INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-103260-00/CC:ITA:B6

Chief, Appeals Office

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Parent =

Subsidiary =

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
Amount 12 =
Amount 13 =

A =
B =
C =
D =

E =

ISSUE:

Whether the discharge in bankruptcy of certain unsecured debt gives rise to a bad debt deduction under section 166 or whether the debt should be treated as a contribution to capital.

CONCLUSION:

Under the facts in this case, the unsecured debt discharged in bankruptcy gives rise to bad debt deduction under section 166.

FACTS:

Parent is a regulated public utility holding company. Parent is the parent corporation of an affiliated group of corporations that file a consolidated return. Subsidiary is a wholly-owned subsidiary of Parent that owns and operates a natural gas transmission pipeline and related underground gas storage fields.

Prior to 1993, Subsidiary purchased gas from producers and other pipeline companies to resell to distribution companies. To ensure a continuous supply of gas, Subsidiary entered into long-term, take-or-pay contracts with gas producers. These contracts imposed minimum gas purchase requirements on Subsidiary at fixed prices.

Thereafter, gas prices and the demand for gas declined causing Subsidiary's long-term gas contracts to become financial liabilities. Subsidiary experienced mounting financial problems, and Parent was unable to reestablish lines of credit with its major lending institutions. As a result, on July 31, 1991, Parent and Subsidiary filed voluntary petitions for bankruptcy reorganization under Chapter 11 of Title 11 of the United States Code. After filing for bankruptcy, Subsidiary, as permitted under the Bankruptcy Code, rejected a substantial number of its long-term gas contracts. The other parties to the long-term gas contracts, the producers, filed claims for rejection damages in the bankruptcy proceedings that exceeded Amount 1.

Parent provided the debt and equity financing for all of its operating subsidiaries and was the principal vehicle for raising funds in the capital markets for the group. Some of the loans that Parent made to Subsidiary were on an unsecured basis. At the time Parent and Subsidiary filed their Chapter 11 petitions, Subsidiary had unsecured debt that it owed Parent totaling Amount 2, which included accrued interest of Amount 3. Parent also made loans to Subsidiary that were secured by first mortgage liens on substantially all of Subsidiary's assets. At the time of the bankruptcy filings, Subsidiary owed Parent approximately Amount 4 on a secured basis. In the bankruptcy proceedings, Parent filed claims for the full amount of both the secured and the unsecured debt owed to it by Subsidiary.

During the bankruptcy proceedings, the producers and certain other creditors sued Parent and one of its other subsidiaries on behalf of Subsidiary. This litigation sought to recharacterize Parent's secured debt owed by Subsidiary as equity or to subordinate the debt to the claims of other creditors; to obtain the return of certain payments made by Subsidiary to Parent; and to set aside the transfer of various oil, gas, and coal properties by Subsidiary to another subsidiary of Parent allegedly for inadequate consideration at a time when Subsidiary was insolvent.

In January 1994, a plan of reorganization was filed in bankruptcy court by Subsidiary. This plan, which provided that unsecured creditors would be paid A percent of their claims, was not adopted. On its 1994 federal income tax return, Parent claimed an Amount 5 bad debt deduction, which represented the amount that Parent would have failed to recover under the plan of reorganization filed in 1994. The 1994 bad debt deduction was eliminated in the Parent group consolidated return because the consolidated return rules required the deduction to be deferred until the unsecured debt was completely discharged.

Subsequently, Parent and Subsidiary each filed final plans of reorganization that were confirmed on November 15, 1995, effective November 28, 1995. The final plans were based on an omnibus settlement proposal made by Parent that was based on Subsidiary's settlement of the long-term contract rejection claims of the producers. In the omnibus settlement, Parent agreed to assist Subsidiary to meet its obligations under the reorganization. In the settlement, Parent also agreed to receive new secured debt, in lieu of cash, in satisfaction of a portion of its secured claim against Subsidiary and to contribute the balance of its secured claim to Subsidiary's equity. In exchange, Parent was permitted to retain its equity in the reorganized Subsidiary, and various claims between Subsidiary, Parent, and Subsidiary's creditors, including intercompany claims, were settled. Parent's unsecured claim against Subsidiary was not part of the omnibus settlement proposal. It was, however, part of the final Subsidiary bankruptcy reorganization plan.

