Tax Accounting

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This month's column discusses a Michigan bankruptcy court's decision which illustrates several aspects of the "all events" test that governs accrual taxpayers' deductions. One key holding was that the taxpayer was entitled to deduct all the interest for which it was legally liable, bucking a trend toward disallowing insolvent taxpayers' deductions for liabilities they are unlikely to pay. The court's reasoning could have significant implications for the tax liability of taxpayers in bankruptcy and other financially moribund entities.

BANKRUPTCY COURT ADDRESSES DEBTORS' INTEREST DEDUCTIONS

The taxpayer in *In re Dow Corning Corp.*[1] was the debtor in an extended Chapter 11 reorganization proceeding. The issue, which came before the court on cross-motions for summary judgment, was whether the taxpayer could deduct interest that accrued during the bankruptcy proceeding on two categories of debt. The first category was "institutional debt," which bore explicit interest in excess of the "federal judgment rate" that applies under the Bankruptcy Code.[2] The second category comprised miscellaneous liabilities that the parties and the court referred to as "trade debt." Although expressing some skepticism, the court assumed, as the taxpayer stipulated, that the trade debt did not expressly call for interest and that the creditors would be entitled to receive interest only under the Bankruptcy Code.[3] As discussed below, this difference in contractual liability proved critical to the first part of the court's analysis.

Except where a special provision applies, accrual taxpayers become entitled to deductions when "all the events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy," and economic performance has taken place.[4] The last requirement was not at issue in *Dow Corning*, because economic performance occurs as the interest accrues.[5] The dispute between the parties concerned whether any or all of the taxpayer's claimed interest deductions met the other requirements for accrual.

Fixed Liabilities

The requirement that "all the events have occurred which determine the fact of liability" rules out deducting liabilities so long as they remain contingent.[6] However, a fixed liability can be deducted even though some future event (a "condition subsequent") may relieve the taxpayer of liability before actual payment occurs.[7]

As noted above, Dow Corning's "institutional debt" provided for interest. The government argued that any of this interest that accrued after the bankruptcy petition was filed represented only a contingent liability and could not be deducted. The government pointed out that only interest through the date of filing was "allowed" as a claim in a bankruptcy proceeding.[8] However, the court held that "allowance" in this context referred to *allowance as a claim against the bankruptcy estate*, and the fact that post-position interest was not "allowed" in this sense did not mean that the *debtor* did not remain liable for whatever interest it had promised to pay. In certain circumstances, the debtor might be discharged from liability for post-petition interest in a so-called "cramdown proceeding," but this possibility represented a "condition subsequent" that did not prevent the taxpayer from initially deducting the interest.[9]

As discussed above, the "trade debt" was assumed to bear no contractual interest. However, the Bankruptcy Code provides that in the event of liquidation, the bankruptcy estate will pay interest upon such claims at the "legal rate" (that is, the federal judgment rate) if there are sufficient assets left after providing for higher priority claims.[10] The taxpayer computed its claimed deductions by applying that rate to the trade debt. Liquidation priorities are not directly applicable in a Chapter 11 proceeding, but in most circumstances the "legal rate" would serve as a floor on the interest that would be awarded in a confirmed plan if sufficient funds were available in the estate.

While, as discussed below, accrual does not generally depend on a taxpayer's ability to pay the amount accrued, if the liability for interest is expressly contingent on the availability of funds, no deduction will be allowed while the debtor cannot pay.[11] Following the Fifth Circuit's decision in *In re West Texas Marketing Corporation*,[12] the court in *Dow Corning* held that where the taxpayer's only right to interest stemmed from the Bankruptcy Code, that right would remain contingent until the court determined there were sufficient funds in the estate and awarded interest. In the meantime, the taxpayer was not entitled to deduct any interest that was not contractually due.

