Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:ITA:B03 – PLR 154257-03
Date:
September 22, 2004

In Re:

TY:

Legend

Taxpayer =
Date 1 =
Defendant 1 =
Defendant 2 =
Defendant 3 =
Country 1 =
Country 2 =
Country 3 =
Regulator =

Company 1 =
Company 2 =
Company 3 =
Company 4 =
Company 5 =
Trust 1 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
US District Court =
US Bankruptcy Court =
Date 2

A
B =
C =
D =
E =
F
Appellate Court =
Date 3 =
Date 4 =

Dear

This is in reply to your letter dated August 25, 2003, and subsequent submissions, requesting a ruling under § 166 of the Internal Revenue Code.

Taxpayer is a corporation that has a calendar year accounting period and utilizes the accrual method of accounting for maintaining its accounting books and records and for filing its Federal income tax return.

Prior to Date 1, Company 1, a Country 1 corporation, owned 100% of Company 2, a Country 2 corporation, and Company 2 owned 95% of the shares of Taxpayer as well as 100% of the shares of Company 3, a Country 3 corporation, which, in turn, owned 5% of the shares of Taxpayer. On Date 1, Defendants 1, 2 and 3, who were minority shareholders but controlling board members of Company 1, restructured the ownership of Taxpayer so that various shell offshore business entities, created to accomplish the restructuring and under the control of Defendants 1, 2 and 3, became owners of Taxpayer's shares. The restructuring was accomplished through Companies 4 and 5 and Trust 1, all foreign corporations and a trust created solely to hold ownership of Taxpayer's shares. Subsequently, Company 1 was left with no ownership interest in Company 2 or Taxpayer.

In early Year 1, Country 1 was in the midst of a banking crisis and various banks sought financial assistance from Regulator. One of Company 1's subsidiaries received financial assistance from Regulator. Regulator ultimately placed both Company 1 and its subsidiary into receivership and also removed the Defendants from management of Company 1 and replaced them with an individual appointed by Regulator (Director). During a subsequent investigation, Company 1's Director discovered the documents detailing the Date 1 transactions. Also, upon learning of the Date 1 transactions, and in order to prevent the Defendants from selling Taxpayer's shares, Regulator and Company 1's Director began an investigation into possible legal action against the Defendants.

In June, Year 2, in order to prevent the Defendants from selling Taxpayer's shares, a lawsuit was filed in US District Court by Regulator and Company 1's Director against

Defendants 1, 2 and 3, as well as the various business entities under their control, Companies 3, 4 and 5, Trust 1 and Taxpayer. The suit sought a constructive trust over Taxpayer's shares or the proceeds from the sale of the shares. The suit alleged that Defendants had perpetrated a fraud arising out of insider loans, self-dealing, the misuse of financial aid provided by Regulator, breach of fiduciary duties, conversion and fraudulent transfer. Although the District Court proceeding was still ongoing, on Date 2 the Defendants caused Taxpayer to declare and pay out a dividend and on Date 3 to declare and pay out another dividend.

On Date 4, the US District Court entered summary judgment in favor of the Regulator and Company 1's Director as to the claims for conversion and wrongful transfer of shares. The District Court's order states that all of the Date 1 transfers are declared void and shall be reversed to recreate the ownership interests prior to the transfers. All dividends disbursed since Date 1 are to be returned and added to Taxpayer's stock. To the extent that dividends cannot be repaid, the party to whom the dividend was disbursed shall be declared a debtor of Taxpayer. The dividends had been ultimately disbursed to Defendants 1, 2, and 3 and were never repaid to Taxpayer.

The District Court's final judgment states that Defendants 1, 2, and 3 are ordered to repay Taxpayer all dividends disbursed by Taxpayer "since Date 1…together with interest from the date of issuance of each dividend plus post-judgment interest until paid." In addition, the District Court stated that "to the extent that any such dividends and interest are not repaid, judgment is entered jointly and severally in favor of the Taxpayer and against the Defendants." Defendants appealed the decision.

Taxpayer immediately began collection efforts against the Defendants. Various assets were located such as automobiles, a boat, real property, safe deposit boxes, bank accounts and other securities. Taxpayer successfully seized several of these assets and sold them.