Under the final Subsidiary reorganization plan, which had to be approved by the bankruptcy court as well as Subsidiary's creditors, all secured claims, other than Parent's secured claim, were paid in full. Parent's secured claim was satisfied with new secured Subsidiary debt and retention of all of reorganized Subsidiary's equity. In addition, under the final plan unsecured claims of Amount 6 or less were paid in full, and certain customers received cash or credits.

The final reorganization plan provided that the producers with contract rejection claims and other general unsecured creditors would be entitled to B percent of their claims, provided that all such claimants accepted the terms of the final plan. If all such claimants did not accept the terms of the final plan, not less that C percent of such allowed claims would be paid.

Under the final Subsidiary plan of reorganization, Parent was permitted to receive up to the same final distribution percentage for its unsecured debt as the producers with contract rejection claims and the other general unsecured creditors, except that Parent was allowed to use any portion of its distribution to fund its obligations under the omnibus settlement.

Ultimately, Parent and the other unsecured creditors were entitled to recover D percent of their allowed claims. Parent accordingly recovered Amount 7 of its Amount 8 allowed claim.

On October 18, 1995, Parent's Board of Directors authorized the contribution of Amount 9 of Subsidiary debt owed to Parent to the equity of Subsidiary. Accordingly, Parent contributed Amount 10 of its secured Subsidiary debt to the paid-in capital of Subsidiary. Parent also contributed to Subsidiary's capital the Amount 11 balance of its unsecured Subsidiary debt, the amount remaining after reduction by the bankruptcy court. The contribution of this amount was done to permit Parent to use the balance of its unsecured claim to fund its obligations under the omnibus settlement.

For financial accounting purposes, Parent treated the Amount 12 amount discharged in bankruptcy as a bad debt.

On its 1995 consolidated federal income tax return, Parent claimed an Amount 12 bad debt deduction. Amount 5 of which was carried over from 1994 and Amount 13 of which represents additional bad debt based on the final Subsidiary plan of reorganization.

LAW AND ANALYSIS:

Section 166(a) provides that there shall be allowed as a deduction any debt which becomes worthless within the taxable year. 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. Section 166(b) provides that the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Section 1.166-1(c) of the Treasury regulations provides that only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166.

Section 1.166-2(a) states that a taxpayer is eligible to claim a bad debt deduction when the debt becomes worthless, which depends on all the facts and circumstances. Section 1.166-2(a) further provides that in determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Section 1.166-2(b) provides that where 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, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

Section 1.166-2(c)(1) provides that bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Section 1.166-2(c)(2) further provides that with respect to bankruptcy a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

Section 1.1502-14, as in effect in the years at issue, provided that a deduction because of the worthlessness of an obligation of one member of a consolidated group to another member of the group was subject to the intercompany deferral rules then in effect.

Section 1.61-12, which pertains to income from discharge of indebtedness, states that, in general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

For purposes of this technical advise request, the Parent and the Service agree that Parent’s unsecured debt is debt and not equity for federal income tax purposes. The parties further agree that if the discharge of the unsecured debt gives rise to a bad debt deduction the Amount 5 partial debt deduction was properly claimed by Parent in 1994; section 1.1505-14, as in effect during 1994 and 1995, required Parent to defer the Amount 5 bad debt deduction until 1995 when the debt was disposed of; and Parent was entitled to an additional bad debt deduction in 1995 of Amount 13 resulting in a total bad debt deduction in 1995 of Amount 12.

