IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Income Tax

SYLVIA THOMPSON aka SYLVIA THOMPSON, DECEASED, Plaintiff, v. DEPARTMENT OF REVENUE, State of Oregon, Defendant.	)	TC-MD 060611D **DECISION**

Plaintiff appeals Defendant's denial of Plaintiff's amended tax return for tax years 1999, 2000, and 2001, and Defendant's decrease in claimed expenses for tax years 2002, 2003 and 2004. This matter is before the court on cross motions for summary judgment.

I. STATEMENT OF FACTS

The parties have stipulated to the following facts and there is no material issue of fact. Plaintiff purchased the subject property in 1996 for $1,500,000 from the Cantwells and the other owners (sellers). (Stip Facts.) In the Sale Agreement (Agreement), Plaintiff acknowledged the sellers' loan with Valley of the Rogue Bank (Bank), which was $600,000 at the time of the sale. (*Id*.; Ptf's Ex A at 2.[1]) The Agreement also provided that the sellers had full responsibility for the loan, would continue to make the monthly payments, and had until April 1, 2004, to pay the full amount of the loan. (*Id.*; Ptf's Ex A at 2.) The sellers secured their promise to pay the loan by granting Plaintiff an interest in all the "fixtures, equipment, inventory, stock and ownership in [the property] as security." (Stip Facts; Ptf's Ex A at 2.)

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[1] Plaintiff's Exhibit A is attached to Petitioner's Opening Brief, filed April 14, 2007.

Following the sale, Plaintiff leased the property back to the sellers. (*Id.*) The lease agreement (Lease) reiterated the sellers' obligation to make monthly payments on the loan as well as the April 1, 2004, deadline to pay off the loan. (*Id.*) The Lease also restated the security interest given to Plaintiff in the Agreement. (*Id.*; Ptf's Ex A at 1.)

The sellers failed to make loan payments in April and May of 2001. (Stip Facts.) On May 23, 2001, the Bank sent the sellers a letter stating the reasons they were in breach of the terms of the loan and listing requirements to remedy the missed payments. (*Id.*) The sellers were given until June 11, 2001, to cure the default. (*Id.*)

On May 18, 2001, Sellers were locked out of the subject property. (Ptf's Opening Br at 1.) On May 24, 2001, the day after the Bank sent the letter informing the sellers of the default on the loan, Plaintiff sent a "written notice to terminate the lease asserting the lessees had abandoned the property." (Stip Facts.) Following her demand and lockout of the sellers, Plaintiff leased the property to another party and sold the fixtures (valued at $300,000) to that party for $100,000. (*Id.*)

On September 7, 2001, Plaintiff paid the remaining balance [$409,000] on the loan to the Bank. (*Id.*) After paying off the loan, on November 8, 2001, Plaintiff accepted assignment. (*Id.*; Ptf's Compl at 11.) Subsequently, Plaintiff filed a claim against the sellers in Jackson County Circuit Court, which was later removed to the United States District Court for the District of Oregon. (Stip Facts.)

Plaintiff filed amended tax returns in 1999, 2000, and 2001. The amended returns stated that Plaintiff "added the payoff amount to the basis of the property, expensed attorney fees involved [with the property], and depreciated the payoff amount over the remaining life of the loan." (Ptf's Opening Br at 2.) In addition, Plaintiff claimed additional expenses for tax years

2002, 2003, and 2004. Defendant denied the amended returns and claimed expenses. (Ptf's Compl at 7.) Plaintiff filed a timely appeal.

II. ANALYSIS

The main issue before the court is whether Plaintiff's payment to the Bank is a deductible expense or an amount that must be capitalized. Oregon has adopted the federal income tax law as a starting point for determining the personal taxable income of its residents. ORS 316.048.[2] In analyzing the law governing state taxable income, the court is guided by the legislature's express intent "to make the Oregon personal income tax law identical in effect to the provisions of the federal Internal Revenue Code relating to the measurement of taxable income of individuals." ORS 316.007. Specifically, the legislature intended the Internal Revenue Code (IRC) provisions "relating to the definition of income, exceptions and exclusions therefrom, deductions * * * [and] depreciation" to be applied. *Id.*

Allowable deductions from taxable income are a "matter of legislative grace" and the burden of proof (substantiation) is placed on the individual claiming the deduction. *INDOPCO, Inc. v. Commissioner*, 503 US 79, 84, 112 S Ct 1039, 117 L Ed 2d 226 (1992). IRC section 162(a) "allows a deduction for ordinary and necessary business expenses paid or incurred during the taxable year in connection with the carrying on of a trade or business." *Winter v. Commissioner (Winter)*, TC Memo 2002-173 (2002), citing *Commissioner v. Lincoln Sav. & Loan Association* (*Lincoln Sav*), 403 US 345, 352, 91 S Ct 1893, 29 L Ed 2d 519 (1971).