During March, Year 3, Defendants 2 and 3 had depositions taken in Country 1 in which they stated that they did not have any assets other than those already seized. During June, Year 3, Taxpayer continued its collection efforts. It attempted to garnish money owed to Defendant 1 and also investigated the fraudulent transfer of additional assets from Defendant 1 to various third parties. In July, Year 3, Defendants' attorneys filed motions seeking to withdraw as counsel because the Defendants could no longer pay their fees.

In dispositions taken in Year 3, Defendant 1 stated that Companies 3 and 4 and Trust 1 had no assets.

In July, Year 3, Defendant 1 filed for Chapter 7 bankruptcy in US Bankruptcy Court. Collection efforts against Defendant 1 were stayed pursuant to Federal law. Collection efforts against the remaining two defendants were reduced significantly due to the inability to locate assets titled in their names.

In September, Year 3, Taxpayer filed proof of claims with US Bankruptcy Court in amount A, an amount which included dividends, pre and post-judgment interest, attorneys fees and costs, less the amounts already recovered in Taxpayer's collection efforts. By December, Year 3, Taxpayer was working with the Trustee of the Bankruptcy estate to develop evidence that would support an action in the court denying the dischargeability of the debt owed by Defendant 1 to Taxpayer and/or denying any bankruptcy discharge. During November, Year 3, various depositions allowed Taxpayer and the bankruptcy trustee to locate additional assets concealed from the bankruptcy estate which Defendant 1 had fraudulently transferred to various third parties. After completing the depositions, in January, Year 4, Taxpayer filed an Adversary Complaint against Defendant 1 requesting the Bankruptcy Court to declare that the debt to Taxpayer was not dischargeable in bankruptcy and/or that Defendant 1 should not obtain a discharge in bankruptcy at all. The Complaint was based on the grounds that Defendant 1 had misrepresented his financial condition to the court. Shortly, thereafter, Defendant 1 made a motion to postpone the hearing on the Complaint until the appeal of the judgment of the US District Court ordering the return of the dividends and other assets was decided. Thus, the Bankruptcy Court proceedings were stayed.

Throughout this entire process, the Trustee had subpoenaed records from various financial institutions in an attempt to locate additional assets fraudulently transferred from the Bankruptcy Estate. In April, Year 4, Taxpayer again deposed Defendants 2 and 3 seeking additional assets for collection. A possible United States bank account for Defendant 3 was noted. By July, Year 4, the Trustee obtained various records leading to the identification of evidence purporting to show that Defendant 1 had lied under oath to the Bankruptcy Court, and the Trustee determined it would utilize the evidence to support Taxpayer's objection to Defendant 1's discharge in bankruptcy.

In August, Year 4, Regulator filed several proofs of claims with the Bankruptcy Court in amount B; Taxpayer's claims were amount C. Remaining creditors had claims of amount D. Regulator's claim involved the following three claims: claims for damages from Defendant 1's fraudulent and negligent management of Company 2 and affiliated institutions, rendering them illiquid and insolvent; claims resulting from Defendant 1's fraudulent and/or negligent misrepresentations and failures to disclose to Regulator at the time that financial aid was sought; and claims for unpaid debts of approximately 66 related companies in which Defendant 1, his family and associates had direct and/or indirect ownership interests. Pursuant to Country 1's law, Defendant 1 is personally liable to Regulator for all the companies' outstanding debts. Taxpayer's counsel explained that based on the amount of administrative expenses and prorated distributions which might be expected on the various claims, Taxpayer could expect to receive only a nominal distribution from the Bankruptcy Estate. Priority payments (administrative expenses) would go to Regulator.

In August, Year 4, the Appellate Court upheld the District Court's judgment which found the Defendants liable and upheld the order which required the Defendants to repay the dividends to Taxpayer. Subsequently, the Bankruptcy Court sought records pertaining to accounts or assets held by Defendant 1, or on which he had signing authority, at any time prior to the date of the initial bankruptcy proceeding.

In November, Year 4, the investigation regarding the bank account of Defendant 3 was still pending. The bank at which the suspected bank account was located indicated that no account existed in Defendant's name. Taxpayer's option was to consider engaging counsel of record from Country 1 to record the District Court judgment against Defendants 2 and 3 in Country 1.

In February, Year 5, the Trustee uncovered evidence that, as of the date of filing of bankruptcy, Defendant 1 had a foreign bank account in amount E. But as of the date of locating the account, assets were no longer in the account. Also, Trustee located both corporate stock and real property that were concealed from the Bankruptcy Estate. The Trustee also obtained an order from the Bankruptcy Court authorizing the seizure of records from one of Defendant 1's entities. The records provided the Trustee with additional evidence of Defendant 1's violation of bankruptcy law requiring the proper turning over of property to the Bankruptcy Estate.

