Office of Chief Counsel
Internal Revenue Service

memorandum

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DRSmith

date: August 7, 2002

to: Shirley Tootle, Revenue Agent, LMSB Group 1717, Miami POD

from: Associate Area Counsel, LMSB, Miami, FL

subject: [redacted]
TIN: [redacted]

This memorandum responds to your request for assistance in this case. This memorandum should not be cited as precedent.

This memorandum constitutes nondocketed significant advice, which is subject to a 10-day post-review in the Office of Chief Counsel. Please do not take any action to implement this advice until at least the expiration of this 10-day period.

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INDUSTRY COUNSEL COORDINATION

This advice was coordinated with [redacted] IC [redacted].

ISSUE

Whether the taxpayer, [redacted], is entitled to a $[redacted] bad debt deduction in the tax year [redacted] on a note or debt owed to it by its subsidiary, [redacted]? This necessitates the following inquiries: whether the purported debt was in fact debt or an equity investment, and if it was in fact debt, whether the debt became worthless.

CONCLUSION

We think that the $[redacted] represented equity, not debt. Also, we think that, even if the $[redacted] represented bona fide debt, it had not become worthless during the taxable year [redacted].

FACTS

[redacted] ("[redacted]") is a subsidiary of [redacted], a United States corporation which is in turn owned by two British corporations, [redacted] ([redacted]%) and [redacted] ([redacted]%). [redacted] was formed in [redacted], to be a holding company for [redacted] businesses in the United States. On [redacted], [redacted] entered into an agreement to acquire [redacted] ("[redacted]"), which operated several [redacted] establishments, including a [redacted] in [redacted] and a [redacted] in [redacted]. The agreed purchase price was $[redacted]. The transaction was made subject to [redacted] and its officers receiving licensing approval from the [redacted] to operate a [redacted] business within that state.

[redacted] ("[redacted]") was incorporated on [redacted]. It was wholly owned by the British parent corporation, [redacted]. Its officers and managers were the same as those of [redacted]. Two days later, on [redacted], [redacted] assigned this $[redacted] agreement to [redacted]. It appears that, in [redacted], the [redacted] approved the [redacted] license application. The taxpayer states that, on [redacted], [redacted] loaned to [redacted] the funds with which to make the purchase. On [redacted], [redacted] completed the $[redacted] purchase of [redacted].

On [redacted], [redacted]'s parent, [redacted], a U.S. taxpayer, acquired [redacted] (and thus [redacted]) from [redacted] for $[redacted]. Per the taxpayer, this transaction was necessitated by the fact that, as of [redacted], the officers of [redacted] ([redacted]'s parent) had not yet received licensing approval from the [redacted]. So these officers resigned, and were replaced by [redacted]'s officers, who had previously been approved in [redacted]. Now, with its [redacted] acquisition of [redacted], [redacted] could legally operate [redacted] businesses in [redacted]. On [redacted], the debt owed by [redacted] to [redacted] became intercompany debt, since [redacted] was now the common parent of both [redacted] and [redacted]. Per Treas. Reg. § 1.1502-13(g)(4), the taxpayer contends that, on [redacted], the debt from [redacted] to [redacted] was deemed satisfied (paid) and a new debt issued to [redacted]

on that date, equal to the fair market value of the old debt, which the taxpayer valued at -0-, based upon its assertion that, at that time, [redacted]'s liabilities exceeded its assets.

No payments of principal or interest were made on the "debt" owed by [redacted] to [redacted], and later to [redacted]. In response to an IDR, the taxpayer provided to the agent a "loan agreement" between [redacted] and [redacted] which stated that [redacted] would extend a loan or line of credit to [redacted] of up to $[redacted] for a period from [redacted] to [redacted]. During that period, [redacted] was to draw upon this line of credit in increments of at least $[redacted]. The agreement appears to have been signed on [redacted], bearing a handwritten notation of "[redacted]" under the signature on behalf of [redacted]. A general ledger provided by the taxpayer showed that, on [redacted], the day before [redacted] acquired [redacted], the balance due on [redacted]'s obligation to [redacted] was $[redacted]. This is the amount of the bad debt deduction claimed by [redacted] for the tax year [redacted].

