

Bad Debts, Worthless Securities: Effect of Pending Collection Litigation and Other Common Issues

David Herzog*

This article examines the availability of a deduction for a bad debt, with a specific focus on the distinctions between worthless securities and bad debts in the context of a simple promissory note issued by the taxpayer. The discussion reviews the law applicable to what might occur where a taxpayer attempts to take a deduction based on the “worthlessness” of the debt, while, at the same time, filing a lawsuit in the hope that the debt is not, in fact, completely worthless.

The General Rule

Generally speaking, bad debts are deductible as either nonbusiness—or business—bad debts.¹ The loss may also be characterized as a worthless security.² The distinction between these is critical. If the debt is a business bad debt, the taxpayer can take a full, or partial (with certain restrictions), deduction against *ordinary* income; ordinary loss is typically, but not always, a taxpayer’s best case scenario.

However, if the debt is a *nonbusiness* bad debt, the taxpayer takes a *capital* loss, i.e., a loss which will offset any capital gains. Any capital losses that are not “used up” in the year of the loss by writing it off against capital gains can be carried over to successive years to write down future gains on the sales of capital assets. Characterization as a capital loss may be beneficial if the taxpayer has sufficient, or expects sufficient capital gains in the future; however, because the tax rate on capital gains is currently significantly lower than on ordinary income, taxpayers are generally seeking deductions against

* David Herzog is an associate with Pinnacle Law Group in San Francisco. He is certified by the California State Bar as a Specialist in Taxation Law, and practices in the areas of business, corporate, and real estate. He can be reached at dherzog@pinnaclelawgroup.com.

¹ Section 166. Section 166 addresses bad debts.

² Section 165 addresses losses, such as wagering, theft, worthless securities, and casualties.

ordinary income, which losses may be carried back to prior years for refunds, or carried forward. As a “bonus,” the Internal Revenue Code allows taxpayers to take an additional deduction against *ordinary* income of \$3,000 of the *capital* loss, if there is loss remaining after reducing the taxpayer’s capital gain for that year.³

Example. Let’s assume a loss that produces a *capital* loss. Assume, in 2007, taxpayer has:

1. Capital gains of \$2,500,000 (i.e., sales of capital assets in 2007, produced a “profit” of \$2,500,000.
2. Ordinary income of \$350,000.
3. A capital loss of \$6,000,000.

The taxpayer, using its *capital* loss, reduces its capital gain (profit) of \$2,500,000 down to \$0, leaving \$3,500,000 of loss still unaccounted for (\$6,000,000–\$2,500,000). \$3,000 of the loss is used to reduce the taxpayer’s ordinary income down from \$350,000 to \$347,000, leaving \$3,497,000 of the loss to carryover to 2008, to be used against additional capital gains (and the \$3,000 against ordinary income). The bottom line in this example? Since the tax on capital gains is, generally speaking, 15%, on the federal level, the tax on the assumed \$2,500,000 profit in this example would be \$375,000 ($\$2,500,000 \times .15$). That \$375,000 tax on the capital gain would be reduced to 0.

There is also a critical distinction between worthless securities and non-business bad debts. Worthless securities can not be *partially* worthless; i.e., the security is totally worthless or it is not. On the other hand, a business bad debt may be *partially* worthless, subject to certain restrictions.⁴

What Is a Worthless Security?

The term “security” is defined in the Code as, among other things—

a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or 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.⁵

³ Section 1211(b).

⁴ Section 166(a)(2).

⁵ Section 165(g)(2).

BAD DEBTS, WORTHLESS SECURITIES

The related regulations do not elaborate on this definition. The first items on this list are self-explanatory; most taxpayers have a working understanding of how shares in a company work.

But a promissory note? When is a note a security for purposes of being a worthless security? An “interest coupon” is a coupon that is typically attached to a bond for the purpose of presentment at a bank for payment upon its maturity. Such coupons are no longer commonplace.

Neither the Code nor the related regulations define “registered form” for purposes of notes issued by a corporation in a private setting.⁶ Traditionally, “registered form” is a security that is a printed certificate with the name of the owner stated on the face of the security. Two cases attempting to define certificates in “registered form” have stated that these are instruments, the ownership of which is recorded on the records of the issuer and could only be effectively transferred if the transfer is recorded in the corporate records.⁷

Where a note is “not issued with interest coupons and is not in registered form . . . it is not a security within the meaning of section 165 of the Code.”⁸

Thus, typical notes, whether secured by the assets of a business or not, are not generally considered securities. Because notes are not typically issued with interest coupons, and are not in registered form (since notes are not subject to the definitions in the Code), notes are typically not securities, and the loss related to it would therefore be determined under Section 166, as either a business or nonbusiness bad debt.