In February, Year 5, a Bankruptcy Court contempt hearing considered Defendant 1's concealment of material assets. Defendant 1 offered to turn over to the Bankruptcy Estate, in lieu of the concealed foreign bank account, a mortgage in the same amount and a deed for his residence in lieu of foreclosure. The Court agreed to this arrangement with a deadline of one month. Defendant 1 also stated an intention to obtain funds to pay Taxpayer's judgment and all other liquidated claims in full. By the end of March, Year 5, Defendant 1 had failed to return the money from the foreign bank account, and thus Trustee recorded the deed in lieu of foreclosure against Defendant 1's residence. After Trustee was awarded the residence, Defendant 1 paid the Trustee amount E plus interest and fees.

In April, Year 5, Defendant 1's deposition was taken, and he claimed the Fifth Amendment privilege against self-incrimination with respect to questions about fraud and concealment of assets, and the use of fictitious aliases. In May, Year 5, a hearing was held on Trustee's Motion to Compel Turnover of Additional Assets to Estate. In May, Year 5, the Bankruptcy Court entered an Order granting a Motion for Summary Judgment requiring Defendant 1 to execute a quit claim deed to a condominium he owned in favor of the Trustee and to account for, and turn over, all rental income received from the condominium for approximately the last two years. In October, Year 5, the Trustee learned that Defendant 1 was in the process of selling the subject condominium, and the Court permitted the sale with the proceeds being held in escrow by Defendant 1's counsel.

In October, Year 5, the Bankruptcy Court granted Trustee's Motion to Compel Turnover of Additional Assets to the Estate. The assets included shares of several corporations, artwork and an apartment in Country 1. Defendant 1 failed to comply with the order.

In November, Year 5, Taxpayer again sought to determine whether Defendants 2 and 3 had any additional assets to disclose since the last discovery action. No assets were located. Taxpayer had not recorded the District Court's judgment in Country 1 as it determined that any further collection efforts against these two defendants would not produce recoveries and that further collection actions would be costly.

In November, Year 5, the Bankruptcy Court granted a Motion for Contempt and a Motion to enter Defendant 1's residence to remove any artwork or other property that belonged to the Estate. Nothing of value was found, and at the motion hearing Defendant's attorney disclosed that he had not had any contact or communication with Defendant 1 in two weeks.

Continuing efforts were made to locate Defendant 1 and the missing assets. Through dispositions and discovery, it was determined that Defendant 1 and his wife had flown to Country 1 in November, Year 5, and that a large amount of their furniture and household items had also been shipped there.

By the end of Year 5, Trustee had collected Amount F for distribution to the Bankruptcy Estate's creditors. As discussed above, amount B was the claim of Regulator, amount C was Taxpayer's claim and amount D represented claims of remaining creditors. As stated, payments to Regulator had priority. Administrative expenses, including actual and necessary expenses of preserving the estate, as well as trustee's fees, taxes, expenses, including attorneys fees incurred by the creditors who recover property for the benefit of the estate, are paid ahead of general unsecured claims, which are paid pro rata.

Taxpayer's attorney for the bankruptcy proceedings stated that all claims, of which proof is filed, are deemed allowed, unless a party in interest, including a creditor, or Trustee, objects to the claim. No objections were asserted to any of the claims.

By the end of Year 3, all of the wrongfully transferred shares of Taxpayer were returned to the rightful party (or were held in escrow for such parties' benefit) as ordered by the District Court.

Taxpayer requests a ruling that these facts establish the worthlessness of the remaining debt obligation due to Taxpayer, giving rise to a bad debt deduction under section 166 in Year 5.

In summary, the ruling request is based on the following:

(1) The non-individual defendants, Companies 3, 4 and 5 and Trust 1 had no assets with which to satisfy the court judgment. Taxpayer determined that collection efforts against these entities would be futile.

(2) With respect to Defendants 2 and 3, in March, Year 3, depositions were taken in Country 1, and no assets were located beyond those already seized. Efforts to locate assets in their names continued. In April, Year 4, and November, Year 5, depositions were again taken seeking information on assets, and none were located. Taxpayer had not recorded the judgment in Country 1 because there was virtually no possibility of any recovery.

