OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: CAROL P. NACHMAN
SPECIAL COUNSEL CC:DOM:FS:FI&P

SUBJECT: _____

This Field Service Advice is in response to your memorandum dated . Field Service Advice is not binding on Examination or Appeals and is not a final case determination. Field Service Advice issued to Examination or Appeals is advisory only and does not resolve Service position on an issue or provide the final basis for closing a case. This document is not to be relied upon or otherwise cited as precedent.

LEGEND:

P =
Year 1 =

Date 1 =
Date 2 =
Date 3 =
X =
Y =
Z =

ISSUES:

1. Whether P is treated as a dealer in securities for purposes of I.R.C. § 475.

2. Whether P properly elected out of the customer paper and negligible sales exceptions.

3. Whether P complied with the identification rules of Holding 15 of Rev. Rul. 97-39, 1997-39 I.R.B. 4.

4. Whether P is required to value each security on an individual basis for purposes of § 475.

5. If P employs the mark to market method to value the securities (debts) at issue, whether P can also potentially claim a bad debt deduction under § 166.

6. Whether the mark to market method overrides the specific identification method for bad debts.

7. If P has marked down a debt and then subsequently recovers more of the debt than its remaining basis, whether the amount in excess of basis should be included in ordinary income.

CONCLUSIONS:

1. P is properly treated as a dealer in securities for purposes of § 475 for Year 1 and all subsequent years.

2. P properly elected out of the customer paper and negligible sales exemptions.

3. P complied with the identification rules of Holding 15 of Rev. Rul. 97-39, 1997-39 I.R.B. 4.

4. P is not required to value each security on an individual basis for purposes of § 475.

5. In no circumstances should P be able to duplicate deductions under both §§ 166 and 475. However, Prop. Treas. Reg. § 1.475(a)-1(f), which only applies to subsequent years, provides that a taxpayer should be able to claim a bad debt deduction under § 166 even though it employs the mark to market method. We conclude that the principle contained in these proposed regulations should also apply to the years in question.

6. Although the mark to market method is arguably similar to the bad debt reserve method, which has been repealed, nothing in § 166 prevents the application of § 475 to receivables.

7. The amount recovered in excess of basis should be included in ordinary income, assuming that P received a tax benefit from the deduction in a prior year.

FACTS:

The facts are taken from your Field Service Advice request and the materials submitted therewith. Petitioner, P, owns and operates acute care hospitals and nursing facilities. As part of its business, P extends credit to the purchasers of its goods and services at the time of the purchase in order to finance the purchase, generating accounts receivable.

On Date 1 (on or before October 31, 1997), P filed a Form 3115, Application for Change in Accounting Method, under sections 4.02, 4.03 and 4.06 of Rev. Proc. 97-43, 1997-39 I.R.B. 12. A statement attached to P's 3115 provides as follows: a) P is electing under Treas. Reg. § 1.475(c)-1(b)(4) (customer paper exception election) and Treas. Reg. § 1.475(c)-1(c)(1)(negligible sales exception election) to be treated as a "dealer in securities" within the meaning of § 475(c)(1) and, as such, P will mark its "securities" (as defined by § 475(c)(2)) to market at the end of each tax year; b) P does not currently mark its securities to market in accordance with § 475; c) In accordance with §§ 4.02 and 4.03 of Rev. Proc. 97-43 and Treas. Reg. §§ 1.475(c)-1(b)(4) and 1.475(c)-1(c)(1)(ii), P hereby requests to be treated as a dealer in securities as defined by § 475(c)(1) and to mark its securities to market in accordance with § 475; and d) P's overall method of accounting is the accrual method. Also attached to P's 3115 is an identification statement under § 4.02 of Rev. Proc. 97-43.

Also on Date 1, P filed an amended return for Year 1. On its Year 1 amended return, P made an election under Treas. Reg. § 1.475(c)-1(b)(4)(i) not to be governed by the exception for sellers of nonfinancial goods or services for Year 1 and all subsequent years. This election required P to change its method of accounting for securities to the mark-to-market method under § 475. On its Year 1 amended return, P claimed losses resulting from marking securities to market under § 475.

