Successful Debt Restructuring (Part II of II)

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The first part of this article, found in M&A Tax Report, Nov. 2006, at 4, laid the groundwork for a messy transaction.

The bad debt issue in this case arose in a fast-paced and changing business environment. While the management group made what it thought to be the best business decisions under the circumstances at the time, exigent circumstances beyond the management group's control caused it not to be able to achieve its goals.

Interestingly, the IRS did not challenge the substance of the transaction. In fact, it agreed with the taxpayer that Properties' purchase of the bottling facilities from CPA7 was not motivated in any significant way by tax considerations, and that Bottlers and Properties were not related parties. If Bottlers and Properties had been related parties, this would surely have made it more difficult for BevAm to claim the deduction.

The parties asked the court to decide whether ABC was entitled to deduct the debt because it was worthless. Yet, more broadly speaking, the court had to decide whether a creditor can deduct a bad debt if the creditor's actions contributed to the debtor's default. This broader question is of great interest, since creditors often contribute to a debtor's demise.

General Rules Under Code Sec. 166

Whether a debt has become partially worthless is a facts-and-circumstances determination. [Code Sec. 166(a)(2); Reg. §1.166-2(a).] A taxpayer can establish worthlessness by showing that a debt has neither current nor potential value. [*H.W. Dustin*, 53 TC 491, 501, Dec. 29,900 (1969), *aff'd*, CA-9, 72-2 USTC ¶9610, 467 F2d 47 (1972).]

Although the IRS's determination is generally presumed to be correct, the IRS must reasonably exercise his discretion. [*E. Brimberry*, CA-5, 79-1 USTC ¶9187, 588 F2d 975, 977 (1979), *aff'g*, 35 TCM 900, Dec. 33,908(M), TC Memo. 1976-209; *Portland Mfg. Co.*, 56 TC 58, 72, Dec. 30,729 (1971), *aff'd on other grounds*, CA-9, 75- 1 USTC ¶9449 (1975).] The IRS's exercise of discretion regarding a bad debt should not be reversed unless it is plainly arbitrary and unreasonable. [*Ark. Best Corp. & Subs.*, CA-8, 86-2 USTC ¶9671, 800 F2d 215, 221 (1986), *aff'g in part and rev'g in part*, 83 TC 640, Dec. 41,581 (1984), *aff'd on other grounds*, SCt, 88-1 USTC ¶9210, 485 US 212, 108 SCt 971 (1988); *Brimberry, supra; H.W. Findley*, 25 TC 311, 318, Dec. 21,348 (1955), *aff'd*, CA-3, 56-2 USTC ¶9960, 236 F2d 959 (1956).]

Whether a bad debt deduction is proper must be analyzed according to "reasonableness, commonsense and economic reality." [*Scovill Mfg. Co. v. Fitzpatrick*, CA-2, 54-2 USTC ¶9568, 215 F2d 567, 570 (1954) (quoting *I.F. Belser*, CA-4, 49-1 USTC ¶9269, 174 F2d 386, 390 (1949), *aff'g*, 10 TC 1031, Dec. 16,425 (1948)).] In addition, the IRS's discretion is not absolute, and he cannot ignore the sound business judgment of a corporation's officers. [*Portland Mfg., supra* at 73 (upholding a partially worthless debt deduction where corporate officers concluded that the debtor had no value as a going concern, and the corporation could recover only the value of the debtor's assets).]

All pertinent evidence must be considered in determining worthlessness. [*See* Reg. §1.166-2.] The evidence to be considered includes the value of the collateral securing the debt and the financial condition of the debtor. Legal action to enforce payment is not required where the surrounding circumstances indicate that a debt is worthless, and legal action would probably not result in satisfactory relief. A debt has been found not to be worthless where the debtor is a going concern with the potential to earn a future profit. [*H.M. Liggett Est.*, CA-10, 54-2 USTC ¶9659, 216 F2d 548, 549–50 (1954).]

Identifiable Events

The key to claiming a bad debt deduction is for the taxpayer to show that *identifiable events* occurred to render the debt worthless during the year in which the taxpayer claimed the deduction. [*Am. Offshore, Inc.*, 97 TC 579, 593, Dec. 47,750 (1991).] There is no succinct definition of what constitutes an identifiable event, and countless taxpayers have litigated this issue. Some objective factors include declines in the value of property securing the debt; the debtor's earning capacity; events of default; the obligor's refusal to pay; actions the obligee took to pursue collection; subsequent dealings between the obligee and obligor; and the debtor's lack of assets. No single factor is conclusive.