Inability to Pay: Two Potential Treatments

As discussed above, the court had held that Dow Corning had a "fixed liability" to pay the contractual interest on the "institutional debt." The court next considered whether Dow Corning's insolvency affected its right to deduct the interest accrued. The law on this point is less settled. As a general rule, the taxpayer's right to accrue a deduction does not depend on its showing a present ability to pay the amount

accrued. However, there is some dispute about whether a deduction is allowable when the taxpayer's financial state is such that there is no likelihood that it ever will be able to pay.

In one of the earliest cases to address the issue, the Eighth Circuit held in *Zimmerman Steel Co. v. Commissioner*[13] that "where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy . . . can not of itself justify denial of [the] deduction." The Fifth Circuit appeared to adopt a similar absolute rule in *Fahs v. Martin*,[14] where it allowed a deduction for interest accruing on amounts some 15 years overdue. The IRS has also made it clear in several published rulings that it generally excludes contingencies relating to the debtor's ability to pay from the category of "conditions precedent" that prevent accrual.[15] On the other hand, the Tax Court has denied a deduction when there was no "reasonable prospect" that payments would ever be made,[16] although it confines disallowance to situations where it can "categorically" be said that the taxpayer will never pay.[17] The Court of Federal Claims seems to agree, judging from its remark in one case that accrual was mandatory "unless it can definitively be concluded that [the] debt will never be repaid."[18] The Ninth Circuit also appeared to employ a similar standard in a recent unpublished opinion.[19]

A Trend Toward Disallowance?

Moreover, despite the broad language in *Martin*, later case law suggests that the Fifth Circuit's standard in practice may not be greatly different from the Tax Court's. In *Tampa & Gulf Railroad Co. v. Commissioner*,[20] the debtor owed money to its corporate parent — which was also the sole source of its operating income. No interest had actually been paid for 30 years. While the taxpayer was deducting the interest currently, its creditor/parent was not accruing income for lack of a "reasonable expectancy" of receipt. While, as discussed above, the standards for income and deductions are not the same, the *Tampa & Gulf* court seemed taken with the obvious potential for abuse in allowing a debtor to deduct interest that the related creditor did not have to report as income, and held that *Martin* did not apply in the "extreme circumstances" of the case.

The Tax Court later concluded that *Tampa & Gulf*'s holding was limited to similar situations where the facts suggested that there was no *bona fide* liability in the first place.[21] However, a Texas district court in *In re Southwestern States Marketing Corp.*[22] read *Tampa & Gulf* more broadly to deny a deduction when the facts demonstrated "[i]mpossibility of payment, as distinguished from current inability," and was affirmed on appeal. The Fifth Circuit itself touched on the issue in *West Texas Marketing*. The panel majority cited *Martin* in support of its observation that the issue was whether the Bankruptcy Code rendered the liability for post-petition interest contingent, not whether the taxpayer could pay.[23] However, Judge Smith's dissent described *Tampa & Gulf* as recognizing an exception from the *Martin* rule for situations "[w]here there is no possibility of eventual payment."[24] The IRS has not clearly committed itself on the issue of whether a deduction can ever be disallowed because of the debtor's inability to pay. The accrual of income generally requires a "reasonable expectancy of payment."[25] The IRS acknowledges that no corresponding requirement applies to deductions.[26] Revenue Ruling 70-367[27] allowed a taxpayer in bankruptcy to deduct interest even when there was no "reasonable expectancy" that it would pay the full amount. However, the ruling does not necessarily mean that the IRS agrees that a deduction will be allowable even if there is no meaningful possibility that the taxpayer will ever pay anything at all.

In summary, apart from the Eighth Circuit, which has not spoken on the subject in a long time, the evolving consensus seems to be that a deduction may be disallowed on grounds of inability to pay, but only in circumstances where there is no realistic possibility that the debtor will ever pay anything. Such a rule can be defended on the grounds that it cannot clearly reflect a taxpayer's income to allow a deduction for an amount that it will never pay. As the standard for disallowance comes close to the circumstances under which debtors will recognize discharge of indebtedness income, another way of looking at such situations is that the taxpayer's liability is effectively being discharged continuously as it accrues.

Dow Corning: A Different View?