In valuing its securities (accounts receivable) for purposes of § 475, P relied on an appraisal prepared by an accounting firm. A draft of the appraisal provided with the materials submitted with the Field Service Advice request reflects that for Year 1, the net bad debt write-offs based on percent of sales was X %. Bad debts and bad debt write-offs were among the various factors considered by the

accounting firm in valuing the accounts receivable. Based on procedures, facts, assumptions employed in their analysis, and certain limiting conditions, the accounting firm recommended specific discounts for each accounts receivable pool (net of contractual allowances) as of certain dates. For the last day in Year 1, the accounting firm recommended a discount of Y%.

On Date 2, the Service issued a statutory notice of deficiency for Year 1. The notice contains four proposed adjustments. The first concerns unreported income. The Service determined that P realized additional income from overpayments on patient accounts. The second concerns P's bad debt expense. The Service disallowed a portion of the deduction for bad debts claimed on P's return on the basis of P's failure to substantiate the deduction in the amount claimed. The third proposed adjustment concerns P's § 475 claim. The Service determined that P is not entitled to an adjustment in the amount claimed on its amended return for the following reasons: 1) P failed to make a valid election; 2) P failed to establish the securities that were eligible to be marked to market; 3) P failed to properly identify the securities that were acquired before the date of the election; and 4) P failed to properly compute the fair market value of the securities. The fourth proposed adjustment concerns an accuracy-related penalty under § 6662.

On Date 3, P filed a petition in the United States Tax Court. In its petition, with respect to the unreported income issue, P states that some of the alleged overpayments on patient accounts receivable were merely credits reflected on P's books to be charged against specific accounts receivable when identified with the proper account. In other cases, P alleges the amounts represented overpayments required to be refunded to the payor, thus precluding realization of income by P.

With respect to the bad debt issue, P states in its petition that it reasonably determined that $ Z of accounts receivable became worthless during Year 1 by applying appropriate factors to determine worthlessness using the specific charge-off method. P states that these accounts receivable include the amount disallowed by the Service as a bad debt deduction. P states further that it has consistently applied the specific charge-off method of determining its bad debts from year to year and has accounted for any recoveries of bad debts as income.

With respect to P's deduction under § 475, P alleges in its petition as follows: 1) P originated trade receivables by the sale of nonfinancial goods and services and was entitled to be treated as a dealer in securities and to apply the mark to market rules with respect to customer paper under § 475 and the regulations thereunder; 2) P timely filed Form 3115, Application for Change in Accounting Method, to request an accounting method change to use the mark to market method for trade receivables under § 475 and made a valid election out of

the customer paper exception and the negligible sales exception in accordance with Rev. Proc. 97-43, Treas. Reg. § 1.475(c)-1(b)(4), and Treas. Reg. § 1.475(c)-1(c)(1); and 3) P properly identified and established the securities that were eligible to be marked to market.

LAW AND ANALYSIS:

Issues 1-4:

Section 475 generally requires a dealer in securities to account for its securities on a mark to market method of accounting. Section 475(a). Section 475(c)(1) defines a dealer in securities as a taxpayer who either: (1) regularly purchases securities from or sells securities to customers in the ordinary course of its trade or business; or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. The term security includes a note, bond, debenture, or other evidence of indebtedness. Section 475(c)(2)(C).

Treas. Reg. § 1.475(c)-1(b) generally excludes from the dealer definition a taxpayer who would not be a dealer in securities but for its purchase and sale of debt instruments that are customer paper. A debt instrument is customer paper with respect to a person at a point in time if: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a member of the same consolidated group as that person. Treas. Reg. § 1.475(c)-1(b)(2).

