OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,
Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: - Applicability of I.R.C. ' 475 to Services and Loans

This Field Service Advice responds to your memorandum dated March 8, 1999. Originally your request was submitted as a nondocketed significant advice review, but was converted to a Field Service Advice request on March 12,1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =
Y =
a =
b =
c =
d =
e =
f =
g =

ISSUE(S):

1. Whether accrued but unpaid management fees and working capital advances transferred between related parties qualify as securities which can be marked to market under I.R.C. ' 475?

2. What is the relationship between a zero fair market value under I.R.C. ' 475 and whether debts were bad and therefore deductible under ' 166?

CONCLUSIONS:

1. Additional information needs to be obtained before it can be determined whether these items are subject to section 475. However, based upon the limited information provided on the accrued management fees and the working capital advances, it is questionable whether these items meet the requirements for section 475. Furthermore, there may be a question as to whether there was bona fide debt created by the accrued management fees and working capital advances. If there is no genuine indebtedness, neither of the items could be a security under section 475. Assuming that there is valid debt, there are still problems with meeting the section 475 requirements. In the case of the accrued management fees, for tax years that end on or prior to July 22, 1998, X does not appear to met the dealer requirement, unless X has elected not to be governed by the exception for sellers of nonfinancial goods or services. For tax years after July 22, 1998, nonfinancial customer paper is no longer a security under section 475 and therefore the mark to market method is not applicable. In the case of the working capital advances, whether the loans would qualify as being made in the ordinary course of X=s trade or business is questionable. We recommend further factual development along the lines suggested below to determine whether the accrued management fees and working capital advances are subject to section 475.

2. Prop. Treas. Reg. ' 1.475(a)-1(f), which only applies to tax years beginning after January 1, 1995, provides that a taxpayer should be able to claim a bad debt deduction under section 166 even though it employs the mark to market method. The principle contained in the regulations should also apply to earlier tax years. But, in no circumstances may X be able to duplicate deductions under both sections 166 and 475.

FACTS:

X is a Subchapter S corporation that owns a nursing homes and manages other nursing homes. The sole shareholder for X is Y. Y is also a shareholder in about b other S corporations and a partner in c partnerships. Y has d% interest in each of the partnerships. The other e % interest in the partnerships is owned by one of the other b S corporations. No facts were given as to Y=s interest in the other b S corporations.

Most of the nursing homes managed by X are owned by partnerships that are related to X, except for f unrelated partnerships. All of the management services provided are pursuant to management agreements. You indicated that the management agreements had restrictions as to when the partnerships could pay X, but we do not know the exact

restrictions. We have requested to see the management agreements. It is unclear from your facts whether there were restrictions on payment for the unrelated partnerships. The management fees were accrued between X and the related partnerships. Income and deductions for the two entities were accrued. X was not paid by the partnerships because of insufficient cash flow. X held the receivables for g years. X marked these receivables down to zero. No mention was made whether there was actual payment of the management fees from the unrelated partnerships.

X also made working capital cash advances or loans to the related partnerships. No further facts were provided as to whether any payment was made on these loans or whether the loan payments were due monthly, yearly or upon maturity. X has taken the position that these loans can be marked to market.

In addition, some of the partnerships were eventually sold and the accrued management fees and the working capital loans were forgiven as part of the sale. No other facts were given regarding the sale of the partnerships.

LAW AND ANALYSIS

Issue 1 - Applicability of Section 475

To determine whether this taxpayer can use the mark to market method of accounting for the accrued management fees (receivables) and the working capital advances (loans), it must be determined whether section 475 is applicable, and if so, was it properly applied. We also need to determine what effect related parties has on the application of section 475. To qualify to use section 475, a taxpayer must be a Adealer in securities@ as defined in section 475(c)(1) and (c)(2), and must not fall within any of the exceptions to dealer status under section 475.

Security is broadly defined under section 475(c)(2), and includes a note, bond, debenture, or other evidence of indebtedness. See section 475(c)(2)(C). Assuming that there was valid bona fide debt created in this case, the accrued management fees and the loans could possibly qualify as securities for section 475 purposes under subsection (c)(2)(C), at least for tax years ending prior to July 22, 1998. For tax years ending after that date, the management fees receivables are unlikely to qualify. Section 475 (c)(4)(A) and (B) excludes nonfinancial customer paper from the definition of security. Nonfinancial customer paper is any receivable which meets the following three requirements:

> (1) is a note, bond, debenture, or other evidence of indebtedness;
>
> (2) arises out of the sale of nonfinancial goods or services by a person the principal activity of which is selling or providing of nonfinancial goods or services; and
>
> (3) is held by such person (or a person who bears a relationship to such person described in section 267(b) or 707(b)) at all times since issue.