Business or Nonbusiness Debt

If a debt is not a security, then is it a business, or *nonbusiness* bad debt? To answer this, the taxpayer must make an analysis of the “trade or business” factor in determining the business, or nonbusiness, character of the debt. As noted above, a taxpayer gets ordinary loss treatment if the debt is a business bad debt. If the debt is *nonbusiness*, then the loss is restricted to offsetting capital gains.

⁶ Reg. 1.165.12 provides a definition applicable to registration-required obligations; such obligations are defined in Section 163(f)(2) (the IRC Section addressing the denial of deduction for interest on certain obligations not in registered form) as “any obligation (including any obligation issued by a government entity) other than an obligation which (i) is issued by a natural person, (ii) is not of a type offered to the public, (iii) has a maturity (at issue) of not more than 1 year, or (iv) is described in subparagraph (B) [dealing with the sale of the obligation to a person who is not a United States person].” Thus, notes between private parties would not be subject to this definition, which generally anticipates a public offering.

⁷ See *Funk* (1960) 35 TC 42 (1960), and *Martin Est.*, 7 TC 1081 (1946).

⁸ Rev. Rul. 80-24, 1980-1 CB 47.

Generally speaking, a business debt is defined as a debt “created or acquired (as the case may be) in connection with a trade or business of the taxpayer.”⁹

[T]he character of the debt is to be determined by the relation which the loss resulting from the debt’s becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt [is a business debt].¹⁰

Proximate Relation. What does it mean for a debt to have a proximate relation to the taxpayer’s trade or business? The only example given in the regulations is that of a sole proprietor in the grocery business extending credit to a customer, and in that situation, generally speaking, if the debt became worthless, it would be a business bad debt. The debt, though, does not have to be a debt created out of a receivable.¹¹

The debt will be considered proximately related to the taxpayer’s trade or business if business is the dominant motivation for the debt.¹² The determination of whether the loss on a debt’s worthlessness has been incurred in the taxpayer’s business is made in substantially the same manner as for determining whether a loss has been incurred in business.¹³ This analysis will hinge on the business activities of the taxpayer.

In the context of a loan, if the taxpayer is in the business of lending, or engaged in a series of loans, then that is evidence of being in that business, and another loan in a series of loans would be considered to be a debt proximately related to the trade or business of the taxpayer.¹⁴

But frequently, it is not clear if a debt is proximately related to a taxpayer’s business. When does the level of activity of a certain set of transactions rise to the level of a trade or business? A trial court will examine all relevant facts and circumstances present in each case and focus on whether the frequency and level of activity constitute a trade or business.¹⁵ Taxpayers may have any mix of investment and business activities, but if the business activities do not rise to the level of a “trade or business” for purposes of

⁹ Section 166(d)(2). Strictly speaking, a business debt is defined in the IRC as a debt which is *not* a nonbusiness debt.

¹⁰ Reg. 1.166-5(b)(2).

¹¹ Bart, 21 TC 880 (1954).

¹² U.S. v. Generes, 405 U.S. 93 (1972).

¹³ Reg. 1.166-5(b).

¹⁴ Giblin, 227 F.2d 692 (5th Cir. 1955).

¹⁵ McCoy, 538-2nd TMP, *Bad Debts*.

BAD DEBTS, WORTHLESS SECURITIES

proximately relating a debt to the trade or business for ordinary loss purposes, then the loss will be characterized as a *nonbusiness* bad debt, and capital loss will ensue.¹⁶ And for those taxpayers who spend much of their time managing their portfolios, the Supreme Court found that a full-time occupation with one's investments, no matter how extensive or numerous, did not constitute a trade or business.¹⁷

If it is determined that the debt is a nonbusiness debt, then the debt, like a worthless security, is subject to the rule of *total* worthlessness, and cannot be partially worthless.¹⁸ In addition, and probably more importantly, the loss is a capital loss.¹⁹ As explained above, this would allow—and force—the taxpayer to reduce its capital gains, rather than its ordinary income.

A Catch-22: Does the Filing of a Lawsuit Delay the Timing of the Deduction for Worthlessness?²⁰ If the taxpayer sues on the debt, does that vitiate its worthlessness as a result of the debt's having value enough to chase? Does the "hope" of the result of a lawsuit delay the timing of the possible deduction? The Code and the regulations do not address this issue. Two cases, and one Revenue Ruling, though not directly on point, do provide some guidance:

Revenue Ruling 80-24.²¹ The taxpayer in this 1980 Ruling purchased the rights under a note from the original holder (payee/maker) of the note. The taxpayer characterized a debt as currently worthless on a debt instrument that he had purchased from the original note holder, despite having filed a lawsuit related to the debt. The *original* debtor dishonored the note, and the taxpayer sued the *seller* of the note for a breach of contract. The damages

¹⁶ See *Groetzinger*, 480 U.S. 23 (1987).

