Black Gold Energy Corp. v. Commissioner, 99 T. C. 482 (1992)

A guarantor can only deduct a bad debt loss under section 166 when an actual payment is made on the guaranty obligation.

Summary

In Black Gold Energy Corp. v. Commissioner, the U. S. Tax Court ruled that an accrual basis taxpayer, Black Gold Energy Corp. , could not claim a bad debt loss deduction in 1984 for its guaranty of another company's debts, as no payment was made until 1985. The court further held that the delivery of a note by the guarantor does not constitute payment for purposes of section 166. This decision emphasizes that actual payment is necessary for a guarantor to claim a bad debt loss, impacting how guarantors must account for their liabilities and deductions.

Facts

Black Gold Energy Corp. guaranteed debts of Tonkawa Refinery, which defaulted in April and July 1984. Black Gold was sued by Tonkawa's creditors, Conoco and First National Bank, in September 1984. Settlements were reached in January 1985, with Black Gold paying $850,000 to Conoco and issuing a $3,850,000 note to First National Bank, on which it paid $50,000 in 1985. Black Gold attempted to claim a $4,700,000 bad debt loss for 1984, which was denied by the Commissioner.

Procedural History

The Commissioner disallowed Black Gold's 1984 bad debt deduction. Black Gold then petitioned the U. S. Tax Court, which upheld the Commissioner's decision, ruling that no bad debt loss was deductible in 1984 and that the delivery of a note did not constitute payment for bad debt deduction purposes.

Issue(s)

1. Whether an accrual basis taxpayer may claim a deduction for a bad debt loss under section 166 in the year of the debtor's default, even though no payment was made on the guaranty until the following year.
2. Whether the delivery of a note by a guarantor to a creditor constitutes payment for purposes of section 166.

Holding

1. No, because section 166 requires actual payment on the guaranty obligation before a bad debt loss can be deducted.
2. No, because the delivery of a note does not constitute payment for purposes of section 166; only actual payments on the note can be deducted as a bad debt loss.

Court's Reasoning

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The court relied on the Supreme Court's decision in Putnam v. Commissioner, which established that a guarantor's bad debt loss arises only upon payment to the creditor, when the guarantor becomes subrogated to the creditor's rights. The court interpreted section 1. 166-9(a) of the Income Tax Regulations as requiring actual payment for a bad debt deduction. The court rejected Black Gold's argument that its liability as primary obligor was fixed in 1984, stating that until payment is made, the debt cannot be considered worthless. Furthermore, the court held that the delivery of a note does not constitute payment, consistent with prior rulings for cash basis taxpayers, extending this rule to accrual basis taxpayers as well.

Practical Implications

This decision clarifies that guarantors, regardless of their accounting method, must make actual payments to claim bad debt losses under section 166. It impacts tax planning for guarantors, requiring them to wait until payments are made to claim deductions. The ruling also affects how settlements involving notes are treated for tax purposes, emphasizing that only payments on notes, not their issuance, trigger bad debt deductions. Subsequent cases have followed this precedent, reinforcing the necessity of actual payment for bad debt deductions by guarantors.

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