(3) As to Defendant 1, in June, Year 3, attempts were made to garnish money owed to Defendant 1, and information was sought on possible fraudulent transfer of assets. In September, Year 3, Taxpayer filed proof of claim with the Bankruptcy Court. In Year 4, Taxpayer took action in Bankruptcy Court alleging Defendant 1 was concealing assets and misrepresenting his financial condition. In Year 5, there was a Bankruptcy Court contempt hearing regarding the concealment of assets. Defendant 1 agreed to turn over a mortgage and a deed to his residence. He also stated his intention to pay Taxpayer's judgment in full. Later, Defendant 1 failed to comply with a Bankruptcy Court order to turn over various assets. Subsequently, it was determined that Defendant 1 and his wife had left the United States for Country 1. By the end of Year 5, it was clear that the amount collected by the Trustee for distribution to the Bankruptcy estate creditors would result in only a minimal recovery for Taxpayer.

Section 166(a)(1) provides that, with regard to wholly worthless debts, there shall be allowed as a deduction any debt which becomes worthless within the taxable year.

Section 1.166-1(c) of the Income Tax 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.

Section 1.166-2(a) of the regulations provides that in determining whether a debt is worthless all pertinent evidence is to be considered, 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.

Sections 1.166-2(c)(1) and (2) provide that bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt and in bankruptcy a debt may become worthless before settlement or sometimes only when a settlement in bankruptcy has been reached. In either case, the fact that bankruptcy proceedings are terminated in a later year, confirming the worthlessness of a debt does not authorize the shifting of the deduction to such later year.

Bad debts may be deducted to the extent of their worthlessness which is a question of fact, and worthlessness can occur before the debt is due. Standard Oil of N.J. v. Commissioner, 7 T.C. 1310, 1321 (1946).

In this case, the District Court judgment ordering the return by the Defendants of the converted stock and the repayment of dividends and interest to Taxpayer created a bona fide debt for purposes of section 166. See Iowa Southern Utilities Co. v. United States, 172 Ct.Cl. 21 (1965) (judgment against the officers determined a valid and enforceable obligation of the officers to pay a fixed or determinable sum of money to the taxpayer within the meaning of 1.166-1(c).)

Furthermore, we find that the succession of events up to and including those of Year 5 establish that as of Year 5 Taxpayer's debt had become worthless. Immediately after the District Court judgment, Taxpayer began collecting assets of the Defendants to satisfy the judgment. The submission states that a portion of the judgment was collected from Defendants immediately after the District Court judgment. Subsequently, and prior to Year 5, further collection action against Defendants 2 and 3 became futile. The facts show that their counsel withdrew because they were no longer able to pay counsel fees. Depositions located no more assets, and lastly, Taxpayer determined that recording the District Court's judgment in Country 1 would have been both costly and futile, as the facts showed that any further collection efforts against Defendants 2 and 3 would not have been successful.

Companies 3, 4, 5, and Trust 1 were all foreign entities with no assets. Collection efforts against these entities were deemed futile.

Because the Defendants were jointly and severally liable, the debt was not worthless until the debt was deemed worthless as to Defendant 1. Subsequent to Defendant 1's bankruptcy, the prospect of recovery remained. Through Years 3 and 4 various assets were discovered which had not been turned over to the Bankruptcy Estate. The facts show that Taxpayer continued to pursue recovery. But in November, Year 5, Defendant 1 left the United States and the prospects for recovery no longer existed. See Briant v. Commissioner, T.C.Memo 1982-397 (taxpayer entitled to bad debt deduction where debtor in another country and that even if the debtor could have been located, there was no reasonable expectation of recovery.)

By the end of Year 5, some funds had been collected for distribution to the Bankruptcy Estate's creditors, but based on priority payments and proration requirements, Taxpayer's potential recovery was a small portion of the debt owed.

As of Year 5 the prospect of any further Bankruptcy recoveries ended due to Defendant 1's flight from the country, This establishes the worthlessness of Taxpayer's debt in that year. Based on all the facts presented, it is apparent that diligent efforts were made up to Year 5 to secure recovery and that further legal action was futile upon Defendant 1's flight from the country. Even though the Bankruptcy case was not settled as of Year 5, we find that the debt was worthless as of Year 5. See Rev. Rul. 71-577, 1971-2 C.B. 129.

In conclusion we rule that Taxpayer is entitled to a worthless debt deduction in Year 5.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosure (1)

cc: