Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Edward J. Laubach, Jr.
Senior Attorney
(Small Business/Self-Employed)

from: Andrew M. Irving
Senior Counsel
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated September 11, 2003. This advice may not be used or cited as precedent.

<u>LEGEND</u>

X:

Equipment:

a:

$*b*:

$*c*:

$*d*:

$*e*:

Year 1:

Year 4:

Year 5:

Year 6:

Year 7:

ISSUES

1) Whether investors can claim a theft or other loss on their investment in X's Equipment? Alternatively, is a bad debt deduction available?

2) When are the investors entitled to claim a deduction?

CONCLUSIONS

1) We agree with your conclusion that investors cannot claim a theft loss on their investment in X's Equipment; the facts do not indicate that a theft occurred. The loss may be deductible as a capital loss under § 165(c)(2) of the Internal Revenue Code. However, if you conclude that the investors did not acquire ownership in the Equipment and that the purported sale-leaseback transaction was, in substance, a lending transaction, the potential deduction allowable to the investors would be a nonbusiness bad debt under § 166(d).

2) Whether the loss is deductible under § 165 or § 166, we agree with your conclusion that investors who elected to receive stock and possible cash under the plan of reorganization cannot take a deduction under either provision until there is no reasonable prospect of recovery. A deduction would be allowable for investors who elected to receive a nominal amount in the bankruptcy proceeding.

FACTS

X is a corporation engaged in the business of operating Equipment. X's Equipment is kept available for the convenience of customers at numerous locations across the United States. X charges a small fee for the use of its Equipment and therefore relies on significant volume of usage. X began selling Equipment to investors, and leasing it back, in Year 1. X entered approximately *a* Equipment sale-leaseback contracts during Year 1 through Year 4. Typically Equipment was sold to investors for a purchase price of $*b* to $*c*, with an attendant lease agreement providing for monthly payments of $*d* to $e. The lease agreement identified the specific Equipment transferred. The typical term was 5 years, with a 5-year renewal. At the end of the lease term the buyer had the option to resell the Equipment to X for the original purchase price. The buyer could also receive a full refund of its investment during the term upon notice to X. X retained responsibility for and control over the Equipment's operation, as well as the risk of loss.

In most instances X's costs of operating the Equipment, including its obligations under the leases, exceeded the amounts generated from the operation of the Equipment. In some cases lease payments were made with the proceeds of current "sales" of Equipment. X filed for Chapter 11 bankruptcy in Year 4. In addition, federal and state securities regulators have commenced proceedings against principals of X for selling unregistered securities.

In Year 5 the bankruptcy court confirmed a plan of reorganization for X. Under this plan X agreed to purchase the Equipment from investors in exchange for stock of X. Investors would also be entitled to receive payments from a litigation trust established to distribute the proceeds of various pending lawsuits. An investor could also opt to reduce his or her claim to $1, which would be received in full settlement of all claims against X, and was to be paid outside of the bankruptcy proceeding. The effective date of the plan was in late Year 7.

We understand that your office takes the position that the purchase and leaseback of the Equipment was, in substance, a loan. Further, it is our understanding that the investors: (1) are cash method individuals; (2) were not engaged in a trade or business involving the use of Equipment, or the lending of money; (3) paid the purchase price of the Equipment in cash; and (4) for the most part, did so with the intent of making an economic profit from the arrangement.

LAW AND ANALYSIS:

Based on your findings, it appears that investors in X's Equipment are or may be entitled to a deduction of some kind, at some point, depending upon whether the transaction is recast.[1] The issues concern the nature and timing of the deduction.

If the principals of X fraudulently induced the investors to part with their money, no debtor-creditor relation would have been created, because the principals lacked the intent to repay the "borrowed" money. In this situation the loss would be a theft loss under 165(c)(3). Rev. Rul. 71-381, 1971-2 C.B. 126.[2]

If there was no fraudulent inducement, and the form adopted by the parties is respected, the loss would arise from a transaction entered into for profit under § 165(c)(2), since they were not engaged in a trade or business.

If there was no fraudulent inducement, and the transaction is recast as a loan, the deduction would be allowed only as a bad debt under § 166. Sections 166 and 165 are mutually exclusive. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934).

These possibilities are discussed in more detail below.

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[1] If an investor was not deceived as to the nature of the transaction and entered into it for the tax benefits, an argument could be made for disallowing any deduction. See, e.g., West v. Commissioner, 88 T.C. 152 (1987). This may apply to particular investors in this case. However, you have concluded that generally investors had a substantial nontax profit motive.

[2] As you note, the distinction between a theft loss under § 165(c)(3) and an investment loss under § 165(c)(2) matters because § 165(h) places limitations on the deductibility of theft and casualty losses.

Theft Loss

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) provides that in the case of an individual, the deduction under § 165(a) is limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Section 1.165-8(d) of the Income Tax Regulations provides that the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

In Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956), the court stated that whether a theft loss occurs depends upon the law of the jurisdiction where it was sustained and that the exact nature of the crime, whether larceny or embezzlement, obtaining money under false pretenses, swindling or other wrongful deprivation of the property of another, is of little importance so long as it amounts to theft.

The use of new investors' money to make payments to old investors is the hallmark of a "Ponzi scheme." However, we agree that the facts submitted do not support a conclusion that the investors were the victims of a theft. There is no indication that X was not a viable business, and its emergence from bankruptcy indicates that it was. There is no indication that X sold Equipment that did not exist. There are currently no facts indicating that the principals of X intentionally made false representations to investors in order to induce them into making their investment. See Rev. Rul. 71-381, 1971-2 C.B. 126.