¹⁷ See *E. Higgins*, 312 U.S. 212 (1941).

¹⁸ Reg. 1.166-5(a)(2) ("A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.")

¹⁹ Section 166(d)(1)(B) ("[W]here any 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 1 year.")

²⁰ There is a great deal of law on the determination of whether a debt is worthless or not. I am not going to address that here. The cases are numerous, and generally, where there is balance sheet insolvency, and no hope of recovery from the debtor, then the debt is worthless. The question in this article is whether a lawsuit filed creates an extension of the time to take the deduction for worthlessness. The issue of what makes a debt worthless is not extensively addressed here.

²¹ A revenue ruling is an interpretation of the tax laws by the IRS. Revenue rulings represent the conclusions of the IRS on how the law is applied to a specific set of facts. Until revoked, modified or clarified, revenue rulings are binding upon the IRS (i.e., they can be relied on by taxpayers), but are not binding upon the courts or taxpayers.

sought were *not* for the principal and interest due on the note, but for what the taxpayer paid when he purchased the note. The taxpayer simultaneously sought to declare the debt worthless under Section 166. The commissioner for the IRS held that the debt was, in fact, worthless, notwithstanding the fact that the taxpayer had filed a lawsuit (with a reasonable prospect of recovering) against the seller (the prior holder) of the note.

This was good news for taxpayers, but note the facts. The lawsuit in the Ruling was not against the *debtor*, but against the *former holder* of the note. The lawsuit was not for payment of the note, but rather sought to recover what the taxpayer had paid for the note, based on theories of misconduct and rescission. In other words, the cause of action against the seller of the note was not based on a debtor-creditor relationship, but on a cause of action based on the sale of the note. Recovery in this Ruling relates to the sale of the note, not the breach of the promise to pay by the debtor. As such, the Service ruled that the debt could be characterized by the taxpayer as currently worthless under Section 166 because the lawsuit did not relate to the note.

And though not specifically stated, the implication of the holding is that, had the lawsuit been based on the debt directly, the lawsuit may have delayed the time to deduct the loss.

Zeeman v. U.S. The case of *Zeeman*²² stands for the general proposition that even a plethora of lawsuits will not prevent a taxpayer from characterizing a debt as currently worthless. However, as in the 1980 Ruling just discussed, the court in *Zeeman* stated that because “recovery in these actions would not be recovery on the debt . . . , the pendency of the suits does not affect the deductibility of the bad debt loss”²³ The court relied on the framework of the lawsuits, i.e., that the suits are not actions on the debt itself, to make its determination against the IRS and in favor of the taxpayer. It did not rule, however, on what would occur if the lawsuits were, in fact, directly on the debt, and whether a lawsuit, for example, against a shareholder of a former corporation creates a direct debtor-creditor relationship.

The court in *Zeeman*, in dictum—a finding not necessary for the ruling but which the court believed appropriate to state nevertheless—opined that even *if* the lawsuits related to the debt, “the complaints have been examined and I [the judge] find they did not offer a reasonable prospect of recovery”²⁴ This dictum leaves the door open for the possibility that a taxpayer may be

²² 275 F. Supp. 235 (SDNY 1967).

²³ *Zeeman* at 251

²⁴ *Id.* at 252.

BAD DEBTS, WORTHLESS SECURITIES

able to argue that, even though the filing of a complaint may delay the timing of the loss, its complaint relating to the debt has no, or very little chance, for recovery, and therefore, accelerating of the date/year of worthlessness to the present is available. However, if the taxpayer makes this argument in the Tax Court while a separate lawsuit for recovery of the debt is pending, the statement in the public forum of the Tax Court could compromise the outcome of the lawsuit against the debtor. Arguing in Tax Court that your lawsuit in civil court has little/no merit is, to say the least, a double-edged sword.

Thompson. In *Thompson*,²⁵ a 1983 Tax Court memo decision, the court found against the taxpayer, and delayed the deduction on its business bad debt to a later year until a decision had been rendered in the underlying debtor-creditor lawsuit. Thompson, the taxpayer, was in the business of, among other things, leasing heavy machinery. Thompson had leased machinery to James T. Gregory, Inc. (“Gregory”) for a highway construction project. Gregory was bonded for its highway projects by USF&G. In early 1971, USF&G took over the project from Gregory, as Gregory was not able to meet its lease obligations. Thompson, despite having filed a lawsuit against Gregory and USF&G for the debt on the leases, made a determination that 1971 was the year it would deem the debt to have become worthless, and that was the year it took the deduction. In 1973, the Chancery Court at Nashville determined that USF&G and Gregory were both liable for the debt, USF&G being specifically liable on its bond. All three parties appealed, and in 1975, the Chancellor entered a decision, again against both Gregory and USF&G, but for different amounts. USF&G appealed; Thompson did not. In 1975, the Court of Appeals in Tennessee reduced the judgment against USF&G, but in all other respects the judgment was affirmed. In 1978, that judgment was affirmed by the Tennessee Supreme Court, and in 1978, Thompson was paid on its judgment, about half of the debt. Eventually, and after an appeal, the Tax Court gave Thompson its deduction, to be taken by the taxpayer in 1975, when the taxpayer decided not to appeal the 1975 decision (though USF&G had appealed the 1975 decision).

