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Fifth Circuit: No bad debt deduction for payment made to address subsidiary's undercapitalization

The U.S. Court of Appeals for the Fifth Circuit affirmed the findings of a federal district court that a taxpayer was not entitled to an income tax deduction related to the payment of \$52 million made by the taxpayer's predecessor in interest to the predecessor's subsidiary.

The taxpayer asserted that the \$52 million payment was a bad debt under section 166 or, alternatively, an ordinary and necessary business expense under section 162. The district court disagreed, and the Fifth Circuit affirmed. Therefore, no income tax deduction was allowed for the \$52 million payment.

The case is: *Baker Hughes, Inc. v. United States*, No. 18-20585 (5th Cir. November 21, 2019). Read the Fifth Circuit's [decision](#) [PDF 150 KB]

Summary

A U.S. parent company operated fracking services in Russia through a Russian subsidiary. [The taxpayer was the successor in interest to the parent company.]

The Russian subsidiary entered into a three-year contract to perform fracking services in Siberia. The Russian company sustained unanticipated losses on the contract in 2006 and 2007, and decided that at the end of the three-year term, it would exit the Russian market.

At this point, the Russian Ministry of Finance informed the Russian subsidiary that it was not in compliance with provisions of the Russian civil law—one of which required a joint stock company (like the Russian subsidiary) to maintain net assets of a certain amount and if there were noncompliance, the Russian tax authority could liquidate the company as being undercapitalized. The parent company eventually made wire transfers of \$52 million to the Russian subsidiary—thereby ending the risk of liquidation by the government. The transfer of funds was made as “free financial aid” pursuant to a provision of Russian tax law that allows such payments to be exempt from Russian profit tax. In making the transfer, the parent company estimated that its losses would have been \$160 million if there had been a liquidation of the Russian subsidiary by the government.

The parent company claimed the \$52 million payment provided to the Russian subsidiary as a bad debt expense on its U.S. income tax return for fiscal year 2008. The IRS disallowed the deduction, finding that the parent company had failed to support the claim that the transaction was a "bad debt or guarantee debt" as allowed under section 166. The IRS also noted that the parent company had not shown that the payment was deductible as an ordinary and necessary business expense under section 162. Rather, the IRS considered the payment was a contribution to capital.

The taxpayer (the successor in interest) filed a refund action in federal district court, seeking a refund of approximately \$17.7 million. The district court granted summary judgment for the government. The Fifth Circuit affirmed, noting that:

- Concerning the claim for a bad debt deduction, the Russian subsidiary had no obligation to repay the \$52 million. The Fifth Circuit looked to a 1956 U.S. Supreme Court case that distinguished between voluntary payments made while knowing there would be no repayment and payments made in compliance with a taxpayer's obligations as a contractual guarantor. Further, the regulations under section 166 provide that a "contribution to capital shall not be considered a debt for purposes of section 166." Reg. section 1.166-1(c).
- Concerning the claim that the payment was an expense, the court disagreed and concluded that it was a non-deductible contribution to capital of the Russian subsidiary.

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