Returning to *ABC Beverage*, the court found that ABC showed that a series of specific, identifiable events occurred during 1995 that, when taken together, rendered the Properties loan worthless. The most important of these events was the failure of the expected source for repayment of the Properties loan: the G&K purchase. Bottlers anticipated that Properties would own the bottling facilities for only a short time while G&K prepared to buy them. When G&K could no longer buy the facilities, the structure became untenable.

Another event that contributed to the worthlessness of the Properties loan was the failure of the zero cashflow transactions. For valid business reasons, Bottlers opted not to pay Properties a portion of the rent. This in turn rendered it impossible for Properties to pay Bottlers the principal on the loan. Although the IRS argued that there was no evidence that Bottlers failed to pay Properties the full amount of rent due on the lease, the court disagreed.

ABC introduced Properties' accounting records that Bottlers did not pay the full amount of rent for 1994 and 1995. Moreover, the zero cashflow plan was flawed. According to the court, if Bottlers paid Properties the full amount of rent, Properties eventually might not have had sufficient cash to pay Bottlers the principal on the Properties loan. After all, Properties then might be required to pay taxes on the rental income it received from Bottlers, thus depleting its cash. This cash depletion was precisely what the management group was attempting to avoid by having Bottlers pay Properties only a portion of the rent due.

Another key event was that soon after Bottlers learned that G&K would not be able to purchase the facilities, Bottlers combined with Brooks to become BevAm, and the Properties structure was no longer necessary. Finally, an appraisal revealed the bottling facilities were worth just under $8 million. Taken together, these specific, identifiable events combined to result in the worthlessness of the Properties loan in 1995.

Future Value

The IRS argued that Properties was a going concern with potential value in 1995, and therefore that the Properties loan was not partially worthless during that year. [*See H. Crown*, 77 TC 582, Dec. 38,251 (1981); *Findley*, *supra,* 25 TC, at 318.] Properties had sufficient income and/or sufficient assets to satisfy its loan obligations, according to the IRS. The IRS set forth several ways in which Properties could have met its obligations.

For example, it argued that Properties could have exercised its rights under the lease to cause Bottlers to buy the bottling facilities when Bottlers failed to pay the full amount of rent. Properties could have found another third party to buy the bottling facilities, the IRS argued. Yet, the IRS's focus on the theoretical possibilities that might occur did not give sufficient credence to the realities of the business environment. [*See Portland Mfg. Co.*, *supra,* 56 TC, at 72.] One of the IRS's theoretical suggestions was that Properties should have caused Bottlers to buy the bottling facilities once Bottlers failed to pay the full amount of rent.

However, that would not have been in the best interests of Bottlers, and the management group (which owed fiduciary duties to Bottlers) could not have done so. There were no other third-party buyers for the bottling facilities, although the IRS suggested other actions Bottlers should have taken to seek them. The management group searched fruitlessly for other third parties when the G&K deal collapsed.

Although the management group may have made other choices if they had the benefit of hindsight, they did what they thought was best for Bottlers based on the circumstances at the time. Properties was unable to repay the loan once G&K's financing fell through, and G&K became unable to purchase the facilities. The structure of the transactions ensured that there was no source of funds for Properties. The IRS's hypothesizing over what could or should have been done ignored the realities of the business and was unreasonable. Consequently, the court found that the IRS's determination that the Properties loan was not worthless in 1995 was arbitrary, unreasonable and an abuse of discretion. The court then ruled that the Properties loan was partially worthless in 1995.

Creditors Contribute to Worthlessness

The second issue the court considered was whether ABC could deduct the Properties loan as partially worthless despite the fact that the legitimate business decisions of taxpayer's predecessor (Bottlers) had contributed to its worthlessness. The IRS argued that Bottlers failed to pay the full amount of rent, which, in turn, caused Properties to be unable to repay the loan. Thus, it argued, ABC was not entitled to the deduction.

The court, however, was of a different mind than the IRS. It found that the fact that the taxpayer's legitimate business decisions contributed to the worthlessness of the Properties loan did not preclude the bad debt deduction. It is well settled that certain actions of a creditor preclude bad debt deductions.

For example, a taxpayer may not voluntarily release a solvent debtor and then claim a deduction for a worthless debt. [*Roth Steel Tube Co.*, CA-6, 80-1 USTC ¶9410, 620 F2d 1176 (1980), *aff'g* 68 TC 213, Dec. 34,416 (1977); *Am. Felt Co. v. Burnet*, CA-DC, 58 F.2d 530, 532 (1932), *aff'g*, 18 BTA 504, Dec. 5700 (1929).] Furthermore, a creditor who voluntarily relinquishes valuable collateral provided by a solvent debtor also may not deduct the debt as worthless. [*O'Bryan Bros.*, CA-6, 42-1 USTC ¶10,176, 127 F2d 645, 646 (1942), *aff'g*, 42 BTA 18, Dec. 11,205 (1940).] Unfortunately, these general rules did not help either side, and neither was able to point to a case directly on point.