The central issue in this case is whether Parent gratuitously forgave a portion of the unsecured debt and should be treated as making a capital contribution of the debt to Subsidiary.

We first note that Parent, pursuant to the bankruptcy and related proceedings, made capital contributions to Subsidiary that totaled Amount 9, Amount 10 secured Parent debt was contributed to Subsidiary as additional paid-in capital and Amount 11 of the unsecured debt was similarly contributed by Parent to the capital of Subsidiary. The amount at issue in this technical advise request is the Amount 12 that Parent was unable, as an unsecured creditor, to recover in bankruptcy. Thus, the bad debt deduction at issue was approximately E percent of the total debt and equity.

Based on all the facts in this case, it is clear that Parent did not gratuitously forgive the unsecured Subsidiary debt. The bankruptcy was an adversarial proceeding in which all of the creditors, secured and unsecured, sought to recover as much as possible. The secured creditors recovered 100 percent of the debt owed to them. The unsecured creditors fared less well.

In bankruptcy, Parent was treated exactly the same as all the other unsecured creditors. Parent ultimately recovered the same percentage, D percent of its unsecured Subsidiary debt, as all the other unsecured creditors. There is no evidence that Parent did not vigorously and fully pursue the complete repayment of the unsecured Subsidiary debt owed to it.

We have carefully considered the cases cited to us by representatives of the Service and find them to be clearly distinguishable from the facts in the present case.

In Lidgerwood Manufacturing Co. v. Commissioner, 22 T.C. 1152 (1954), aff'd 229 F.2d 241 (2d Cir. 1956), the Tax Court found that a corporate parent voluntarily canceled debt owed to it by two wholly-owned subsidiaries. The court cited the fact that book adjustments were made reflecting the cancellation of indebtedness and an increase in the capital accounts, the fact that the purpose of the debt cancellation was to enable the subsidiaries to obtain bank loans that were not otherwise possible to obtain, and the fact that the parent corporation received additional stock for canceling the debt. Based on these facts, the court concluded that the cancellation of the subsidiary debt was voluntary and that "[g]ratuitous forgiveness of a debt is no grounds for a claim of worthlessness." 22 T.C. at 1157.

In Parent's case, it consistently reported the debt discharged in bankruptcy as a bad debt for both tax and financial purposes. Furthermore, Parent did not voluntarily cancel the debt in order to obtain some benefit for Subsidiary; the debt was canceled in bankruptcy at the same rate as all the other unsecured creditors. Finally, Parent received no additional stock for the cancellation of the Subsidiary debt for which it seeks a bad debt deduction. As the Second Circuit observed in Lidgerwood Manufacturing Co., "[t]he cancellation of indebtedness by a creditor may be either a gift, a contribution to capital, if the debtor be a corporation, or a sale of a claim for less than its face value. Determination of which category a particular transaction falls into depends on the facts of the particular case, and largely on the intent of the creditor." 229 F.2d at 242. Parent's intent was consistently to try to recover as much of the

Subsidiary debt as possible.

The Service representatives also rely on W. A. Krueger Co. v. Commissioner, T. C. Memo. 1967-192, which is also clearly distinguishable from the present case. In W. A. Krueger Co., a parent corporation canceled the debt of its subsidiary in exchange for newly issued common stock of the subsidiary. The Tax Court, following Lidgerwood Manufacturing Co., held that the receipt of the newly issued common stock and the recording the transaction as a capital contribution for financial purposes were inconsistent with a bad debt deduction. The court accordingly denied the deduction and treated the debt cancellation as a capital contribution.

In Parent's case, it did not receive any additional stock for the debt canceled for which it claims a bad debt deduction, and it treated this amount consistently for both tax and financial purposes as a bad debt.

Accordingly, we do not think that the facts support characterizing the transaction at issue as a contribution by Parent to the capital of Subsidiary. The portion of the unsecured debt discharged in bankruptcy in this case should be treated as a bad debt and thus gives rise to a bad debt deduction under section 166.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.