The taxpayer has stated that, several months later, in [redacted], it sold [redacted] back to [redacted] for $[redacted]. According to the taxpayer, there had been "poor results" at these businesses, and the management officials had been terminated. This meant that [redacted] no longer had any officers licensed to operate a [redacted] establishment in the State of [redacted]. These [redacted] businesses generally continued operations for several more years, until the former [redacted] business assets were sold in [redacted] for a price of $[redacted]. The taxpayer has acknowledged, in hindsight, that the [redacted] businesses formerly owned by [redacted] had some value after [redacted]. Specifically, it has acknowledged that the [redacted] in [redacted], had a value of $[redacted] at that time, such that the claimed bad debt deduction should be reduced by that amount. The taxpayer says it ceased operations at the [redacted] in [redacted].

LEGAL ANALYSIS

(1) Was the $[redacted] "loaned" by [redacted] to [redacted] debt or an equity investment?

The $[redacted] represented the amount [redacted] was going to pay to acquire [redacted] and the businesses it operated, clearly a capital or equity investment by [redacted]. Prior to closing on the purchase, [redacted] loaned [redacted] the funds to make the purchase, thereby attempting to convert a $[redacted] equity investment into a $[redacted] note receivable owed to it by [redacted]. To make this happen, [redacted]

[redacted]'s U.S. parent, acquired [redacted] for $[redacted] to bring it into the consolidated group and convert the "debt" to intercompany debt. Three months later, with the acquisition of [redacted] having served its purpose, [redacted] sold it back to [redacted] for $[redacted].

It has been said that the ultimate question is whether an investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or whether it represents a strict debtor-creditor relationship. Fin Hay Realty Co v. United States, 398 F.2d 694 (3rd Cir. 1968). The Tax Court has framed the question as whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship? Litton Business Systems, Inc., 61 T.C. 367 (1973). There are a number of factors to consider in making a debt vs. equity determination. Per the decided cases, these factors include, not in any particular order:

(1) whether there was identity of interest between creditor and stockholder;

(2) whether the debtor corporation was thinly capitalized;

(3) whether the instrument was called debt or stock;

(4) whether the instrument had a fixed maturity date;

(5) whether interest was stated at a fixed rate and whether repayment was unconditionally required;

(6) whether the instrument was subordinated to the claims of other creditors;

(7) whether the parties to the transaction treated the instrument as debt or equity on their books;

(8) whether the parties intended to create debt or equity;

(9) whether the instrument was issued to acquire the essential operating assets of the business;

(10) whether the rights that are usually available to a creditor were available to the holder of the note;

(11) whether the debt would be repaid only out of profits;

(12) whether the holder enforced its rights as a creditor;

(13) whether the holder gained the right to participate in management as a result of making the advances;

(14) whether the debtor had the ability to obtain loans from outside lending institutions;

(15) whether the issuer had defaulted on other obligations at the time the instrument was issued; and

(16) whether repayment was secured.

See, Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); Anchor National Life Insurance Co. v. Commissioner, 93 T.C. 382 (1989); American Offshore Inc., v. Commissioner, 97 T.C. 579 (1991); Flint Industries, Inc., and Subsidiaries, v. Commissioner, T.C. Memo 2001-276.

The analysis is as follows:

(1) In this case, there was an identity of interest between the holder of the note and the sole shareholder. After acquiring [redacted], [redacted] owned both [redacted] (the holder) and [redacted] (the debtor). Loans or advances made by a sole shareholder, or successor in interest, are indicative of an equity investment.

(2) There is no evidence to indicate that [redacted] was capitalized in any amount beyond the $[redacted] assigned to it by [redacted] to acquire the [redacted] businesses. This is clearly indicative of an equity investment.

(3) The instrument was labeled a "loan agreement", indicating that it was debt. But it should be pointed that this loan agreement was not drafted until well over a year after the alleged debt was made, thus seriously calling its credibility into question.

(4) The purported loan agreement did have a fixed maturity date of [redacted], indicating debt. But again it must be noted that the note was not created until well after the fact, and that no payments of principal or interest were ever made.

(5) Under the terms of the note, interest was stated at a variable but determinable rate, and interest payments were due to be made quarterly, with the entire balance of the note due on the maturity date. Again, this factor would be indicative of debt, if it were not for the fact that the note itself seems to have been a mere afterthought.