1. *Bad Debt*

Plaintiff alleged that her payment to the Bank and her subsequent inability to recover the amount paid from the sellers should be deductible as a bad debt, an "ordinary and necessary

[2] All references to the Oregon Revised Statutes (ORS) are to 1999 unless otherwise stated.

[business] expense." IRC § 162(a).[3] Bad debts are debts that "becom[e] worthless within the taxable year." IRC § 166(a)(1). Only bona fide debts are allowed to qualify as bad debts. Treas Reg § 1.166-1(c) (as amended in 1983). "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Id.* However, there is a "general rule that a debt does not arise for the purpose of section 166 where the obligation to repay is subject to a contingency that has not occurred." *Zimmerman v. US (Zimmerman)*, 318 F2d 611, 612 (9th Cir 1963) (emphasis omitted).

At the time the Agreement and Lease between Plaintiff and the sellers were signed, Plaintiff received a security interest in exchange for a promise that the sellers would continue to make loan payments to the Bank. There was no obligation between Plaintiff and the sellers requiring sellers to pay a "fixed or determinable sum of money" to Plaintiff, and therefore no bona fide debt. Treas Reg § 1.166-1(c) (as amended in 1983). Furthermore, the Agreement was contingent on a future event: the sellers' promise to make payments to the Bank. Under the general rule, obligations subject to contingencies that have not occurred do not create debts; in fact, such obligations are precluded from being bona fide debts. *See Zimmerman*, 318 F2d at 612-13. In order for a debtor-creditor relationship to arise and for a debt to be created, the contingent event would have to take place. *See Alexander & Baldwin v. Kanne*, 190 F2d 153, 155 (9th Cir 1951) (holding that the occurrence of a contingency [future event] would create a debtor-creditor relationship). However, even if the contingency occurred and the sellers failed to make payments to the Bank, there would still be no debtor-creditor relationship between Plaintiff and the sellers because the sellers' "obligation to pay a fixed * * * sum of money" was to the Bank, not to Plaintiff. Treas Reg § 1.166-1(c) (as amended in 1983). Therefore, with neither a

[3] All references to the Internal Revenue Code (IRC) are to 2000 unless otherwise stated.

contingency occurring that would create a debtor-creditor relationship nor an actual debtor-creditor relationship between Plaintiff and sellers, there was no debt, bona fide or otherwise, that could qualify as a bad debt.

Additionally, Plaintiff alleged that she did have an obligation because she was put in the position of a guarantor to the sellers by having bought a property subject to a loan the payments of which were the responsibility of others. (Ptf's Opening Br 6.) A guarantor is entitled to a bad debt deduction under Treasury Regulation section 1.166-9 (1963) (as amended in 1983). However, there was no contractual obligation for Plaintiff to make the loan payments should the seller default. Plaintiff was not a guarantor of sellers' obligation to the Bank. Further, Plaintiff's payoff of the loan did not create a debtor-creditor relationship because a voluntary undertaking to pay the debt of another may not create a debtor-creditor relationship.[4] *See Wortham Mach. v. US*, 521 F2d 160, 164 (10th Cir 1975). With no such relationship, there is no bona fide debt to qualify as a bad debt.

Because she fails to meet the statutory definition, Plaintiff may not claim a bad debt deduction under IRC section 166.

2. Deductible Expense or Capital Asset

In the alternative, Plaintiff alleged that the payment to the Bank should be deductible as an ordinary and necessary business expense. IRC § 162(a). The process of determining whether an expenditure is deductible or must be capitalized "is not always a straightforward or mechanical process. [E]ach case turns on its special facts, and the cases sometimes appear difficult to harmonize." *Lychuk v. Commissioner* (*Lychuk*), 116 TC 374, 387-388 (2001) (citing *INDOPCO*, 503 US at 86) (internal quotations omitted).

[4] In addition, voluntary payment of another's debt does not constitute a loss under IRC § 165, losses incurred in certain instances. *See Comm'r v. Alamitos Land Co.*, 112 F2d 648 (9th Cir 1940).

