Crown v. Commissioner, 77 T. C. 582 (1981)

A cash basis taxpayer who uses borrowed funds to pay a debt as a guarantor may claim a bad debt deduction in the year of payment, but the deduction for the underlying debt's worthlessness is deferred until the debt becomes worthless.

Summary

Henry Crown guaranteed a debt of United Equity Corp. and paid it off with borrowed funds in 1966. The court held that Crown made a payment in 1966 sufficient to establish a basis in the debt, allowing for a potential bad debt deduction. However, the deduction was postponed until 1969, when the underlying claim against United Equity became worthless. This decision clarifies that the timing of bad debt deductions for guarantors using borrowed funds hinges on both the payment and the worthlessness of the debt, with significant implications for tax planning and the structuring of financial transactions.

Facts

In 1963, Henry Crown guaranteed a loan of United Equity Corp. to American National Bank. In November 1965, Crown replaced United Equity's note with his personal note to American National. In December 1966, Crown borrowed money from First National Bank and used it to pay off his note to American National. In March 1967, Crown borrowed from American National to repay First National. United Equity was adjudicated bankrupt in 1967. In 1968, Crown collected $70,000 from co-guarantors. In 1969, Crown assigned his interest in the collateral and indemnity rights for $2,500, marking the year when the debt became worthless.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency for Crown's tax years 1966-1969. Crown petitioned the U. S. Tax Court, seeking a bad debt deduction for 1966, or alternatively for 1969 or a capital loss for 1969. The Tax Court held that Crown made a payment in 1966 but delayed the bad debt deduction until 1969 when the debt became worthless.

Issue(s)

1. Whether Crown made a payment in 1966 sufficient to support a bad debt deduction?
2. Whether the bad debt deduction should be allowed in 1966 or postponed until the year the debt became worthless?
3. Whether Crown is entitled to a capital loss deduction for the assignment of collateral in 1969?

Holding

1. Yes, because Crown borrowed funds from First National Bank and used them to pay off his note to American National in 1966, establishing a basis in the debt.
2. No, because the deduction was postponed until 1969, when the debt became worthless, as evidenced by identifiable events indicating no hope of recovery.
3. No, because the assignment of collateral in 1969 did not result in a capital loss due to the debt's worthlessness being established in that year.

Court's Reasoning

The court applied the rule that a cash basis taxpayer must make an outlay of cash or property to claim a bad debt deduction. Crown's substitution of his note for United Equity's in 1965 did not constitute payment, but his use of borrowed funds from First National to pay American National in 1966 did. The court rejected the Commissioner's argument that the transactions were a single integrated plan, citing the distinct nature of the loans and the lack of mutual interdependence. The court also clarified that payment with borrowed funds gives rise to a basis in the debt, but the deduction is only available when the debt becomes worthless, which was determined to be 1969 due to identifiable events such as the reversal of the Bankers-Crown agreement. The court emphasized the form over substance doctrine in this area of tax law, where the timing of deductions is critical. No dissenting or concurring opinions were noted.

Practical Implications

This decision impacts how guarantors using borrowed funds should approach tax planning for bad debt deductions. Attorneys must advise clients that while payment with borrowed funds can establish a basis in the debt, the deduction is only available when the underlying debt becomes worthless. This ruling necessitates careful tracking of the worthlessness of debts and the timing of payments. It also affects the structuring of financial transactions to optimize tax outcomes, as the timing of loans and payments can influence the year in which deductions are claimed. Subsequent cases like *Franklin v. Commissioner* have continued to apply these principles, reinforcing the importance of form in tax law. Businesses and individuals must consider these factors when dealing with guarantees and potential bad debts, ensuring they document identifiable events that signal worthlessness to support their deductions.

