Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR: [redacted]:TL-N-1366-00
[redacted]

date:

to: Chief, Examination Division, [redacted] District
Attn: [redacted], Group Manager, Group [redacted]

from: District Counsel, [redacted], [redacted]

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subject: [redacted]

Request for Advice on Investor Losses

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ISSUE

Whether the investors at the [redacted] are entitled to loss deductions for their investments with the [redacted] to the extent they are not recovered in the [redacted] s Chapter 7 bankruptcy. If so, what are the character and year of the deductions?

CONCLUSION

An investor's entitlement to a deduction for his or her investment at the [redacted] is controlled by section 166 dealing with bad debt deductions. Whether an investor is entitled to a deduction will depend upon the facts of each individual case.

If the investor is a corporation or an individual that held his or her account(s) in connection with a trade or business, the investor is entitled to a bad debt deduction for the partial or total worthlessness of the debt. The character of the deduction is ordinary and it may be taken in the year the accounts become partially or wholly worthless.

All other individual investors will not be entitled to a deduction for the monies lost in their accounts until the year their claim against the [redacted] is totally worthless (i.e., there is no more hope that they may recover something in the liquidation). Upon total worthlessness, the investor is entitled to a nonbusiness bad debt deduction, which is treated as a short-term capital loss and limited to $3,000 per year.

FACTS

The [redacted] is currently in chapter 7 bankruptcy. The [redacted] is a tax exempt organization, although the Service is currently examining its tax exempt status, and it handled investments for its members (the investors). The [redacted] offered several types of investments, including accounts similar to savings accounts, CD accounts, IRA's, and other accounts involving securities. The accounts relevant herein are described below. The [redacted] had [redacted] of investors involving [redacted] of dollars, yet it maintains that it is not a bank or seller of securities. The [redacted] has never been "chartered" by any State to conduct business as a bank (or any other business), and it has never subjected itself to state or federal banking or securities laws. All of its "banking" activities were unregulated. The SEC and state and federal banking regulators are investigating the [redacted] for possible law violations. The accounts of all investors have been frozen since [redacted] due to the bankruptcy.

The [redacted]'s bankruptcy is [redacted] in [redacted], and most of the investors will get only a small percentage of their investment back when the bankruptcy estate is ultimately liquidated. Many investors are elderly individuals who have lost their retirement savings. This matter is [redacted]. As such, the issues discussed herein are particularly sensitive. The Service currently has an outreach

program with the [redacted] through which the Service is assisting the [redacted] investors in dealing with Federal income tax issues raised by the bankruptcy.

[redacted] Accounts - One type of account at the [redacted] was the [redacted] account.[1] This account was very similar to a traditional savings account at a bank. The investor initially put in a lump sum, and interest accrued on the principal at a stated amount. The [redacted] credited the interest to the account quarterly or monthly. All interest accrued to the account was reported to the taxpayer on a Form 1099 each year, and presumably included in income by the investor.[2] Once interest was credited to the account, it became part of the principal, and interest would accrue on it as well. The investor could elect to withdraw some or all of the funds in the account at any time by giving notice to the bank.

[redacted] Notes ([redacted] notes) - These accounts were essentially a promissory note between the [redacted] and the investor. These notes were purportedly secured by the [redacted] pledging a pool of various assets to a trust to be held for the benefit of the note holders. (See Attachment B for a complete copy of the note and trust indenture). Interest accrued on the [redacted] notes quarterly. The investor could elect to have accrued interest credited to the account and added to principal, or paid out to the investor. The [redacted] notes provide the following:

> **FOR VALUE RECEIVED,** [redacted] promises to pay to the order of _____ at _____ the principal sum of _____ DOLLARS ($_____) together with interest thereon computed as follows:

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[1] We do not have a copy of the savings account contract or other documentation evidencing the relationship between the [redacted] and the account holder.

[2] Except that we recently opined that interest accrued in [redacted] (the year the accounts were frozen) need not be included in the Form 1099 unless actually received by the investor/taxpayer. (See Attachment A for a copy of our memorandum dated February 3, 2000). For purposes of this advisory request, assume all interest amounts for which the investor seeks to claim a loss were included in income.

1. **Interest:**

Interest from the date hereof on the principal amount hereunder to the date of maturity shall accrue daily at the rate of __ percent (__%) per annum, shall be compounded on the last day of each fiscal quarter and, thereafter, unless paid to the Note holder as provided below, shall be added to, and bear the same interest as, the original principal amount and is not subject to withdrawal prior to maturity.

