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to: William P. Brennan, Internal Revenue Agent
Small Business/Self-Employed, Examination Division
Exam-- , ( )

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subject: Proper Federal Income Tax Treatment of Losses on Promissory Notes

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

LEGEND

Note A =

Note B =

C =
D =
E =
F =
G =

H =
$k = $
$m = $
$n = $
$w = $
$x = $
$y = $
$z = $
Year 1 =
Year 2 =
Year 4 =

ISSUES

1. Whether the taxpayers may apply section 1341 for Year 4 to the income included for Year 1 to the extent that it is attributable to the unpaid portion of Note A.

2. Whether the taxpayers may apply section 1341 for Year 4 to the income included for Year 1 to the extent that it is attributable to Note B.

3. Whether the taxpayers may claim a deduction for the losses on either or both of Notes A and B under section 165 or section 166.

4. If the taxpayers end up sustaining net operating losses (NOLs) for Year 4, whether they may carry them three years, rather than two years, back to Year 1.

CONCLUSIONS

1. The taxpayers may not apply section 1341 to the income attributable to the unpaid portion of Note A that they included in gross income for Year 1.

2. The taxpayers may not apply section 1341 to the income attributable to Note B that they included in gross income for Year 1.

3. The taxpayers may claim deductions for ordinary losses on Note A and Note B under section 165 or under section 166.

4. If the taxpayers sustain NOLs for Year 4, they may not carry them back three years to Year 1, and instead must carry them back two years to Year 2, before carrying them forward.

FACTS

The taxpayers are C, an individual who is the sole beneficiary of D, and E. D and E are trusts established by C's deceased spouse.

D and E were members of F, a limited liability company treated as a partnership for purposes of Federal income taxation. F engaged in the business of H. In Year 1, F sold all its assets to G, an unrelated corporation. In return G paid F $w in cash, and two promissory notes: Note A, providing for a total of $x payable over several years, and Note B, providing for a maximum amount of $y. The terms of Note B provided that G would pay F portions of $y each year from Year 1 to Year 4 if G's H business meets a predetermined financial target for that year. F distributed all remaining assets (namely, cash and Notes A and B) to D and E, and dissolved itself in Year 1.

On its final return for Year 1, F used the maximum face values of Note A and Note B to determine the amount realized from the sale of assets to G, and allocated the amount realized among three classes of assets: inventory ($k), section 1231 assets ($m) and goodwill ($n). Having presumably applied section 453(b)(2)(B) to the purchase price for the inventory, F did not apply the installment method to the gain on section 1231 assets or to the gain on goodwill, and effectively elected out of using the installment method under section 453. On their respective Federal income tax return for Year 1, C, D, and E each took a return position consistent with that of F, and reported their full shares of the gain from the sale of the assets in Year 1. The periods of limitations on assessment on the returns of C, D, E and F for Year 1 closed before the due dates of their returns for Year 4, so that they could no longer amend their returns.

In Year 4, G defaulted on Note A with $z in outstanding balance. Further, in each year between Year 1 and Year 4, the H business of G failed to achieve the earnout target. As a result, no part of Note B was payable as of the end of Year 4. G closed down the H business in Year 4.

The taxpayers claimed on their returns for Year 4 that G's failure to make payments on Note A and Note B entitles them to compute their income taxes for that year under section 1341. For Year 4, the taxpayers did not elect, or otherwise indicate any intent, to use an extended period to carry back a NOL under section 172(b)(1)(H). It appears that, as of the end of Year 4, D and E continued to hold both Note A and Note B.

LAW AND ANALYSIS

Issue 1. The taxpayers may not apply section 1341 to previously included items of income attributable to the unpaid portion of the Note A.

Section 1341 of the Internal Revenue Code[1] confers certain tax benefits to a taxpayer if the taxpayer establishes (a) that an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item, (b) that a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not

[1] Unless noted otherwise, all section references are to the Internal Revenue Code.

have an unrestricted right to such item or to a portion of such item, and (c) that the amount of such deduction exceeds $3,000. If section 1341 applies, it imposes on the taxpayer the lesser of (1) the normal income tax for the year in which the item is restored by the taxpayer with a deduction for the amount restored, or (2) a tax computed for the current taxable year without the deduction for the restored item of income but with a reduction in tax equal to the amount that the tax for the year in which the taxpayer received the item would have been decreased if the restored item had been excluded from income in that year.