Investment Loss

You have concluded that most investors were promised a fixed return on a cash investment and had a motive other than tax avoidance to invest. If the transaction is not recast as a loan, then it would appear to lead to a potential loss deduction. Because the investors are not in the business of leasing telephone equipment, the loss would be an investment loss deductible under § 165(c)(2). For the same reason, the Equipment would be a capital asset in the hands of the investors, not a section 1231 asset. See § 1221(a)(2). The receipt of consideration, however nominal, renders a transaction a "sale or exchange" under § 1222, see Fairbanks v. United States, 306 U.S. 436 (1939), and any loss would therefore be a capital loss.

Bad Debt

The foregoing discussion assumes that the transaction in question was a sale and leaseback, and that the investors acquired the benefits and burdens of ownership in Equipment. However, you have concluded that this was not the case in most, if not all, of these transactions, and that the transactions, in substance, were secured loans.[3]

Sections 166(a)(1) and (d)(1) provide that a debt is deductible by a taxpayer in the year that it becomes worthless, except that a nonbusiness debt, as defined in § 166(d)(2), that becomes worthless during the taxable year is treated as a short-term capital loss. The amount of the deduction is generally the adjusted basis of the debt under § 1011. § 166(b).

Section 1.166-1(c) of the regulations provides, in part, that only a bona fide debt qualifies for purposes of § 166. 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.

Section 1.166-5(a)(2) of the regulations provides, generally, that if, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the resulting loss is treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more that 1 year. A loss on a nonbusiness debt is treated as sustained only if and when the debt has become totally worthless, and no deduction is allowed for a nonbusiness debt which is recoverable in part during the taxable year.

Section 1.166-5(b) of the regulations provides, in part, that for purposes of § 166, a nonbusiness debt is any debt other than a debt which is created, or acquired, in the course of a trade or business of the taxpayer.

In the transaction as you have recast it, the investors loaned money to a corporation in exchange for a security interest, evidenced by the lease in Equipment. Since this loan was not proximately related to a trade or business of the investors, it would be a nonbusiness bad debt, deductible as a short-term capital loss.

Timing

Section 1.165-1(d)(1) provides that a loss is allowed for the year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring in that year. If there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with

[3] In addition, regardless of the nature of an investor's prior relationship with X, arguably once X filed for bankruptcy the relationship became a creditor-debtor relationship by operation of law. Cf. Rev. Rul. 69-458, 1969-2 C.B. 33.

respect to which reimbursement may be received is sustained until it can be ascertained with reasonable certainty whether or not the reimbursement will be received.

A reasonable prospect of recovery will also prevent or postpone a deduction for the worthlessness of a bad debt under § 166. See §§ 1.166-2(a), 1.166-5(a)(2); Spring City Foundry.

Some investors in the present case have suggested that their loss was allowable in Year 4, when the Chapter 11 bankruptcy was filed. We agree that a prospect of recovery existed at that time that would preclude any deduction, whether under § 165 or § 166. See §§ 1.165-1(d)(1); 1.166-5(a)(2).

The bankruptcy reorganization plan was confirmed in Year 5. It provided that investors would receive stock in the reorganized X, and would participate in a litigation trust attempting to recover additional funds. Alternatively, an investor could elect to reduce his or her claim against X to the nominal sum of $1 in cash, to be paid outside the bankruptcy.

We agree with your conclusion that, for those investors who agreed to accept stock and participation in the litigation trust, there will be no deduction until the litigation is resolved. It is possible for investors or creditors to realize, and recognize, a loss or bad debt deduction at the time they receive stock in a taxable bankruptcy reorganization[4] (although, in appropriate cases, subsequent gain on the stock may be recaptured as ordinary income). See § 1001 (exchange of property); Rev. Rul. 68-523, 1968-2 C.B. 82; Commissioner v. Spreckels, 120 F.2d 517 (9th Cir. 1941) (property received in partial satisfaction of debt); § 108(e)(7)(ordinary income recapture). However, this is only true if, in the case of a loss deduction, there has been a closed and completed transaction or, in the case of a bad debt deduction, the remaining debt is worthless. In the present case, if the taxpayer is viewed as owning the Equipment, there has been no closed and completed transaction for purposes of § 165, because the taxpayer is still seeking additional reimbursement for the loss. § 1.165-1(d)(1). Similarly, if the transaction is recast as a lending transaction, the prospect of recovery prevents any deduction because the debt is not totally worthless for purposes of § 166. § 1.166-5(a)(2).

With respect to those investors who elected to receive $1 in complete satisfaction of their claims, we agree with your conclusion that a deduction would be available, at the latest, in the year they receive the $1. If the taxpayer is viewed as having owned the Equipment, then the Equipment has effectively been sold for $1; as noted above, the resulting loss would be a capital loss.[5] If the transaction is recast as a secured lending,

[4] We assume that, even when the transactions are recast, the investors are not subject to non-recognition treatment under the corporate reorganization provisions.

[5] We agree with your conclusion that the amount of any loss would be reduced by any prior depreciation taken on the property.

generally a bad debt deduction is allowable only when the debt becomes totally worthless. However, if a claim is reduced to a nominal amount, and the remainder discharged in bankruptcy, the claim to the discharged portion is rendered wholly worthless. Minneapolis, S. P. & S. S. M. R. Co. v. United States, 164 Ct. Cl. 26 (1964); Rev. Rul. 71-577, 1971-2 C.B. 129. As a nonbusiness bad debt, the resulting deduction would be a short-term capital loss, under § 166(d).

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Please call if you have any further questions.