2. **Payments:**

a. At the election of the Note holder(s), interest only may be paid on the last day of each month or calendar quarter.

b. At anytime each anniversary year the holder may elect, in writing, to withdraw the interest posted to the account during the current anniversary years. The anniversary years shall first commence on the date of the Note and on each and every anniversary date thereafter.

c. The principal of this Note and all unpaid interest thereon shall be due and payable on the __day of __, ___.

d. Maker shall have the right with or without notice to prepay part or all of this Note without penalty, and such prepayment shall include all interest then due as set forth above.

3. **Election**

Note holder(s) elect(s) to have interest [paid ____] or [compounded and added to principal]. This election may be changed by Note holder's written direction.

APPLICABLE LAW/DISCUSSION

Relationship of the [redacted] to the Investors - Initially, we define the relationship between the investors and the [redacted] with respect to the [redacted] accounts and the [redacted] notes. It is well-established that the relationship established between a bank and a depositor by a checking or savings account is that of debtor and creditor, founded upon contract. The credit balance in a depositor's account represents the amount of the bank's indebtedness to the account holder. Barley v. Brinson, 286 U.S. 254 (1932); Manhattan Bank v. Blake, 148 U.S. 412, 425, 426 (1893); Phoenix Bank v. Risley, 111 U.S. 125 (1884).[3]

While the [redacted] did not label itself a bank, it functioned like a bank and offered similar services and financial products. We believe the law which defines the bank/depositor relationship is applicable to these facts. As such, the investors in the [redacted] accounts had a debtor/creditor relationship with the [redacted] and the amount of the bank's indebtedness to the account holder on the day the accounts were frozen equaled the total balance in the account (including accrued interest). The [redacted] notes also created a debtor/creditor relationship between the [redacted] and the investor. The [redacted] note was a promissory note from the [redacted] to the investor to pay back an amount certain on a date certain. The investor could elect whether the interest was paid or accumulated. The debtor/creditor relationship is self-evident from the contract language. The amount of the bank's indebtedness to the [redacted] note holder on the day the accounts were frozen equaled the total principal amount plus accrued (and unpaid) interest.

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[3] In considering the tax consequences of the many bank failures of the 1930's, courts also treated as bad debts losses sustained by the depositors. See e.g., Kentucky Rock Asphalt Co. v. Helburn , 108 F. 2d 779, 781 (6th Cir. 1940); Swastika Oil & Gas Co. v. Commissioner, 40 B.T.A. 798, 801-802 (1939), aff'd, 123 F. 2d 382 (6th Cir. 1941); Eastern New Jersey Power Co. v. Commissioner, 37 B.T.A. 1037, 1039 (1938); Est. of Grant v. Commissioner, 36 B.T.A. 1233, 1242 (1937); see Rev. Rul. 71-577, 1971-2 C. B. 129.

Controlling Code Section/Law - We turn now to the law governing the investor's right to write-off or claim a loss with respect to their bad debt. Section 166 controls the tax treatment of bad debts.[4] That section provides:

> (a) General Rule.--
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> > (1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
> >
> > (2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.
>
> (b) Amount of Deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

I.R.C. § 166(a) and (b) [emphasis added].

A special rule applies, however, to bad debts which are considered "non business" bad debts:

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[4] We are aware of Section 165(l) which provides special treatment to certain losses caused by deposits in insolvent financial institutions. See Fincher v. Commissioner, 105 T.C. 126 (1995). If its statutory prerequisites are met, section 165(l) permits individuals to treat a loss on a deposit as a casualty loss in the year the loss amount can be reasonably estimated. This option may be elected as an alternative to the bad debt provisions of section 166. Since the [redacted] is not a "qualified financial institution", we need not and do not analyze whether section 165(l) applies. See Aston v. Commissioner, 109 T.C. 400 (1997) (for a detailed discussion of "qualified financial institution"). Where section 165(l) is not available, the only statutory basis for deduction by a depositor is section 166.

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation-

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

I.R.C. § 166(d) [emphasis added].

Definition of Nonbusiness - There are two kinds of bad debts--business bad debts and nonbusiness bad debts. Worthless debts owed to corporations are business bad debts.[5] With regard to other taxpayers, a debt is a nonbusiness bad debt unless (1) the debt was 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, or (2) the debt is worthless debt which is incurred in the taxpayer's trade or business. I.R.C. § 166(d)(2); Treas. Reg. §1.166-5(b).

[5] Except see Rev. Rul. 93-36, 1993-1 C.B. 187, for special rules in the case of a Subchapter S corporation.

The question of whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination is made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). Treas. Reg. § 1.166-5(b)(2). Courts will look to the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged, the debt is considered business related. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. A nonbusiness debt does not include a debt described in section 165(g)(2)(C), relating to losses on worthless securities. See Treas. Reg. § 1.165-5.

