No. 99-1557

In the Supreme Court of the United States

ROBERT C. COBORN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner was entitled to a worthless bad debt deduction in 1988 with respect to advances he had made to his controlled corporation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-2a) is unpublished, but the per curiam decision is noted at 205 F.3d 1345 (Table). The opinion of the Tax Court (Pet. App. 3a-9a) is unofficially reported at 76 T.C.M. (CCH) 705.

JURISDICTION

The judgment of the court of appeals was entered on December 23, 1999. The petition for a writ of certiorari was filed on March 22, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner was the controlling shareholder of Environmental Protection Laboratories, Inc. (EPL) from

1983 until 1990. Pet. App. 4a.[1] EPL was a Minnesota corporation that developed products for laboratory testing, environmental monitoring and microbiology. Petitioner began purchasing shares of EPL stock in 1972. He hoped to help develop EPL into a successful corporation that could be sold for a profit to a third party. In 1983, petitioner's son became president of EPL and helped develop a business for its most promising product lines. *Ibid.*

Beginning in 1972, petitioner began advancing funds to EPL. Both petitioner and the corporation characterized those advances as loans. Pet. App. 4a-5a.[2] By 1988, those advances amounted to $1,571,429. *Id.* at 4a. Although the gross receipts of the business increased by 400% between 1983 and 1987, the corporation did not achieve any net profits in those years and had a negative net worth. *Id.* at 6a. The corporation remained a viable operating entity during those years, however, and it made payments to petitioner in 1986, 1987, and 1988. *Id.* at 5a-6a. Despite its losses, petitioner felt that the business prospects of the corporation remained good in 1988, particularly with respect to certain product lines. *Id.* at 6a. The financial statement of the corporation for 1986 listed product rights valued at $2,369,810. Although this asset was not contained on

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[1] Although petitioner died while this case was pending in Tax Court, there has been no suggestion of death made on the record and no motion to substitute a personal representative has been filed. See Tax Ct. R. 63(a); Fed. R. App. P. 43(a).

[2] The Commissioner took the position that these transfers were capital contributions rather than loans. See 26 C.F.R. 1.166-1(c) ("only a bona fide debt qualifies for purposes of Section 166"). Neither the Tax Court nor the court of appeals addressed this issue.

the corporation's 1988 statement, there is no evidence that the product rights lost value in that year. *Ibid.*

During 1988, EPL continued to try to attract outside investors and planned a public sale of its stock. Pet. App. 7a. To improve the appearance of the company's balance sheet, petitioner executed a document purporting to cancel $1.6 million of the debt owed to him by the corporation on December 30, 1988. The document stated that petitioner was forgiving the debt to conform to the request of L'Argent International to induce it to purchase a portion of the Company's stock. It made no reference to the worthlessness of any part of the purported debt. Before thus canceling the purported debt of the corporation (see note 2, *supra*), petitioner never formally demanded repayment and took no steps toward collection. Pet. App. 2a.[3]

EPL continued to operate after 1988. Pet. App. 7a. Despite incurring losses in 1989 that were larger than those incurred in 1988, EPL designed a new business plan and continued its efforts to attract outside investors. Petitioner also continued to transfer funds to EPL after 1988. *Ibid.* In 1992, EPL changed its name to Micro Bio Logics, Inc., and conducted an unsuccessful initial public offering of its stock. *Ibid.*

2. Petitioner claimed a $1.6 million nonbusiness bad debt deduction on his 1988 federal income tax return. He reported this deduction as a capital loss. In 1988, petitioner also realized a capital gain of $2,044,998 from

[3] EPL reported $1.6 million of cancellation of indebtedness income on its 1988 corporate tax return. The corporation also sustained a net operating loss of $717,119 in 1988 which, when coupled with a $1,653,328 accumulated net operating loss carried forward from 1982-1987, enabled the company to recognize the $1.6 million of cancellation of indebtedness income and still claim no tax liability for 1988. Pet. App. 7a-8a.