Section 1.1341-1(g) of the Income Tax Regulations provides that section 1341 does not apply to deductions attributable to bad debts.

In the present case, the taxpayers included the income relating to Note A in the gross income for Year 1. In that year, the taxpayers had an actual unrestricted right to that promissory note, which entitled them to receive all payments on time and, in the event of any default, to enforce the applicable default provision of the note. In Year 4, the taxpayers continued to have the unrestricted right to Note A. While G's default indeed decreased the value of Note A, the taxpayers' right to Note A itself remained the same between Year 1 and Year 4. By including in gross income the full amount promised on Note A ($x) for Year 1, the taxpayers may have overstated amounts they would eventually receive under Note A. The overstatement, if it occurred, raises an issue of valuation of the note and not of the applicability of section 1341. Further, D and E's inability to collect on Note A gives rise to a possible bad debt deduction. See the discussion under Issue 3 below. Because the taxpayers had an unrestricted right to Note A in the year of inclusion (Year 1) and continue to have the same right in the taxable year in issue (Year 4), they may not apply section 1341 to income attributable to $z, the unpaid portion of Note A, that they included in gross income for Year 1.

Issue 2. The taxpayers may not apply section 1341 to previously included items of income attributable to Note B.

The taxpayers included the income relating Note B in the gross income for Year 1. In that year, the taxpayers had an actual unrestricted right to that note. In Year 1, Note B entitled them to receive all payments on time if and only if the H business of G met the predetermined financial targets and, in the event of any default, to enforce the applicable default provision of that note. In Year 4, Note B entitled the taxpayers to the same rights and duties as in Year 1. While the failure of G's H business to meet the financial targets decreased the value of Note B, the taxpayers' right to that note remained the same between Year 1 and Year 4. By including in gross income $y, the maximum amount payable on Note B, although any payment was contingent on future events, the taxpayers may have overstated the total amount of income that they would eventually receive under Note B. The overstatement, if it occurred, is a matter of valuation of the note, and does not entitle the taxpayers to the benefits under section 1341. Accordingly, the taxpayers may not apply section 1341 to income attributable to

$y, the maximum amount payable on Note B, that they included in gross income for Year 1.

Issue 3. The taxpayers may claim deductions under section 166 for ordinary losses on the unpaid portion of Note A for Year 4. The taxpayers may claim deductions under section 165 or 166 for ordinary losses on Note B.

Section 165(a) 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) limits the deduction under section 165(a) for individual taxpayers 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, except as provided for in section 165(h), losses of property not connected with a trade or business or a transaction entered into for profit, if such loss arises from fire, storm, shipwreck, theft or other casualty.

Section 166(a)(1) provides that, with regard to wholly worthless debts, there shall be allowed as a deduction any debt which becomes worthless within the taxable year.

Section 1.166-1(c) of the Income Tax Regulations provides that only a bona fide debt qualifies for purposes of section 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 166(d)(1) provides that the worthlessness of a nonbusiness debt is considered to be a short-term capital loss.

Section 1.166-5(b)(2) provides that a nonbusiness debt is a debt other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business or a debt that is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless. Whether a debt is a nonbusiness debt is a question of fact in each particular case.

In Felmann v. Commissioner, 77 T.C. 564 (1981), the court held that the loss on a trade receivable that the taxpayer acquired in the liquidation of a corporation in which he was a shareholder was a nonbusiness bad debt because it was not incurred, created, or acquired in a trade or business of the taxpayer. The court cited legislative history intended to preclude a business bad debt in such situations:

> It is possible to argue that a business-created debt would qualify as being fully deductible against ordinary income in the hands of a donee, executor, or transferee who was not, and never had been, engaged in the trade or business in which the debt arose. To preclude this possible result, the House bill changes

> the reference to "a taxpayer's trade or business" to "a trade or business of the taxpayer."

77 T.C. at 567-68, citing S. Rep. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 938-939. See also Income Tax Regs., § 1.166-5(d).

In Arrowsmith v. Commissioner, 344 U.S. 6 (1952), two taxpayers were required to pay a judgment relating to a corporation that they had previously liquidated. The taxpayers argued that because each taxable year stands on its own under the annual accounting principle, they were entitled to an ordinary business deduction for their payment of the judgment in 1944. This view was rejected by the Court, however, which held that the loss was capital because the taxpayers' liability arose from the corporation's liquidation proceedings and thus should be treated in the same manner as the liquidation proceeds they received which was treated by both taxpayers as capital gain.