Under Treas. Reg. § 1.475(c)-1(b)(4)(i), a taxpayer may elect to waive the customer paper exception. The waiver may be elected for a year ending on or before December 24, 1996, by attaching a statement to an amended return filed not later than October 31, 1997. See Rev. Rul. 97-39, Holding 13. An election under Treas. Reg. § 1.475(c)-1(b)(4)(i) also is deemed to be an election to waive the exemption from the application of § 475(a) provided by Treas. Reg. § 1.475(c)-1(c) for taxpayers with negligible sales of securities. See Rev. Rul. 97-39, Holdings 17 and 18.

Rev. Proc. 97-43 provides procedures for a taxpayer to obtain the automatic consent of the Commissioner to change its method of accounting to reflect the application of § 475 as a result of making the election under Treas. Reg. § 1.475(c)-1(b)(4)(i). Rev. Proc. 97-43 became effective on September 10, 1997.

P is treated as a dealer in securities for purposes of § 475 for Year 1 and for all subsequent years. P regularly originates accounts receivable, which are evidences of indebtedness, with customers in the ordinary course of its business. Although P fits within the customer paper and negligible sales exemptions from dealer status, it has complied with the requirements in Treas. Reg. § 1.475(c)-1(b)(4)(i) necessary to waive those exemptions. Further, P has substantially complied with the automatic consent procedures in Rev. Proc. 97-43 to change its method of accounting to the mark to market method. Thus, P is subject to mark to market accounting under § 475 for Year 1 and all subsequent years.

Section 475(a) provides the general rule that a dealer in securities must mark to market all of its securities. Section 475(b)(1)(A), (B), and (C) provide that § 475(a) does not apply to: (1) any security held for investment; (2) certain securities that are not held for sale; and (3) any security that is a hedge of an item that is not subject to the mark-to-market rules. Further, under § 475(b)(2), a security is not treated as described in § 475(b)(1)(A), (B), or (C) unless it is clearly identified in the dealer's records as being described in such subparagraph before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe). An exception to this same-day identification rule is contained in Holding 15 of Rev. Rul. 97-39.

Holding 15 of Rev. Rul. 97-39 provides a special identification regime for a taxpayer that: (1) made an election out of the customer paper exemption, the negligible sales exemption, or both; and (2) was not treated as a dealer in securities under § 1.475(c)-1T. P meets both of these requirements and, therefore, is subject to the special identification regime.

The special identification regime applies only to securities ("transition securities") for which an identification would have been timely under the general rule (described in Holding 14 of Rev. Rul. 97-39) and only if made on or before October 31, 1997. Rev. Rul. 97-39, Holding 15. Under the special identification regime, a transition security was properly identified as exempt for the purposes of § 475(b)(2) or (c)(2)(F)(iii) if the information that was contained in the taxpayer's books and records and that was entered substantially contemporaneously with the date of acquisition of the transition security supports a conclusion that the transition security was described by § 475(b)(1)(A), (B), or (C). Id. This rule applies even if the information in the taxpayer's books and records does not meet the specificity that Holding 5 of Rev. Rul. 97-39 generally requires for identification. Id.

Holding 15 also states that a taxpayer must, by October 31, 1997, place in its books and records a statement resolving ambiguities, if any, concerning which transition securities are properly identified under the special identification regime. Any information that supports treating a transition security as being described in § 475(b)(2) or (c)(2)(F)(iii) must be applied consistently.

The information in P's books and records that was entered substantially contemporaneously with the date of the acquisition of the transition securities does not support the conclusion that the transition securities were described by § 475(b)(1)(A), (B), or (C). In fact, P represents that its books and records at the time the transition securities were originated did not contain any statements indicating that the transition securities were either held for investment or held for sale to customers. Pursuant to Holding 15 of Rev. Rul. 97-39, P resolved the ambiguity regarding whether the transition securities were properly identified under the special identification regime by placing a statement in its books and records specifically stating that the transition securities are not identified as exempt under § 475(b)(1)(A) or (B) as either held for investment or not held for sale. Thus, based on these facts, P is required to mark to market the transition securities.