an installment sale of his stock in a retail grocery store chain in which he was an officer and shareholder. Pet. App. 8a. Petitioner reported $855,089 of this capital gain in 1988, $451,494 in 1989, $30,786 in 1990, and $34,730 in 1991. *Ibid.* Petitioner's asserted bad debt deduction thus produced a net capital loss of $710,474 in 1988. He claimed $3,000 of this net capital loss in 1988, and carried forward the unused portion of the loss to 1989, 1990 and 1991. The loss carried forward produced net capital losses in each of those following years. The claimed bad debt deduction thereby allowed petitioner to offset the substantial capital gains he recognized in 1988, 1989, 1990 and 1991. *Ibid.*

The Commissioner determined that petitioner was not entitled to the $1.6 million bad debt deduction in 1988 or to the resulting capital losses carried forward to 1989-1991. The Commissioner concluded that petitioner (i) had not established that the purported debt was a loan rather than a capital contribution and (ii) had not established that the purported loan became "worthless" in 1988.

3. The Tax Court concluded that petitioner failed to establish that the purported loan became worthless in 1988. The court emphasized that petitioner made no demands for repayment from EPL, took no steps to enforce collection, and forgave the debt in 1988 to enhance the financial statements of EPL in anticipation of a sale of its stock. Pet. App. 7a. The court noted that "[d]eclining business, lack of profits, or poor financial condition do not necessarily establish worthlessness of a debt," especially when the debtor continues to operate as a business and the creditor continues to make loans to the debtor. *Id.* at 8a. In concluding that petitioner's debt did not become worthless in 1988, the

court cited the continuing activity of the company after that year (*id*. at 9a):

> The evidence establishes that, after 1988, EPL continued to operate as a business. Petitioner continued to seek a sale of the stock of EPL, and EPL conducted ongoing business activity. In 1989, a new business plan for EPL was formulated, and in 1992 a public offering of EPL stock occurred. Significantly, after 1988, petitioner continued to transfer funds to EPL. The evidence does not demonstrate that EPL's purported debt to petitioner became worthless in 1988.

4. In a per curiam decision, the court of appeals affirmed "on the basis of the tax court's opinion." Pet. App. 2a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. A taxpayer may deduct a debt that "becomes worthless within the taxable year." 26 U.S.C. 166(a), (d).[4] A debt becomes worthless when there are "reasonable grounds for abandoning any hope of repayment in the future." *Estate of Mann* v. *United States*, 731 F.2d 267, 276 (5th Cir. 1984). The question of worthlessness is a factual one. *Boehm* v. *Commissioner*, 326 U.S. 287, 293 (1945); *Cox* v. *Commissioner*, 68 F.3d 128, 131 (5th Cir. 1995). Events that bear on worthlessness

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[4] While a business bad debt may be deducted from ordinary income, a nonbusiness bad debt (such as the debt claimed by petitioner in this case) is treated as a short-term capital loss subject to limits on deductibility. 26 U.S.C. 166(a), (d), 1211(b).

include the debtor's serious financial reverses, insolvency, persistent refusals to pay on demand, abandonment of business, bankruptcy, the unsecured or subordinated status of the debt, or the fair market value of assets available to creditors ahead of the taxpayer. Events that militate against worthlessness include the creditor's failure to press for payment (especially if the debtor is a relative or a friend), the debtor's ability to continue operations in the face of losses or insolvency, the creditor's willingness to make further advances, the debtor's earning capacity, or payment of interest or principal. See, *e.g.*, *Cole* v. *Commissioner*, 871 F.2d 64, 66-67 (7th Cir. 1989); *Roth Steel Tube Co.* v. *Commissioner*, 620 F.2d 1176, 1181-1182 (6th Cir. 1980); *Riss* v. *Commissioner*, 478 F.2d 1160, 1165-1166 (8th Cir. 1973); *American Offshore, Inc.* v. *Commissioner*, 97 T.C. 579, 594 (1991); 26 C.F.R. 1.166-2(a) (worthlessness is determined by considering "all pertinent evidence" such as the value of any collateral securing the debt and the debtor's financial condition).

In finding that petitioner failed to establish that the asserted debt of EPL was worthless in 1988, the Tax Court cited evidence that EPL continued its operations, petitioner continued to lend money to EPL, and EPL developed a new business plan in 1989 and had an initial public offering in 1992. Pet. App. 9a. The Tax Court also found that petitioner never attempted to collect the asserted debt, that petitioner and his son still considered EPL's business prospects to be good in 1988, and that petitioner forgave the asserted debt to make its balance sheet more attractive to investors in anticipation of a stock sale. *Id.* at 6a-7a. Taken together, this evidence was ample to support the Tax Court's finding that petitioner failed to establish the worthlessness of a debt in 1988. There is no basis to disturb this factual determination "concurred in by two lower courts." *Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982). See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1989).