Total-v-Partial Worthlessness - A nonbusiness debt cannot be a bad debt for income tax purposes unless it becomes totally worthless. In such case, a deduction is available for the loss only in the tax year in which the debt becomes totally worthless. A taxpayer does not have to wait until a debt is due to determine whether or not it is worthless. Once the taxpayer establishes the nonbusiness debt is totally worthless, the resulting loss is considered a short-term capital loss in the year it becomes worthless. I.R.C. § 166(d)(1).

A debt becomes worthless when there is no longer any chance of the debt being paid. Where there is some chance that a creditor may recover the debt, even in part, the debt is not worthless. In Perrotto v. Commissioner, T.C. Memo. 1977-99, the court held that deposits in an insolvent bank were not worthless where there was a reasonable prospect that the depositor would recover them, at least in part. In Aston v. Commissioner, 109 T.C. 400 (1997), an individual was not entitled to a nonbusiness bad debt deduction resulting from the loss of a deposit in an insolvent financial institution. In Aston, the taxpayer's claim was pending in the bank's liquidation, she continued to pursue her claim, and there remained a chance she would recover at least part of her deposit in that liquidation proceeding.

Application to Facts - Whether any particular investor in the [redacted] will be entitled to a bad debt deduction will depend upon several factors, and each investor's case must be scrutinized on its own facts:

1. Is the investor a corporation? If the investor is a corporation, it will be entitled to a bad debt deduction for total or partial worthlessness. The character of the deduction will be ordinary. See I.R.C. § 166(a). Based on the facts we know, the [redacted]'s liquidation is pending, and there is a good chance

the investors will recover at least part of their investment. Thus, any corporate investors will probably be entitled to a deduction for partial worthlessness in the current year. We do not have enough information to opine on what percent of the debt is worthless.

2. Is the investor an individual? If yes, was the debt created in connection with the taxpayer's trade or business? We assume the vast majority of the investors were individuals. We also assume that, to date, their debts are not totally worthless because there is a reasonable chance some of the debt is recoverable. In such case, the investor would not currently be entitled to a deduction. Once it is clear that they will no longer recover any more funds, the investor may claim a nonbusiness bad debt deduction in the year of worthlessness. Such deduction will be treated as a short-term capital loss and subject to the $3,000 per year limitation.

Conversely, if the individual created the debt (or held the account and/or [redacted] note) in connection with his/her trade or business, then the investor may take a deduction currently for the partial worthlessness. Whether the investor held either the [redacted] account or the [redacted] note in connection with their trade or business is a question of fact. We would need the facts of an individual's specific case to opine on this.

TAXPAYER'S POSITION

Lawyers assisting the [redacted] investors argue that the investors are entitled to: (1) an ordinary loss deduction for the accrued interest allocable to their [redacted] accounts and the [redacted] notes, and (2) a capital loss deduction for the principal amount. They opine that the deduction may be taken currently, notwithstanding that the monies are still recoverable, at least in part. Attached is a copy of the materials they submitted in support of their position along with a summary of their position prepared by our client. They do not mention section 166 or raise the issue of whether there is a debtor-creditor relationship. It appears they believe the [redacted] accounts and [redacted] notes are capital assets in the hands of the investors.

We do not believe the authority cited by the [redacted]s lawyers in support of their position is relevant. They cite Carman v. Commissioner, 189 F. 2d 363 (2nd Cir. 1951), T.A.M. 9538007, and section 354(a)(2)(B) (and the legislative history). In summary, they argue that the interest on the debts can be treated different than the underlying principal, with the interest receiving ordinary loss treatment. They cite section 354(a)(2)(B) to support this contention. That section provides

that accrued but unpaid interest on securities which are exchanged for other securities in a reorganization must be included in ordinary income rather than added to the adjusted basis of the new securities. That section effectively overruled the Carman case, which treated the accrued interest as part of the principal debt and allowed that interest to be added to the basis of property exchanged therefor in the reorganization.

Section 354(a)(2)(B) is plainly inapplicable to these facts as it deals specifically with "exchanges of stock and securities in certain reorganizations." This is not a reorganization, the [redacted] is in liquidation, and the investors are not receiving "stock or securities" in exchange for "stock or securities". Moreover, the section does not, even by analogy, entitle the investors to an ordinary loss for accrued and unpaid interest. Losses of individuals are controlled by section 165, or section 166 if applicable. Nonbusiness related losses of individuals (excluding casualty losses), under either section, are treated as capital losses and are limited to $3,000 per year.

In summary, we find no provision of the Code which would entitle individual investors to an ordinary deduction for either interest or principal lost on their investments with the [redacted] except in the limited circumstances described herein (trade or business related). Should you have any questions concerning this matter, please contact me at [redacted].

[redacted]
Acting District Counsel

By: [redacted]
Attorney

cc: Regional Counsel, Western Region
Office of Assistant Chief Counsel, Field Service

Attachments