In determining whether an expenditure "that might otherwise qualify as currently deductible must be capitalized (IRC § 263[5])," the following factors should be considered:

(1) Does the expenditure create or enhance "a separate and distinct additional asset;"[6]

(2) Does the expenditure produce "a significant future benefit;"[7] and

(3) Was the expenditure incurred "in connection with the * * * acquisition of a capital asset."[8]

Considering the first factor, capitalization of an expenditure "does not hinge on the amount of value added to property." *Lychuk* 116 TC at 414. But rather "[w]hen the nature of an expenditure bears a direct relation to the acquisition of a capital asset, * * * the expenditure must be capitalized." *Id*. In the case before the court, at the time Plaintiff entered into the Agreement and Lease, Plaintiff knew that the sellers' debt to the Bank was secured by the subject property. Facing the prospect of foreclosure by the Bank, Plaintiff paid off the outstanding loan balance to obtain clear title to the subject property. After the payment to the Bank was processed, the value of the subject property was enhanced because the land was no longer subject to a lien of the Bank that held a mortgage on the subject property.

The second factor to consider is whether an expenditure produces "a significant long-term benefit." *Id*. At 416 (citing *Woodward*, 397 US at 577-78; *Idaho Power* 418 US at 12-14, and other cases (citations omitted.)) Plaintiff's payment to the Bank allowed her to continue the

[5] IRCsection 263(a)(1), which contains language that dates back to the Revenue Act of 1864, states that: "No deduction shall be allowed for – (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

[6] *Lincoln Sav*., 403 US at 354.

[7] *INDOPCO*, 503 US at 87-89.

[8] *Commissioner v. Idaho Power Co.* (*Idaho Power*), 418 US 1, 13, 94 S Ct 2757, 41 L Ed 2d 535 (1974); *see also Woodward v. Commissioner* (*Woodward*), 397 US 572, 575-576, 90 S Ct 1302, 25 L Ed 2d 577 (1970).

business of leasing the subject property and to generate income. If she had not made the payment and the sellers failed to bring the loan current, the Bank could have exercised its right to foreclose the subject property. Plaintiff's expenditure resulted in immediate and long-term benefits, allowing her to continue leasing the subject property without interruption.

With respect to the third factor, there is a "longstanding, firmly established body of law under which expenditures incurred 'in connection with' the acquisition of a capital asset are considered capital expenditures includable in the acquired asset's tax basis." *Lychuk*, 116 TC at 388-89 (citing, among other cases, *Idaho Power,* 418 US at 13; *Woodward*, 397 US at 575 ("It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures"); *Ellis Banking Corp. v. Commissioner*, 688 F2d 1376, 1379 (11th Cir 1982) ("an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset."). In defining "in connection with," the Supreme Court developed a "process of acquisition test" which focuses on "whether the expenditure was directly related to that acquisition." *Lychuk*, 116 TC at 391.

In looking at the facts of this case, it is agreed that, at the time Plaintiff purchased the subject property, she knew of the sellers' obligation to the Bank. In exchange for the sellers' promise to pay their obligation to the Bank, Plaintiff obtained an interest in all the "fixtures, equipment, inventory, stock and ownership in [the property] as security." (Stip Facts.) Subsequently, sellers defaulted on their obligation to the Bank and their promise to Plaintiff. Plaintiff made a payment in satisfaction of the loan to the Bank and invoked her right to the other property in which she had a security interest.

When the sellers failed to fulfill their promise to make loan payments to the Bank, Plaintiff took ownership of other property. The amount ($409,000) of the payment Plaintiff made to the Bank may have exceeded the value of the other property she received. In other judicial proceedings related to the subject property, the court reported that the real market value of the other property, specifically the fixtures, was $300,000, which she sold for $100,000, and that Plaintiff was unable to secure clear title to the other property in which she was given a security interest.[9] First, the payment amount must be allocated to the other property Plaintiff received. Failure to allocate any of the payment to the other property (fixtures, etc.) that Plaintiff received would suggest that the other property had no value, which is contrary to the stipulated facts of the case. There is no evidence suggesting that Plaintiff's original purchase price for the subject property in the amount of $1.5 million was less than the real market value. Absent evidence to the contrary, the payment to the Bank must first be allocated to the other property (fixtures, etc.) because it is directly related to sellers' default of its promise to Plaintiff that they would pay their obligation to the Bank. Second, to the extent Plaintiff's payment was in excess of the value of the other property she received and subsequently sold, the balance must be allocated to the acquisition of the subject property from the sellers because, in addition to enhancing the value of the subject property and producing a significant long term benefit, Plaintiff's payment was "directly related" to the acquisition of the subject property, which at the time of purchase was subject to the Bank's lien.