The taxpayer in *Thompson* relied on *Zeeman* and the 1980 Ruling, arguing that lawsuits against third parties (USF&G in the case of *Thompson*) are separate and independent from the debt, and therefore did not extend the time for the determination of worthlessness. The Tax Court disagreed. It distinguished *Zeeman* by stating that *Zeeman* was a case involving lawsuits for fraud and misrepresentation, resulting in damages, and that the 1980 Ruling was another case of a creditor suing not the original debtor, but a third party

²⁵ 45 TCM 693 (1983), aff’d in part, 761 F.2d 259 (6th Cir. 1985).

who had sold the debt to the creditor/taxpayer; thus the 1980 Ruling was also distinguishable. The court in *Thompson* reasoned (restating the rule set forth in *Zeeman*):

None of these suits [the lawsuits in *Zeeman*] seems to deal with the debt owed by Allied [the debtor] to Haupt [the partnership of which the taxpayer was a limited partner], or with collateral, guarantees or indemnity contracts directly related to the debt as such. Although they deal with the transactions which caused the debt to become worthless, and the damages claimed may be measured by the amount of the bad debt loss, recovery in these actions would not be recovery on the debt, and, therefore, the pendency of the suits does not affect the deductibility of the bad debt loss for 1963 by Haupt.” *Thompson* at 36-37. “Here, however, Thompson & Green’s rights against USF&G, the surety, were “directly related to the [Gregory] debt as such.”²⁶

As a result of *Thompson*, a debt is not going to be considered worthless if it is “secured.” and the creditor is pursuing that security. The court in *Thompson* defined “security” for these purposes as a “guarantee, collateral, or, as [in *Thompson*], a statutory surety bond.”²⁷ Even though *Thompson* pointed to the insolvency of Gregory in 1971, the court rejected that argument.

Although hardly conclusive, the fact that Thompson & Green maintained a lawsuit against Gregory and *USF&G* to collect on the Gregory debt strongly indicates to us that Thompson & Green did not consider its claim to be worthless.²⁸

In short, *Thompson* has been cited for the proposition, among others, that an “enforceable obligation of guarantor on debt owed to the taxpayer bars the taxpayer from deducting the debt as a loss or addition to bad debt reserve.”²⁹

Alter Ego Liability?

What if plaintiff is attempting to collect on a debt owed by a corporation from its individual shareholders by way of an alter ego liability theory? Under the

²⁶ *Id.* at 37.

²⁷ *Id.* at 38.

²⁸ *Id.* at 40.

²⁹ *Centex Corp. v. U.S.*, 395 F.3d 1283, 1294 (2005).

BAD DEBTS, WORTHLESS SECURITIES

alter ego liability theory, in which instance, a shareholder typically stands in the shoes of the corporation for purposes of being obligated on a debt. Alleging alter ego liability is a typical allegation when a lender is attempting to collect on a debt owed by a corporation.

Liability based on alter ego has not been tested in a reported decision. If a complaint is an action “related to the debt,” then the debt’s worthlessness is not yet ascertainable. In that respect, the only door open for the IRS to argue as a relationship to the debt would be based on the theory of alter ego. However, not being an action on a “security” makes it distinguishable from the applicable cases, and thus certainly leaves the door open for current worthlessness. In other words, though it is still unsettled as to the issue of whether a complaint based on alter ego is related to the debt, and therefore extends the time for taking a loss, it is not, as the courts have prescribed, a lawsuit on “security,” like a bond or collateral, and therefore, leaves plenty of room open for the loss to be taken currently, even where the creditor is chasing the corporate shareholders on the debt.

Conclusion

Debts proximately related to the taxpayer’s business are deductible as bad business debts, entitling the taxpayer to a deduction against ordinary income. Debts structured as securities will be treated as worthless securities, and provide the taxpayer with a capital loss, in the year in which the security became worthless. Promissory notes are generally not securities, unless they meet certain qualifications. Where the note does not meet the qualification, any deduction related to its loss will be either against ordinary income or capital gain. The deduction will offset ordinary income if the note is proximately related to the taxpayer’s business, but the offset will be against capital gains where it is not. Where the taxpayer files a lawsuit, that may delay the timing of the deduction, depending on the basis of the lawsuit. Suing a shareholder on an alter ego liability theory has not yet been decided in a reported decision.