The IRS relied on a Court of Federal Claims decision indicating that a taxpayer could not deduct a worthless debt if the taxpayer's actions, standing alone, made the debt uncollectible. [*See PepsiAmericas, Inc.*, FedCl, 2002-1 USTC ¶50,326, 52 FedCl 41 (2002).] The IRS argued that the reasoning of *PepsiAmericas* should be extended to this case. It asked the court to hold that ABC could not deduct a portion of the Properties loan as a worthless debt because Bottlers contributed to its worthlessness when it failed to pay Properties the full amount of rent.

In *PepsiAmericas*, the taxpayer made a loan to its ESOP, terminated the ESOP and then tried to deduct the amount the ESOP owed as a worthless debt. The court held the taxpayer could not deduct the amount lent to the ESOP because the taxpayer's own conduct caused the worthlessness. [*Id.*, at 48 (*citing Roth Steel Tube Co.*, *supra*, at 1181; *O'Bryan Bros., Inc.*, *supra*, at 646; and *Am. Felt Co. v. Burnet*, *supra*, at 532).]

Control and Causation

Although *PepsiAmericas* involves a worthless debt where the creditor's action contributed to its worthlessness, the court found the case was not controlling. There were significant factual differences between *PepsiAmericas* and BevAm's claiming a worthless debt deduction. Control was the first major difference. PepsiAmericas controlled the entity whose debt it caused to become worthless. In contrast, Bottlers did not control Properties. While the management group had some ownership of both entities, the parties stipulated that the entities themselves were not related. Bottlers itself could not control the decisions of Properties, alter the ownership of Properties or cause Properties to take any actions whatsoever other than under the lease and the loan.

The second major difference was the cause of the worthlessness. While PepsiAmericas terminated its ESOP and thus unilaterally caused the ESOP to be unable to pay its debts, several factors contributed to the worthlessness of the Properties loan. The key contributing factor to Properties' inability to repay the loan was G&K's failure to obtain financing. That was wholly out of the control of Bottlers. Properties anticipated that G&K would purchase the bottling facilities, but ultimately G&K could not.

While Bottlers' failure to pay the full amount of rent due contributed to the worthlessness of the loan, other factors contributed as well. Even if Bottlers had paid the full amount of the rent due under the lease, Properties still might have been unable to satisfy its obligations under the loan without a third party purchasing the bottling facilities. Properties would not be able to deduct principal payments it paid Bottlers on the loan, and thus would have more income than deductions, giving rise to an income tax liability. This liability would ruin the net zero cashflow, causing Properties to be unable to repay the loan.

These two significant differences in the *ABC* facts convinced the court that it would be inappropriate to follow *PepsiAmericas*. Not surprisingly, the IRS asked the court to articulate an absolute rule that a taxpayer may never deduct a debt as worthless if the taxpayer contributed to the worthlessness. Thankfully, the court declined to paint with such a broad brush.

In fact, the court refused to follow the IRS's arguments, and sided with the taxpayers. The court found that legitimate business decisions contributing to the worthlessness of a debt do not preclude a bad debt deduction in these circumstances. Thus, the taxpayer was able to deduct the worthless portion of the Properties loan notwithstanding the fact that Bottlers' actions contributed to its worthlessness.

Conclusion

Ultimately, ABC was unable to deduct $10 million as a worthless debt in 1995. The Properties loan was partially worthless in 1995 because identifiable events occurred during that year that made it certain that Properties would be unable to repay it. The IRS's determination to the contrary was unreasonable and an abuse of discretion. Although ABC's predecessor, Bottlers, may have contributed to the worthlessness of the Properties loan, this action did not preclude ABC from claiming a bad debt deduction where other major business factors contributed to the worthlessness.

Cases like *ABC* portray how difficult it is for taxpayers to determine whether a bad debt deduction is proper. For 50 years, the Code has relied on what is essentially a facts-and-circumstances test. Indeed, it is hard to imagine how a question as prosaic as the one addressed in *ABC* had never been addressed before.

Yet, to its credit, ABC successfully navigated this morass. Although other taxpayers will reap the benefit of ABC's successful battle, prudence suggests that we all still must be careful out there.