Value is a question of fact and the court did not receive affidavits nor was testimony offered on this issue. The parties are encouraged to discuss whether Plaintiff's payment exceeded the value of the other property she received (and thereafter sold) in the context of the court's holding that any excess amount must be capitalized as part of the cost of the subject property. The excess amount, if any, should be allocated to the subject property. In addition, the

[9] *Thompson v. Cantwell*, 2003 WL 23957144 (D Or) (2003) referencing Thompson Deposition Transcript pp 213-16, Cantwell Decl ¶ 16, and Supplemental Affidavit of Brent Thompson, pg. 4-5.

parties will need to compute allowable depreciation based on the expected life of the subject property, beginning from the date the payment was made. Because the fixtures and other property were sold almost immediately after being acquired, it is unlikely there will be an allowable depreciation expense for the other property. However, the parties should confirm that there is no allowable depreciation for the fixtures and other property.

In addition to claiming a deduction for the payment to the Bank, Plaintiff claims a deduction for legal fees incurred in seeking repayment of her payment of the sellers' obligation to the Bank. "Whether legal costs are incurred in connection with the acquisition of a capital asset depends on whether the *origin of the claim* litigated is the process of the acquisition itself." *Winter*, TC Memo 2002-173 (citing *Woodward*, 397 US at 577-78) (emphasis added). "Under the *origin of the claim test*, the nature of the transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the payor's motives in making the payment." *Id*. (emphasis added). "In determining whether the underlying transaction is capital in nature, the search for the *origin of the claim* is not limited to a simple determination of the first event in a chain which led to the litigation but, instead is an examination of all the facts * * * to (ascertain) the kind of transaction out of which the litigation arose." *Freeland v. Commissioner (Freeland),*[10] TC Memo 1986-10 (citing *Boagni v. Commissioner*, 59 TC 708, 713 (1973)) (emphasis added) (internal quotations omitted). In this case, "the kind of transaction out of which the litigation arose" was Plaintiff's payment of sellers' loan to the Bank. Plaintiff unsuccessfully attempted through litigation to recover her payment.

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[10] In *Freeland*, the court held that legal fees incurred in the defense of a foreclosure transaction must be capitalized as part of the cost of the assets acquired.

"When the nature of an expenditure bears a direct relation to the acquisition of a capital asset * * * the expenditure must be capitalized." *Winter*, TC Memo 2002-173 (citing *Lychuk* 116 TC at 414). When sellers defaulted on their loan to the Bank, Plaintiff satisfied sellers' debt to secure a clear title to the property she had purchased. Plaintiff's legal fees directly relate to her acquisition of other property (*i.e.* fixtures) and the subject property, and the legal fees must be capitalized. The legal fees shall be capitalized and allocated to the cost of the subject property and other property that secured sellers' promise to pay its obligation to the Bank.

III. CONCLUSION

After careful review of the statutes and case law, the court concludes that Plaintiff cannot claim a bad debt expense in the amount of her payment to the Bank. The court concludes that to the extent the payment amount exceeds the value of the other property she received as security for the sellers' promise to pay its loan to the Bank, the excess amount must be capitalized as part of the acquisition cost of the subject property. Allowable depreciation shall be computed. The legal fees Plaintiff incurred when seeking reimbursement of her payment to the Bank from the sellers must be capitalized because those expenditures arose out of the acquisition of the subject property. If there had been no acquisition of the subject property by Plaintiff, there would have been no payment to the Bank and therefore no need to incur legal fees in an effort to obtain reimbursement from the sellers. Now, therefore,

IT IS THE DECISION OF THIS COURT that Plaintiff's cross motion for summary judgment is denied; and

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IT IS FURTHER DECIDED that Defendant's cross motion for summary judgment is granted in part and denied in part.

Dated this _____ day of August 2007.

JILL A. TANNER
PRESIDING MAGISTRATE

If you want to appeal this Decision, file a Complaint in the Regular Division of the Oregon Tax Court, by mailing to: 1163 State Street, Salem, OR 97301-2563; or by hand delivery to: Fourth Floor, 1241 State Street, Salem, OR.

Your Complaint must be submitted within 60 days after the date of the Decision or this Decision becomes final and cannot be changed.

This document was signed by Presiding Magistrate Jill A. Tanner on August 31, 2007. The Court filed and entered this document on August 31, 2007.