] Pub. L. No. 110-343, Div. C §702(c)(3).
[922] Pub. L. No. 110-343, Div. C §702(e)(4).
[923] Pub. L. No. 110-343, Div. C §702(e)(4)(A).
[924] Katrina Emergency Tax Relief Act of 2005 (KETRA), Pub. L. No. 109-73, §401(d).
[925] §108(i)(1); Reg. §1.108(i)-1(a), §1.108(i)-2(a). T.D. 9622, 78 Fed. Reg. 39984 (July 3, 2013), added Reg. §1.108(i)-0, §1.108(i)-1, and -3, replacing substantially similar temporary regulations added by T.D. 9497, 75 Fed. Reg. 49394 (Aug. 13, 2010). Additionally, T.D. 9623, 78 Fed. Reg. 39973 (July 3, 2013), added Reg. §1.108(i)-2, replacing substantially similar temporary regulations added by T.D. 9498, 75 Fed. Reg. 49380 (Aug. 13, 2010). Reg. §1.108(i)-1 and 1.108(i)-2 apply on or after July 2, 2013, to reacquisitions of applicable debt instruments in tax years ending after Dec. 31, 2008. Reg. §1.108(i)-3 applies on or after July 2, 2013, to debt instruments issued after Dec. 31, 2008, in connection with reacquisitions of applicable debt instruments in tax years ending after Dec. 31, 2008. Reg. §1.108(i)-0(b). For further discussion of income in certain debt restructurings and these regulations, see 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses.*

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cellation of indebtedness income) and deduct it over the five-tax-year recognition period.[926] An applicable debt instrument is any debt instrument (within the meaning §1275(a)(1)) that is (i) issued by a C corporation or (ii) issued by any other person in connection with a trade or business by such person.[927] Under certain circumstances (e.g., death of the taxpayer, a liquidation of the business, or the taxpayer's disposition of the interest in a pass-through entity debtor), recognition of the cancellation of indebtedness income is accelerated.[928] A reacquisition is any acquisition of a debt instrument by the obligor under the instrument or by a related person (as defined in §108(e)(4)) to such obligor.[929]

> *Example:* In 1990, X, a C corporation with a taxable year ending June 30, issued publicly traded bonds due in 2015; the bonds were issued at face value and thus had no original issue discount. On August 15, 2009, when the bonds are trading for 75% of face value, X acquires $10 million face value of the bonds from an unrelated party in exchange for X's $9 million note (the "Note") due in 2020 with interest of 5% per annum payable semi-annually.

The issue price of the Note is $7.5 million,[930] and the Note has $1.5 million ($9.0–$7.5) of original issue discount. X realizes cancellation of indebtedness of $2.5 million (adjusted issue price of the reacquired bonds ($10 million) minus the $7.5 million issue price of the Note). If X does not elect to defer recognition of the cancellation of indebtedness income, it will (absent any statutory exceptions such as insolvency) recognize the $2.5 million of taxable income in its taxable year ended June 30, 2010, and, in each taxable year through maturity of the Note, will be entitled to interest deductions for the 5% stated interest and for the taxable year's ratable portion (determined under §1272) of the original interest discount.

If X elects to defer recognition of the cancellation of indebtedness income: (i) it will recognize $500,000 ($2.5 million ÷ 5 years) of the cancellation of indebtedness income in each of its tax years ended June 30, 2015, 2016, 2017, 2018, and 2019;[931] (ii) for its tax years ended June 30, 2010 through 2014, X will be entitled to interest deductions for the note's stated interest of 5% but not for the year's ratable portion of the original issue discount; and (iii) for each taxable year in the recognition period, X will be entitled to interest deductions (x) for the 5% stated interest, (y) for the taxable year's ratable portion of the original interest discount, and (z) for 20% of the ratable portion of the original issue discount attributable to the deferral period.

Note: Both the deferral and the recognition periods are measured by tax years, not calendar or 12-month fiscal years. Accordingly, a short taxable year during the deferral period will accelerate the beginning of the recognition period and a full 20% of the cancellation of indebtedness income must be included in any short taxable year occurring during the recognition period.

C. Equity for Debt

Before 1984, the tax consequences to a corporation of satisfying its debt by issuing stock to the creditor were governed by a body of case law that held that there was no cancellation of indebtedness income because the creditor was continuing his investment albeit in another form.[932] Code provisions enacted in 1984 provided that, as a general rule, such a transaction would be treated as though the corporation had satisfied its debt for an amount equal to the fair market value of the stock; however, exceptions to the general rule provided that at least some transactions occurring in a bankruptcy case or involving an insolvent debtor continued to be governed by the case law.[933] The last of the exceptions for bankruptcies and insolvent debtors were eliminated for stock transfers after 1994.[934]

The tax consequences of a partnership's transferring a capital or profits interest in the partnership to a creditor in satisfaction of its debt were unclear. Prior to 1984 would such a transaction have been entitled to the same case law equity for debt exception available to corporations? If so, what was the effect of the statutory changes that overruled the case law with respect to corporations but was silent as to the tax treatment of partnerships?[935] In 2004, the Code was amended to eliminate this uncertainty. A debtor partnership which transfers a profits or capital interest to a creditor in satisfaction of its indebtedness on or after October 22, 2004, is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the transferred partnership interest.[936]

For a complete discussion of the repeal of the stock-for-debt exception, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

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[926] §108(i)(2)(A). Reg. §1.108(i)-0(a)(12) (defining "deferred OID deduction"), §1.108(i)-1(b)(4), §1.108(i)-2(a).

[927] §108(i)(3). Reg. §1.108(i)-0(a)(2) (defining "applicable debt instrument").

[928] §108(i)(5)(D). Reg. §1.108(i)-1(b) (C corporations), §1.108(i)-2(b)(6) (partnerships), §1.108(i)-2(c)(3) (S corporations).

[929] §108(i)(5)(A); Reg. §1.108(i)-0(a)(26) (defining "reacquisition").

[930] §1273(b)(3).

[931] Because the reacquisition occurred in calendar year 2009, the recognition period begins with the fifth taxable year following X's taxable year (YE 6/30/10) in which the reacquisition occurred. Had the reacquisition occurred on January 15, 2010, the five-tax-year recognition period would have begun in X's tax year ended June 30, 2014, the fourth taxable year following X's taxable year (YE 6/30/10) in which the reacquisition occurred.

[932] *E.g., Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946).

[933] §108(e)(8), §108(e)(10) before amendment by Pub. L. No. 103-66 §13226(a)(1).

[934] §108(e)(8).

[935] See S. Rep. No. 192, 108th Cong., 2nd Sess. 179 (2004). For a discussion of whether a partnership interest-for-debt exception to COD income existed before the 2004 amendment to §108(e)(8), see "American Jobs Creation Act Addresses Exchanges of Partnership Debt for Equity But Creates Ambiguity Regarding Prior Law," 21 *Tax Mgmt. Real Est. J.* 46 (Feb. 2, 2005).

[936] §108(e)(8); *see also* Prop. Reg. §1.108-8, §1.721-1(d) and the preamble REG-164370-05, 73 Fed. Reg. 64903 (Oct. 31, 2008) (if certain conditions met, fair market value equals increase in liquidation value (generally increase in capital account), otherwise fair market value determined based on all facts and circumstances; §721 precludes creditor recognizing loss on excess of basis in debt over value of partnership interest received; basis in debt becomes basis in partnership interest).

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