(6) The instrument does not state whether the debt will be

subordinated to the rights of other creditors, so this factor appears to be neutral. But failure to demand repayment has been said to effectively subordinate intercompany debt to the rights of other creditors.

(7) [redacted] treated this as debt on its books, as per the general ledger mentioned above.

(8) In the loan agreement, the parties stated their intent to create debt. But in light of the after-the-fact creation of the loan agreement, it is highly questionable whether the parties intended to create bona fide debt.

(9) The instrument or indebtedness was used to acquire the operating assets of the businesses, highly indicative of a capital investment.

(10) There was an acceleration clause and a "no assignment without written consent" clause. Other than that, the holder had no other rights which are usually available to creditors in such situations. It should be pointed that the holder did not invoke the acceleration clause, even though no payments on the loan were ever made.

(11) There was no provision in the loan agreement which specified that repayments would only be made out of profits. But since no repayments were made, this factor is neutral.

(12) The holder did not enforce its rights as a creditor, indicative that this was not bona fide debt but equity.

(13) The holder ([redacted]'s) officers and the debtor ([redacted]'s) officers were already the same individuals, a fact tending to indicate an equity investment, since advances made by a sole shareholder are likely to be committed to the risks of the business.

(14) It appears highly unlikely that [redacted], a newly created entity with no apparent capital other than the $[redacted] advanced by [redacted] and no business activity other than acting as a holding company for assets formerly owned by [redacted], could have borrowed funds from outside lenders.

(15) There is no indication that [redacted] had any other debt, so this factor is neutral.

(16) Repayment was not secured, such that this factor tends to indicate an equity investment.

Based upon the above analysis, we think that the $[redacted] ostensibly owed to [redacted] by [redacted] was not bona fide debt, but equity. It was clearly a capital investment when originally expended by [redacted] as the purchase price to be paid for the [redacted] businesses. [redacted] then utilized the [redacted] transaction, in which it acquired [redacted] for the nominal sum of $[redacted], to buy itself a $[redacted] bad debt writeoff. Once satisfied that this had been accomplished, by legal operation of the regulations under I.R.C. Sect. 1502, it sold [redacted] back to the same party from whom it had been acquired, for the same nominal sum of $[redacted]. Another fact that should not be overlooked is that [redacted] and [redacted], while not directly related, are both part of the international [redacted] conglomerate. There is really no economic substance to the [redacted] transaction, and the reverse sale of [redacted] back to [redacted] several months later.[1]

A clear majority of the sixteen factors, when applied to the facts in this case, indicate that the funds advanced by [redacted] to [redacted] were an equity investment rather than debt. Most of the remaining factors are either neutral or tend to indicate equity. In our opinion, the factors that relate to the loan agreement should not be accorded much weight because of the fact that the agreement was not drawn up until well after the transaction had taken place.

We think that several of the factors are particularly significant here, and should be accorded additional weight. They are the fact that the holder of the note was also the sole shareholder of the debtor, the fact that the loan agreement document was not created until [redacted], the fact that [redacted] was a holding company with no capital structure, the fact that no payments were ever made on the alleged debt, and the fact that the funds advanced by [redacted] to [redacted] were for the sole purpose of acquiring the business assets of [redacted].

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[1] Applying the step transaction doctrine here would arguably justify disregarding the [redacted] acquisition of [redacted] by [redacted] for $[redacted], and the subsequent resale, also for $[redacted], as steps having no economic reality or substance, and no purpose other than to avoid federal income taxes. This would preclude the conversion of any "debt" owed by [redacted] to [redacted] to intercompany debt. See, True v. United States, 190 F.3d 1165 (10th Cir. 1999); Penrod v. Commissioner, 88 T.C. 1415 (1987).

(2) If the $[redacted] is ultimately found to be debt, what was the fair market value of the debt owed by [redacted] to [redacted] on [redacted]? Under I.R.C. § 166, was the debt worthless?

I.R.C. § 166 permits a taxpayer to deduct any debt that becomes worthless within the taxable year for which the deduction is claimed. Business bad debts are deductible as ordinary losses to the extent of the taxpayer's adjusted basis in the debt. I.R.C. Sect. 166(b). To obtain such a deduction here, [redacted] must establish that a bona fide debt existed between [redacted] (creditor) and [redacted] (debtor) to pay a fixed or determinable sum of money, that the debt was created or acquired in connection with [redacted] trade or business, and that the debt became worthless in the year for which the deduction was claimed ([redacted]).

