



TaxNewsFlash

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Ninth Circuit: Discharged debt resulting in COD income not presumed worthless for purposes of claiming section 166 bad debt deduction

The U.S. Court of Appeals for the Ninth Circuit today held that the Tax Court did not err by requiring the taxpayer to prove the worthlessness of his discharged debts for purposes of claiming a nonbusiness bad debt deduction under section 166 and declining to presume worthlessness simply because cancellation-of-debt (COD) income arose from that discharge.

The case is: *Kelly v. Commissioner*, No. 23-70040 (9th Cir. June 5, 2025). Read the Ninth Circuit's [decision](#)

Summary

Between 2007 and 2010, the taxpayer transferred millions of dollars between his business entities, characterizing them as loans. On December 31, 2010, he cancelled many of these purported loans, and on his 2010 income tax return, he reported \$145 million of COD income, but excluded it due to his personal insolvency. He also reported a short-term capital loss of nearly \$87 million due to a nonbusiness bad debt deduction under section 166, claiming that the discharged debt automatically or presumptively rendered it worthless.

The Ninth Circuit held that in order to claim a nonbusiness bad debt deduction under section, a taxpayer must establish that the debt is bona fide, he has an adjusted tax basis in the debt sufficient to claim the deduction, and the debt became wholly worthless within the tax year. The court was not persuaded by the taxpayer's contention that "worthless" debt for purposes of claiming a nonbusiness bad debt deduction under section 166 was the same as "discharged" debt under section 61(a)(11), such that a debt discharge eliminates the debt's prior objective value and renders it worthless as a matter of law. Thus, the court found that the Tax Court did not err in requiring the taxpayer to prove the worthlessness of his discharged debts instead of presuming worthlessness because COD income arose from that discharge.

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