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Bad Debt Deduction Denied to Guarantor: *Baker Hughes v. United States*

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A bad debt deduction may be available to a guarantor that suffers a loss by reason of performance of the guarantee. In general, where a taxpayer guarantees the debt obligation of another person in the course of the taxpayer's trade or business, and latter makes a payment as guarantor, the payment is treated under IRC §166 (relating to bad debt deductions) as a debt that became worthless in the year in which the payment is made, or, if the taxpayer had a right of subrogation against the original debtor, in the year in which the right of subrogation becomes worthless (see Treasury Reg. §1.166-9).

The appropriate tax treatment is less clear where a taxpayer makes a payment not in respect of a guarantee of another person's debt obligation, but, rather, by reason of a guarantee of performance of some other sort of contractual obligation of another person. In *Baker Hughes Incorporated v. United States*, 943 F.3d 255 (2019), a recent decision by the U.S. Court of Appeals for the Fifth Circuit affirming a district court decision, a deduction was disallowed for an expenditure that was at least arguably of this nature.

Facts in 'Baker Hughes'

During and prior to 2008 (the tax year at issue), BJ Services Company (BJ Parent) was the parent company of a group of affiliated corporations and subsidiaries that provided fracking services.

A Russian subsidiary (BJ Russia) of BJ Parent entered into a contract to provide pressure pumping services to a joint venture (TNK-BP) between a Russian company and British Petroleum. As required to obtain the contract, BJ Parent agreed to be responsible to perform any contractual obligation of BJ Russia that BJ Russia was unable to perform (the performance guarantee) and to be liable for any damages resulting from BJ Russia's failure to perform.

After BJ Russia sustained unexpected losses under the contract in 2006 and 2007, it decided to exit the Russian market and informed TNK-BP in September 2008 of its intention not to renew the contract; rather, it "would exit the Russian market after BJ Russia had fulfilled its contractual obligations" (according to the Court of Appeals decision).

In October, the Russian Ministry of Finance notified BJ Russia that it was not maintaining sufficient net assets to meet requirements of Russian law, and that BJ Russia would be subject to liquidation by the Russian taxing authority if the shortfall in net assets was not promptly addressed.

BJ Parent believed that, if a liquidator was appointed for BJ Russia, TNK-BP would compel BJ Parent to finish the contract pursuant to the performance guarantee, BJ Parent would in turn have to hire a third party to complete the work, and the potential financial exposure to BJ Parent under these circumstances exceeded $160 million. In addition, a default by BJ Russia might damage the business reputation of BJ Parent.

To prevent these potential consequences of inadequate capitalization, BJ Russia told the Ministry of Finance that steps would be taken in 2008 to increase its net assets. Ultimately, BJ Parent made wire transfers of $52 million in the aggregate to BJ Russia as "Free Financial Aid" (FFA) under the Tax Code of Russia, on behalf of the majority shareholder of BJ Russia. Such amounts, if paid by a majority shareholder without consideration, were exempt from a Russian profit tax. BJ Russia and its majority shareholder agreed in writing that BJ Russia had no obligation to repay those amounts.

BJ Russia used at least part of the FFA to partially repay a loan to BJ Russia from another subsidiary of BJ Parent. The FFA contribution apparently resolved the undercapitalization problem identified by the Ministry of Finance.

BJ Parent reported the payments aggregating $52 million on its tax return for fiscal 2008 as a bad debt expense. The IRS disallowed the deduction, stating that BJ Parent failed to show that the payment was deductible as a "bad debt or guaranteed debt" under IRC §166, or otherwise deductible as an ordinary and necessary business expense under IRC §162. The IRS considered the payments

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to be nondeductible contributions to the capital of BJ Russia.

Baker Hughes, as the successor to BJ Parent, filed suit in U.S. district court, asserting that it was entitled to a tax refund for 2008 on the basis that the $52 million expenditure either gave rise to a bad debt deduction under §166, or otherwise constituted a business expense deductible under §162. Upon cross motions by the parties for summary judgment, the district court granted summary judgment to the government, and Baker Hughes appealed.