With respect to Note A, if Examination determines that it became worthless in Year 4, a bad debt deduction under section 166 would be allowable for the unpaid balance of that note. Since a partner is generally regarded as in the trade or business of the partnership, it would be a business bad debt in the hands of the partner trusts.[2]

With respect to Note B, a deduction would be available when the note became worthless, but it is unclear from the facts whether the loss would be deductible under section 166 or section 165.

If Note B is treated as debt, then the answer would be same as for the promissory note.

If Note B is treated as a contract right, but not debt, then the character of the loss would still be an ordinary loss under section 165 and the Arrowsmith doctrine. The parties expressly conditioned the ultimate purchase price on the profitability of the purchaser and built the contingency into the sales agreement. Therefore the loss on the contingent debt should relate back to the initial sale, which was reported as ordinary income.[3]

Issue 4. If the taxpayers end up sustaining NOLs for Year 4, they may not carry them three years back to Year 1 and instead must carry them two years back to Year 2.

Section 172(a) allows a deduction equal to the aggregate of the NOL carryovers and carrybacks to the taxable year. Section 172(b)(1)(A)(i) provides that an NOL for any

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[2] An argument could be made that it was a nonbusiness bad debt, under Felmann, if it became worthless after it was distributed to the individual beneficiary, and the beneficiary was not engaged in a trade or business. We leave it to you to determine the relevant facts.

[3] As in the case of the bad debt deduction, if the loss was sustained in the hands of the individual beneficiary, rather then a trust/partner, an argument could be made that it was a capital loss, since in applying Arrowsmith, the transaction in which the *beneficiary* acquired the contingent note was arguably a distribution from a trust, not the sale of business assets.

taxable year generally must be carried back to each of the 2 years preceding the taxable year of the NOL.

Section 172(b)(1)(H)(i) permits a taxpayer to elect to carry back its "applicable net operating loss" to 3, 4, or 5 years preceding the taxable year of the applicable net operating loss. Under section 172(b)(1)(H)(ii), the term "applicable net operating loss" means the taxpayer's NOL for a taxable year ending after December 31, 2007, and beginning before January 1, 2010. Section 172(b)(1)(H)(iii) provides that the election under section 172(b)(1)(H) is required to be made in a manner prescribed by the Secretary, and must be made by the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009. The election is irrevocable and, in general, may be made for only one taxable year.

In section 4.01(3) of Rev. Proc. 2009-52, 2009-49 I.R.B. 744, the Internal Revenue Service prescribed the manners in which a taxpayer must make an election under section 172(b)(1)(H). In order to make the election, the taxpayer must attach a statement to the taxpayer's federal income tax return for the taxable year of the applicable NOL. In the statement, the taxpayer must state that the taxpayer is electing to apply section 172(b)(1)(H) under Rev. Proc. 2009-52, that the taxpayer is not a TARP recipient or an affiliate of a TARP recipient. The taxpayer must specify the length of the NOL carryback period elected. The taxpayer must file the election statement with the taxpayer's original or amended return for the taxable year of the applicable NOL on or before the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009. In the alternative to the foregoing, the taxpayer may make the election by attaching the required election statement to the claim for tentative carryback adjustment (Form 1045 or Form 1139) or amended return applying the applicable NOL to the carryback year. An election made through a claim for tentative carryback adjustment is due on the date to file the return for the taxpayer's last taxable year beginning in 2009 (including extensions).

In the present case, if the taxpayers sustain any NOL for Year 4, that NOL may constitute an applicable NOL under section 172(b)(1)(H)(ii). The taxpayers, however, made no election to use an extended carryback period under section 172(b)(1)(H). Most significantly, the taxpayers indicated no intent or desire to rely on section 172(b)(1)(H) on the statutorily provided due date, the due dates (including any extensions) of their returns for Year 4. Accordingly, the taxpayers may not carry back any NOLs sustained in Year 4 to Year 1. Instead, they must carry the NOLs back two years to Year 2.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any further questions, please call at (on Issues 1, 2 and 4) or at (on Issue 3).