Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-811-00
REGole

date: JUN 09 2000

to: District Director, Brooklyn District
Attn: R.A. Isaac Wachsman (E:1013)

from: District Counsel, Brooklyn

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subject: [redacted]
EIN: [redacted]

This is in further response to your request for advice as to whether the subject taxpayer is entitled to a claimed bad debt loss. Under routine Counsel procedures, we forwarded this case to our National Office for their review of the conclusions rendered in our memorandum dated May 12, 2000.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

We are enclosing a copy of the Informal Field Assistance dated June 1, 2000 which was drafted by the National Office. The memorandum indicates that the National Office generally concurs with the conclusions reached by our office that the taxpayer has not established that its purported debt was partially worthless in [redacted]. However, the National Office recommends additional consideration of whether the purported debt is bona fide. The memorandum contains additional legal authority and details the factors relevant to the debt-equity analysis.

If you have any questions, please call Rose Gole at (516) 688-1739. If we do not hear from you within one week, we will close our file in this case.

JODY TANCER
Acting District Counsel

By: Rose E. Gole
ROSE E. GOLE
Attorney

Attachment: As stated.

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subject: [redacted]
EIN: [redacted]

This is in response to your request for advice as to whether the subject taxpayer is entitled to a claimed bad debt loss. The taxpayer alleges that a loan to its subsidiary became partially worthless as a result of a decline in the value of real estate held by its subsidiary.

DISCLOSURE STATEMENT

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FACTS

The facts in [redacted], as we understand them, were as follows: The taxpayer, [redacted] (hereafter referred to as [redacted]"), owned [redacted]% of the stock of its subsidiary [redacted], (hereafter "[redacted]")." [redacted] was a [redacted]% partner in [redacted], referred to as "[redacted]." [redacted], an unrelated third party, was the other [redacted]% investor in [redacted].

[redacted] is a partnership which owned land in [redacted] for development and resale. [redacted] extended loans to its subsidiary which in turn loaned money to [redacted] for land development. [redacted] has not been successful. The real estate market in [redacted] was in decline. In addition, higher order zoning which would have allowed for the development of residential units on the [redacted] properties was declared null and void in [redacted]. According to the taxpayer's [redacted] appraisal, the ruling with respect to the zoning was subject to appeal. [redacted] lacked sufficient cash flow to repay its loans as a result of the reduced sales of plots in [redacted]. The partners of [redacted] purportedly tried to sell their interest since the business was not profitable.

The partners obtained an appraisal of [redacted]'s real estate holdings. The appraisal assumed that the zoning nullification would be upheld. In addition, phase [redacted] of the property was discounted by [redacted]%. We do not know if this discount is reasonable. The appraisal concludes that the fair market value of the subject property was $[redacted]. Its book value was $[redacted]. [redacted] wrote down its assets by $[redacted] ($[redacted] -$[redacted] = $[redacted] the difference between the purported fair market value and the book value of its assets) in [redacted] based on the appraisal. [redacted] reduced the value of its loan receivables form [redacted] in the amount of $[redacted], or [redacted]% of the reduction in the value of the [redacted] assets. [redacted] in turn wrote-off its correlative portion of the loan due from [redacted].

DISCUSSION

I.R.C. § 166(a)(2) provides generally that, "When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." The literal language of the code states that the Secretary "may" allow a deduction. Therefore, the Court has interpreted I.R.C. § 166(a)(2) to confer "some measure" of discretion upon the Service in determining whether a debt shall be determined to be worthless. Thompson v. Commissioner, T.C. Memo. 1983-81, citing, Mayer Tank

Manufacturing Co. v. Commissioner, 126 F. 2d 588 (2d Cir. 1942). To overcome respondent's determination, a taxpayer must show that respondent acted so unreasonably or arbitrarily as to amount to an abuse of his discretion. Sika Chemical Corp. v. Commissioner, 64 T.C. 856, 863 (1975); Bullock v. Commissioner, 26 T.C. 276 (1956). The unsupported representation of a taxpayer that a debt is worthless is not proof of worthlessness. Dustin v. Commissioner, 53 T.C. 491 (1969).

Based on the facts as we understand them to be, the taxpayer could not demonstrate that its loans to [redacted] through [redacted] were partially worthless in [redacted] because no identifiable event occurred demonstrating worthlessness. In addition, the amount of any purported worthlessness can not be determined with reasonable specificity.

Furthermore, since [redacted], [redacted], and [redacted] are related parties, the taxpayer is held to high level of proof. "When the parties are not dealing at arms' length and the creditor stands to benefit from the cancellation, the worthless must be clearly established." Roth Steel Tube Company 620 F.2d 1176 (6th Cir. 1980). Since [redacted], [redacted] and [redacted] are all related parties, this taxpayer should be subject to a high degree of scrutiny.