Also, based on the facts here, P is not required to value each security on an individual basis for purposes of § 475. Neither § 475 nor the regulations thereunder impose such a requirement. However, as described in the case development section, below, further factual development is required before we can provide conclusive advice on whether, with respect to P's application of the mark-to-market method of accounting under § 475, P is entitled to any of the deductions in the amount claimed.

Issue 5:

As a general rule, any debt that becomes worthless within the taxable year is allowed as a deduction under §166(a)(1). Further, under §166(a)(2), the Secretary may allow a partially worthless debt as a deduction in an amount not in excess of the part charged off within the taxable year.

Section 166(b) provides that the basis for determining the amount of deduction for any bad debt under §166(a) is its adjusted basis as provided in §1011 for determining the loss from the sale or other disposition of property. This basis would be adjusted by deductions in prior taxable years. See Treas. Reg. § 1.166-3(b).

Prop. Treas. Reg. § 1.475(a)-1(f) coordinates the mark to market rules with the bad debt rules and provides that any portion of loss attributable to a bad debt continues to be accounted for under the bad debt provisions of the Code. The basis of the debt is likewise adjusted in a manner consistent with a deduction under §166(b). Normally, the amount of gain or loss recognized under § 475(a)(2) when a debt instrument is marked to market is the difference between the adjusted basis and fair market value of the debt. If a debt becomes partially or wholly worthless during a taxable year, the amount of any gain or loss required to be taken into account under § 475(a) is determined using a basis that reflects the worthlessness. Any gain or loss attributable to marking a debt to market is determined by the

debt's adjusted basis under Treas. Reg. § 1.1011-1, less any amounts previously charged off that did not reduce basis. Thus, if the debt is wholly worthless, its basis would be reduced to zero and no gain or loss would be taken into account under § 475(a)(2). Instead, the debt would be deductible under section 166.

The proposed regulations apply only to tax years beginning after January 1, 1995, and thus are not applicable to the present case. However, the principle espoused in the proposed regulations should be applied to the year at issue.

Nothing in §166 prevents a taxpayer from deducting a debt under § 166 even if the debt is subject to the mark to market method. Section 166(e) only prevents the application of § 166 to a debt that is evidenced by a security as defined in § 165(g)(2)(C). Section 165(g)(2)(C) defines a "security" to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision, with interest coupons or in registered form. The explicit exclusion from § 166 of indebtedness covered by § 165(g)(2)(C) implies that there are no other exceptions. See Schumann v. Commissioner, 857 F.2d 808, 811 (D.C. Cir. 1988); Mertens Law of Fed Income Tax § 3.44. Thus, logically, § 166 would apply to other indebtedness including the receivables involved in the present case.

Whether or not the principle found in the proposed regulations is applied here, the same debt should not result in a bad debt deduction under § 166 and a loss deduction under § 475 in the same tax year. (The proposed regulations take care of this potential double deduction through a basis adjustment.) Even without the regulations, there is a presumption that the same amount cannot be deducted twice without definite authority under the law. Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934); United Telecommunications v. Commissioner, 589 F.2d 1383, 1388 (10th Cir. 1978), cert. denied, 442 U.S. 917 (1979). In the present case, the adjustments to bad debt deductions and the mark to market method for Year 1 are so close in amount, it appears P may have actually deducted the same amount twice. If so, the adjustment for one of two duplicated amounts is all but automatic.

Issue 6:

Currently, § 166 requires that bad debts be deducted under the specific charge off method, that is, where the worthlessness of each debt is specifically determined. Previously, § 166(c) also allowed taxpayers to use the reserve method under which the taxpayer could deduct a "reasonable amount" added to its bad debt reserve in anticipation of debts that would be uncollectible. Section 166(c) was repealed in the Tax Reform Act of 1986 (P.L. 99-514) making the reserve method unavailable for most taxpayers, including P.

It has been suggested that § 475 implicitly permits taxpayers to circumvent the prohibition against reserves for bad debts. However, that the proper application of the mark to market method may have a result that is similar to the use of the repealed reserve method does not prevent its proper application to the receivables in question.