Even if, for purposes of this analysis, the $[redacted] owed by [redacted] to [redacted] is found to be debt rather than equity, and after recognizing that such debt arose in connection with the taxpayer's trade or business, the determination must be made as to whether the debt became worthless during the taxable year [redacted]. On this point, the taxpayer maintains that, since [redacted] was already its wholly owned subsidiary, and since it acquired [redacted] on [redacted], the debt owed by [redacted] to [redacted] became intercompany debt on that date. Therefore, says the taxpayer, under the applicable regulations, Treas. Reg. § 1.1502-13(g)(4), the debt from [redacted] to [redacted] was deemed satisfied on that date, and a new debt issued based upon the fair market value of the old debt on that date. Per the taxpayer's general ledger, the amount of the debt was $[redacted] on [redacted]. According to the taxpayer, on that date, [redacted]'s liabilities exceeded its assets, with the result that [redacted] was insolvent, and the fair market value of its debt to [redacted] was -0-. However, there are serious flaws in the taxpayer's reasoning, as will be explained below.

I.R.C. § 166(a) allows a deduction for a debt which becomes worthless within the taxable year. The regulations say only that "all pertinent evidence" will be considered in determining whether a debt is worthless. Treas. Reg. § 1.166-2(a). A determination of worthlessness requires proof by the taxpayer that the debt became worthless in whole or in part during the year for which the deduction is claimed. Boehm v. Commissioner, 326 U.S. 287 (1945). The taxpayer must establish that the debt had some value at the beginning of the year, and that something occurred during the year that caused it to abandon any hope or expectation that it would have some value at some future time. Steadman v. Commissioner, 50 T.C. 369 (1968), aff'd., 424 F.2d 1 (6th Cir. 1970), cert. denied, 400 U.S. 869 (1970).

A taxpayer generally meets this burden by showing some "identifiable event" which occurs during the tamable year and which clearly establishes the time the debt became worthless. This could be, for example, a bankruptcy filing, or the entry of a court judgment which cannot possibly be satisfied. Sometimes, this can be a series of events which in the aggregate present a picture which establishes that the debt has become worthless. Dustin v. Commissioner, 53 T.C. 491 (1969), aff'd., 467 F.2d 47 (9th Cir. 1972). The regulations also state that a bad debt deduction is warranted if the surrounding 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. Treas. Reg. § 1.166-(2)(b).

Based upon the above authorities, we think that some of the facts that indicate that the debt did not become worthless during the year [redacted] are: (1) [redacted] carried on business operations after [redacted]; (2) [redacted] still had valuable business assets after [redacted]; (3) [redacted] made no effort to collect on the loan agreement; (4) [redacted] made no effort to exercise any rights it had as a creditor under the agreement; (5) there was no bankruptcy filing by [redacted] or appointment of a receiver; (6) by any objective analysis, it would appear that [redacted] had some hope of recovery under the loan agreement after the end of the year [redacted]; and (7) since [redacted] and [redacted] were both under the [redacted] corporate umbrella, extra scrutiny was warranted here before it could be concluded that the debt had become worthless.

Moreover, the mere fact that a debtor's liabilities may exceed its assets on a given date does not necessarily mean that the debtor is insolvent on that date, or that its obligations can be written off as worthless. Trinco Industries, Inc., v. Commissioner, 22 T.C. 959 (1954). Evidence of insolvency based upon the books does not establish worthlessness of debts where the debtor continues to actively conduct business. Cimarron Trust v. Commissioner, 59 T.C. 195 (1972); Trinco Industries v. Commissioner, supra; Del Norte Natural Gas Co. v. Commissioner, T.C. Memo 1983-454; Book Production Industries, Inc., v. Commissioner, T.C. Memo 1965-65.

For the foregoing reasons, even if the "obligation" owed by [redacted] to [redacted] was bona fide debt, the debt had some value on [redacted], the date on which it became "intercompany debt", and, therefore, was not worthless. Thus, under Treas. Reg. § 1.1502-13(g)(4), since the debt was deemed satisfied on that date, and a new debt issued based upon the fair market value of the old debt, the new debt also had value, and was not worthless.

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