There is no fixed formula for determining the year in which a deductible loss was sustained. Worthless, or partial worthless, is a question of fact requiring an examination of all the circumstances. Lucas v. American Code Co., 280 U.S. 445 (1930); Boehm v. Commissioner, 326 U.S. 287 (1945). The date of worthlessness is fixed by identifiable events which form the basis of reasonable grounds for abandoning hope for the future. Joyce v. Gentsch, 141 F. 2d 891 (1944); United States v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927). Dallmeyer v. Commissioner, 14 T.C. 1282 (1950); Estate of Pachella v. Commissioner, 37 T.C. 347 (1961).

The facts presented to our office and contained in the taxpayer's memorandum to Agent Wachsman do not allude to any identifiable event rendering the obligations worthless. It appears that the taxpayer relied upon an appraisal which reduced the fair market value of the [redacted] property. The solicitation of the appraisal is not an identifiable event for purposes of determining partial worthlessness. For example, in Post v. Commissioner, T.C. Memo. 1979-419, the Tax Court concluded no identifiable event occurred which established the worthlessness of a debt to the developer of a hotel since the hotel remained open for several years, construction continued, and the developer had not abandoned hope of making a profit. The taxpayer's

memorandum does not imply that [redacted] ceased its plans to develop the [redacted] property.

The taxpayer claims that the local real estate market was depressed. In addition, the taxpayer's appraisal alludes to a change in the available zoning for the [redacted] property which could substantially undermine the possibility of developing a portion of the [redacted] property. However, it appears that the zoning determination was being appealed in [redacted] when the appraisal was prepared. In addition, there is no indication that the local real estate market was in a permanent state of decline. It would be premature for the taxpayer to determine that [redacted]'s debt obligation was partially worthless prior to the conclusion of the zoning proceedings. Likewise, the taxpayer should not be afforded an opportunity to partially write-off the debt based on a temporary depression of the real estate market. While the tax law does not require the taxpayer to be an "incorrigible optimist," requiring clearly identifiable events discourages the "premature pessimist." United States v. S. S. White Dental Manufacturing Co., 274 U. S. 398 (1927); Winn v. Commissioner, T.C. Memo. 1975-213.

We recommend that you request the taxpayer to produce additional information regarding [redacted]'s efforts to sell and develop its properties, as well as information pertaining to the change in zoning. Absent additional information, the taxpayer has not sufficiently demonstrated that an identifiable event has occurred which renders it unlikely that the corporation will be repaid.

We also do not believe that the appraisal can be used to sustain the taxpayer's burden of introducing evidence which establishes that the amount the obligation was rendered partially worthless could be predicted with "reasonable certainty." Trinco Industries, Inc. v. Commissioner, 22 T.C. 959, 965 (1954). The sole basis for determining the amount of the obligations' purported worthlessness is the representations regarding the decrease in the fair market value of [redacted]'s assets. The appraisal's conclusions should not be assumed to be reliable. Moreover, even if correct, a reduction in the fair market of [redacted]'s assets does not demonstrate that [redacted] could not satisfy its debt obligation. Compare IDI Management Inc. v. Commissioner, T.C. Memo. 1977-369. (Taxpayer deducted as a partially worthless debt the difference between the face value and the fair market value of notes where the Service stipulated to the reduction and the fair market value of the notes).

The only other evidence pointing to the alleged partial worthlessness of [redacted]'s debt is the taxpayer's representation that

[redacted] lacked sufficient cash flow to repay its loans because of a decline in lot sales. However, a debt is not worthless for tax purposes even if the debtor is technically insolvent, particularly if the debtor continues to operate as a going concern. Roth Steel Tube Company 620 F.2d 1176 (6th Cir. 1980), aff'g 68 T.C. 213; Bullock v. Commissioner, 26 T.C. 276 (1956). Moreover, worthlessness is not demonstrated by a reduction in a debtor's balance sheet position. A taxpayer is required to show some severe, permanent reduction in the debtor's ability to generate the future income from which the debt could be repaid. Sika Chemical Corp. v. Commissioner, 64 T.C. 856 (1975). No such drastic event has occurred which would permanently jeopardize [redacted]'s income producing potential.

You have not asked our office to opine on the issue of whether the underlying debt obligation between [redacted] and the taxpayer is bona fide. However, we recommend that you further consider the facts relevant to a determination of whether the underlying debt should be characterized as a capital contribution. The pertinent regulations provide that only a bona fide debt qualifies for purposes of section 166. "A gift or contribution to capital shall not be considered a debt for purposes of section 166." Treas. Reg. § 1.166-1(c); American Underwriters, Inc. v. Commissioner, 97 T.C. 579, 602 (1996). Where a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction generally amounts to a contribution to the capital of the corporation. Bratton v. Commissioner, 217 F.2d 486 (1984).

Our office has not been provided with sufficient information to consider the issue of whether the purported debt should be treated as a capital contribution. However, if you wish further assistance on the issue, please contact Rose Gole at (516) 688-1702.

You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this opinion to the National Office for review. That review might result in modifications of the conclusions herein. We will inform you of the result of the review as soon as we hear from the National Office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary. Therefore, we request that you contact our office before relying on the conclusions, set forth above.

JODY TANCER
Acting District Counsel

By: _____
ROSE E. GOLE
Attorney