2. Petitioner errs in contending (Pet. 16-23) that it was improper for the Tax Court to rely upon events occurring after 1988 as evidence that the asserted debt did not become worthless in that year. The subsequent recovery of a debt may not, by itself, establish that the debt was in fact not worthless in a prior year. But evidence of subsequent recovery is irrelevant only if, during the year in which the deduction is claimed, the taxpayer could not reasonably have foreseen the *possibility* of recovery in the future. See, *e.g.*, *United States* v. *S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927) (corporation allowed a deduction for its investment losses in a subsidiary German corporation whose property was sequestered by the German government during World War I); *Jeppsen* v. *Commissioner*, 128 F.3d 1410, 1415-1416 (10th Cir. 1997) (in evaluating deduction for theft loss, court refused to consider evidence of ultimate recovery when the prospect of such recovery was not reasonably foreseeable at close of pertinent tax year), cert. denied, 524 U.S. 916 (1998); *Halliburton Co.* v. *Commissioner*, 946 F.2d 395 (5th Cir. 1991) (corporation allowed a deduction for losses from a mining venture in Iran where Iranian government expropriated facilities after the 1978 Islamic revolution).

It is obvious, however, that subsequent events often bear proper weight in analyzing whether a claim of worthlessness has a reasonable basis in fact. As the Fifth Circuit explained in *Estate of Mann*, 731 F.2d at 276-277, 278 n.19, courts properly may consider subsequent events to evaluate the reasonableness of the claim that a debt in fact became worthless during the year at issue. Accord, *Reading & Bates Corp.* v. *United States*, 40 Fed. Cl. 737, 760 (1998); *Crown* v. *Commissioner*, 77 T.C. 582, 600 (1981). The subsequent events cited by the Tax Court in the present case—the corporation's continued operations, petitioner's continued advances, and the corporation's new business plan and stock offering—were all relevant to petitioner's contention that, in 1988, he lacked any reasonable grounds for expecting subsequent repayment. See *Riss* v. *Commissioner*, 478 F.2d at 1167 ("Of course, the granting or extending of additional credit after failing to receive proper payment from a prior debt would also indicate that the debt was not worthless."); *Bullard* v. *United States*, 146 F.2d 386, 388 (2d Cir. 1944) ("when the business does continue, the circumstances must be exceptional which will induce us to hold that the shares have as yet become worthless").

Moreover, even without reference to events after 1988, there is ample evidence that EPL continued to operate and continued to receive advances from petitioner in the face of mounting losses both before and during 1988. This evidence is alone sufficient to support the court's finding that petitioner's asserted debt did not become worthless in that year. See *Roth Steel Tube Co.* v. *Commissioner*, 620 F.2d at 1182; *Intergraph Corp.* v. *Commissioner*, 106 T.C. 312, 323 (1996), aff'd without published opinion, 121 F.3d 723 (11th Cir. 1997) (Table); *Sika Chemical Corp.* v. *Commissioner*, 64 T.C. 856, 863 (1975), aff'd without published opinion, 538 F.2d 320 (3d Cir. 1976) (Table).

Petitioner also errs in contending (Pet. 10-13) that reliance upon events occurring after 1988 violates the annual accounting principle described in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). The fact that taxes are determined and paid on an annual basis under the Internal Revenue Code does not mean that evidence concerning transactions and events from other years has no bearing on a proper determination of taxes. In particular, events from other years may be considered in determining whether, in the year at issue, the taxpayer had honest and reasonable grounds for abandoning any expectation of repayment of a debt. *Estate of Mann* v. *United States*, 731 F.2d at 277; *Reading & Bates Corp.* v. *United States*, 40 Fed. Cl. at 760. In the present case, the Tax Court properly determined that petitioner lacked a reasonable basis for treating his advances to the corporation as worthless in 1988. That factual determination, concurred in by the court of appeals, does not warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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