The court in *Dow Corning*, however, began with first principles and emerged with a fresh analysis. The court's first and most basic premise was that nothing suggested Congress intended to qualify Code Section 163(a)'s deduction for interest with an implicit exception for interest paid by insolvent taxpayers (or even only deeply insolvent taxpayers). In this connection, the court noted specific provisions such as Code Section 163(j), which defers "overleveraged" corporations' interest deductions in narrowly defined circumstances.

The bankruptcy court found still more significant the Code's allowing creditors bad-debt deductions for their worthless claims and Code Section 108's detailed provisions that exclude some income from discharge of indebtedness. The court concluded that conditioning deductions on solvency would frustrate the Congressional purpose by effectively requiring insolvent taxpayers to currently recognize income from discharge of indebtedness without the benefit of the carefully crafted rules for relief in Code Section 108.

Finally, the bankruptcy court discussed and dismissed as irrelevant the Fifth Circuit's decision in *Mooney Aircraft v.*

United States.[28] That case denied deductions for liabilities represented by "Mooney bonds" that only became payable as the aircraft that the taxpayer sold were retired from service. The court held that allowing current deductions for amounts payable at an indefinite time in the distant future did not "clearly reflect" the taxpayer's income.[29] *Mooney* noted among other factors supporting disallowance the increased risk of nonpayment that accompanies long lags in payment.[30] However, the *Mooney* court was not challenging the existence of a "fixed" liability, but merely citing another reason why allowing a current deduction for amounts payable decades hence would not clearly reflect the taxpayer's income.[31] The court in *Dow Corning* observed that *Mooney* was off point because "a court's holding that the IRS properly invoked IRC § 446(b) does not warrant the inference that the reported income or expense was nonaccruable [in the first place]."[32]

Before *Dow Corning*, the weight of authority, apart from *Zimmerman Steel* and other old Eighth Circuit case law,[33] had favored limiting insolvent taxpayers' accruals, at least in some circumstances. Now there is at least some recent precedent, albeit only at the bankruptcy court level, on the other side.

Disputed Liabilities

The final part of the court's opinion concerned whether the interest deductions for the institutional debt might be disallowed in part or in full on the grounds that the taxpayer's liability was disputed. In contrast to the insolvency issue, the governing legal principles were fairly clear, although the facts were not. Liabilities are generally not deductible while they remain disputed,[34] unless the disputed amount is paid in the meantime.[35] A dispute requires "[a]n affirmative act denying the validity or accuracy, or both, of an asserted liability," although this "affirmative act" need not necessarily be in writing.[36]

In keeping with the well-accepted principle that the propriety of accruals is to be determined based on the information "known or knowable" to the taxpayer as of the end of the year,[37] a dispute that begins after the end of the year should not affect an accrual that arises *during* the year. Thus, for example, *Globe Products Corp. v. Commissioner*[38] involved deductions for interest on a consolidated federal tax deficiency. The deficiency had been determined in a stipulated Tax Court decision entered in 1972. A year later, the taxpayer became aware that the tax had not been properly assessed before the statute of limitations ran, and launched an ultimately successful challenge to its liability. The court found that there had been no dispute in existence as of December 31, 1972; the contest only arose during 1973, when the taxpayer became aware of the defect and denied that it was liable to pay. The taxpayer was therefore allowed to deduct the interest that had accrued during 1972.

Against this background, the court in *Dow Corning* considered the amount of the taxpayer's deduction for interest on the "institutional debt." The taxpayer was contending in the bankruptcy proceeding that its liability for interest that accrued after it filed for bankruptcy should be limited to interest computed at the federal judgment rate. However, the deductions at issue were for the taxable years 1995 and 1996, and the taxpayer had evidently not formally raised this argument until 1998. The bankruptcy court held, consistently with the Tax Court's holding in *Globe*, that the validity of a deduction could not be affected by a dispute that arose after the end of the year. However, the court granted the taxpayer summary judgment only for a deduction for interest at the federal judgment rate, holding that there was a factual question as to whether there had been at least a latent dispute as to the rest of the interest during 1995 and 1996.

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