A similar situation arises under § 448(d)(5), under which an accrual-method taxpayer may not be required to accrue income earned with respect to the performance of services, if, based upon experience, the taxpayer will not collect the income. This "nonaccrual-experience" method, like the mark to market method, is treated as a method of accounting. Temp. Treas. Reg. § 1.448-2T(b). Under the nonaccrual-experience method, a taxpayer may elect the periodic system which is described in Notice 88-51, 1988-1 C.B. 535. The periodic system requires the taxpayer to establish an account representing the accounts receivable the taxpayer estimates will not be collected. At year end, the account is adjusted to reflect the aggregate amount of outstanding accounts receivable the taxpayer estimates will not be collected. The adjustment is deducted from (or added to) the taxpayer's income. Accordingly, the periodic system of the nonaccrual experience method is "somewhat similar" to a reserve method for accounting for bad debts. Hospital Corporation of America v. Commissioner, 107 T.C. 116, 128 (1996), citing Notice 88-51, 1988-1 C.B. at 536.

This similarity does not keep the periodic system from being a proper method of accounting. The same conclusion is necessarily drawn in regard to accounts receivable properly subject to the mark to market method under § 475.

Issue 7:

Prop. Treas. Reg. § 1.475(a)-1(f)(2) provides that, to the extent that a bad debt has been previously charged off, mark-to-mark gain is treated as a recovery. As discussed above, the proposed regulations apply only to tax years beginning after January 1, 1995, and thus are not applicable to the present case. However, the principle espoused in the proposed regulations should be applied to the year at issue.

The recovery of a bad debt deducted in an earlier taxable year is includible in gross income except to the extent that the deduction did not reduce tax imposed. I.R.C. § 111(a); Treas. Reg. § 1.111-1(a)(2) and Treas. Reg. § 1.166-1(f). But see Union Trust Co. v. United States, 173 F.2d 54 (7th Cir.), cert. denied, 337 U.S. 940 (1949), holding that an earlier and arguably distinguishable wording of the tax benefit doctrine (now embodied in § 111) did not apply to the write down of bonds to market value.

The amount P receives in excess of its basis in the accounts receivable would be ordinary income to it. The receivables would not be capital assets in the hands of P. I.R.C. § 1221(4).

ASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We strongly recommend that you continue to develop the facts of this case and that you confirm the facts as set forth herein. [redacted] We note that you have issued a Branerton letter, but that it has been suspended at the request of P.

[redacted] In this context, fair market value is a hypothetical sales price between a willing seller and willing buyer, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Cf. § 20.2031-1(b)(estate tax valuation rules). Accordingly, the fair market value of an item is not to be determined by a forced sales price. The market for trade receivables is illiquid, and quotes from factors should not necessarily be relied on. Those quotes may undervalue the securities if they reflect the discount that factors demand from sellers whose cash-flow problems create a compulsion to sell.

[redacted]

[redacted]

[redacted] As discussed above, however, a taxpayer that originated trade receivables without placing any explicit, contemporaneous statement in its books and records regarding its intent to hold the receivables (i) for sale to customers, (ii) for investment, or (iii) to hedge a non-mark-to-market security, generally may place a statement in its books and records by October 31, 1997. The statement should indicate either that the taxpayer chooses to treat all such receivables as held for sale (even if actually held to maturity) and thus as subject to mark-to-market under § 475, or that it chooses to identify as exempt all such receivables. A taxpayer whose contemporaneous books and records contain explicit statements concerning its purpose in holding receivables, however, is bound by those statements under Holding 15. [redacted]

[redacted] Under Holding 15, Rev. Rul. 97-39, a taxpayer need not show that it had sold or held for sale its transition securities in order to mark them to market. Under Holding 15, the key to whether to mark to market transition securities is the entries in the taxpayer's books and records (e.g., account name), not the taxpayer's actions or business practices.