Discussion

It was undisputed that, taking into account the characterization of the payments as FFA under Russian law, the payments did not result in a debt obligation of BJ Russia to BJ Parent. Baker Hughes argued, however, that several cases (cited in the Court of Appeals opinion) supported a bad debt deduction by reason of a payment by a guarantor, even where the guarantor did not have a subrogation right or other right of repayment.

Those cases were distinguished, however, as involving situations where the guaranteed obligation was itself a debt obligation, such that the creditor would have been entitled to a bad debt deduction if the guarantor had not satisfied the obligation of the debtor. As was discussed by the Supreme Court in *Putnam v. Commissioner*, 352 U.S. 82 (1956), a payment by a guarantor of a note causes the guarantor to be viewed as stepping into the creditor's shoes as (in effect if not in form) the successor holder of the original debt.

The Court of Appeals reasoned that, although a bad debt deduction may arise even if the guarantor never actually acquired the debtor's obligation or another right to be repaid, there must be a debt in the first instance in order for there to be a bad debt deduction. By contrast, the payments the tax treatment of which was at issue in *Baker Hughes* did not result from a default or threat of default by BJ Russia with respect to any debt obligation of BJ Russia.

Baker Hughes further argued that, in *Myers v. Commissioner*, 42 T.C. 195 (1964), advances made by a stockholder of a corporation that had entered into a construction contract to build homes were held to be deductible, in a context in which the completion of construction had been guaranteed by the stockholder and its owners for the benefit of the corporation's lender. *Myers* was distinguished by both the district court and the Court of Appeals on the basis that the advances created a debtor-creditor relationship (even though the corporation may have been insolvent at the time the advances were made); in contrast, BJ Russia had no obligation to repay the FFA that it received.

The Court of Appeals further noted that TNK-BP never asserted that that BJ Russia was in default on its contractual obligations to TNK-BP and never made a demand on BJ Parent to perform the contractual obligations of BJ Russia that BJ Parent had guaranteed.

Both the district court and the Court of Appeals were also unpersuaded by Baker Hughes' arguments that the FFA was also deductible as an ordinary and necessary business expense of BJ Parent. The courts reasoned that a fundamental requirement of deductibility under §162 is that the expenditure be an ordinary and necessary business expense of a business carried on by the person claiming the deduction, and that Baker Hughes had failed to establish that the FFA was an ordinary business expense of any business carried on by BJ Parent.

Baker Hughes argued that, under *Lohrke v. Commissioner*, 48 T.C. 679 (1967) and other cases, as well as under the reasoning in an IRS technical advice memorandum (TAM 9522003 (June 2, 1995)), a taxpayer could claim a deduction for a payment made by it of a business expense of another person, where the payment furthers the paying taxpayer's own business interests, such as by preserving its reputation and goodwill or by accomplishing another business objective of the taxpayer, for example, the orderly liquidation of its subsidiary. More specifically, Baker Hughes argued that the FFA was paid to permit the winding up of BJ Russia's business operations in a cost-efficient manner.

Both the district court and the Court of Appeals found, however, that BJ Parent could not rely on the principles of *Lohrke* and similar cases, because the payment of FFA was not directly linked to any specific expenditure by BJ Russia to perform contractual obligations covered by the performance guarantee, and because the intended and actual result of the FFA was to permit BJ Russia to continue to carry on, rather than terminate, its business operations. Accordingly, the Court of Appeals affirmed the decision of the district court that no deduction was allowable to BJ Parent in the year at issue by reason of the FFA payment.

Observations

Under the analysis in the *Baker Hughes* decisions, the FFA payments should have increased the tax basis of the majority stockholder of BJ Russia in its stock in BJ Russia. The opinions do not discuss whether BJ Parent received a tax benefit from that basis (or any related basis adjustment) in a later year. Regardless, *Baker Hughes* is a reminder of the difficulty in claiming as an ordinary business expense any expenditure that is documented as a contribution to capital by the person making the payment, even where the contribution to capital is made not with the expectation of profiting from a business or investment activity of the recipient, but rather to minimize the exposure to loss of the person making the payment.

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