The management fees are accrued pursuant to management agreements X has with related partnerships to manage the nursing homes. These receivables represent evidence of indebtedness. X, who is in the business of owning and managing nursing homes, sells its management services to the related partnerships and to some unrelated partnerships. The management agreements are held by X throughout the term of the agreement. The receivables are also held by X. The accrued management fees in this case appear to fall within this nonfinancial customer paper definition and therefore are not a security under section 475. If taxpayer=s taxable year ends after July 22, 1998, then for 1998 and years forward, the accrued management fees are not subject to the mark to market method of section 475.

For years prior to 1998, it is likely that the accrued management fees fall within the definition of a security for purposes of section 475, but before section 475 can apply, we must determine whether the taxpayer meets the dealer definition under section 475. A dealer is defined in section 475(c)(1) as a taxpayer who either:(1) regularly purchases securities from or sells securities to customers in the ordinary course of a 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.

Treas. Reg. ' 1.475(c)-1(b) generally provides that sellers of nonfinancial goods and services are not dealers in securities for purposes of section 475, if at the time of purchase or sale, the debt instruments are customer paper. The regulations also provide that a debt instrument is customer paper 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 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 corporation that is a member of the same consolidated group as that person.

Treas. Reg. ' 1.475(c)-1(b)(2)(i),(ii) and (iii).

Based upon the limited information provided, the accrued management fees would be customer paper (for the reasons discussed above for the section 475 (c)(4) discussion) and therefore not subject to the mark to market method of accounting under section 475. However, there is an exception to this exception. Under Treas. Reg. ' 1.475(c)-1(b)(3) and (4), taxpayer could elect not to have the exception for sellers of nonfinancial goods or services apply. The regulations provide the specific manner in which such an election can be made. See Treas. Reg. ' 1.475(c)-1(b)(4)(i). See also Rev. Proc. 97-43, 1997-2 C.B. 494. You should verify whether an election was made. It could make a difference in whether taxpayer meets the dealer requirements of section 475.

However, even if the exception to the sellers of nonfinancial goods or services was elected, section 475 can only apply if X meets the definition of a dealer. Specifically, does X regularly sell or purchase the management agreements or management fees in the ordinary course of its trade or business? See discussion on Aordinary course of trade or business@ under working capital advances on page 6. See Case Development section also.

Furthermore, there is a serious question whether there is bona fide debt arising from the accrued management fees. The reasons for this concern include:(1) the restriction on the payment of the management fees for the related partnership and (2) the relationship of the parties involved (i.e., whether Y is creating Adebt@ with Y). Since Y is the sole shareholder of X and Y is also the only partner and shareholder in the related partnerships, the use of a mark to market method of accounting for Aindebtedness@ that Y created with itself is suspect. See further discussion under Case Development section.

Working Capital Advances

More factual development is necessary before an opinion can be rendered as to whether these loans are subject to section 475. All we know is that these loans were made to

related partnerships. Whether these loans meet the definition of security under section 475 depends on whether a valid and enforceable debt was created.

Another significant issue is whether X is a dealer for purposes of these loans. Unlike the accrued management fees, these loans do not fall within the exception for sellers of nonfinancial goods or services. The issue here is whether the loans were made in the Aordinary course of a trade or business.@ Whether X, who appears to be in the business of owning nursing home and management of nursing homes, can make loans to related partnerships in the ordinary course of X=s trade or business. Whether these are loans made in the ordinary course of trade or business may be determined by looking at other sections that use similar terminology, such as sections 162 and 166. The request has some discussion of Aordinary course of a trade or business@ under section 166. Further development along that line may provide some assistance.

ATrade or business@ as used in section 162 generally means an activity carried on with regularity for economic profit or livelihood. The concern that often arises in this area is whether an activity constitutes an investment as opposed to a business. Ordinary as used by section 162 means one that is normal, customary or usual for a business under the facts and circumstances of its situation. See Case Development section for more discussion on the type of factual development necessary.

Another point that needs to be made is that if a taxpayer qualifies as a dealer in securities for a particular type of securities, then that taxpayer is a dealer in securities for all of its other securities. For this rule to apply however, the other securities must be securities as defined in section 475. Section 475 (b)(1) provides exceptions to the application of section 475(a) for securities held: (1) as investments; (2) in the ordinary course of a trade or business and not for sale; or (3) as certain hedges. Unless securities are specifically identified under section 475(b) as being excluded from section 475, it applies. This provision allows a dealer in securities to use the mark to market method for some securities but to exclude certain types of securities from mark to market treatment. Section 475(b)(2) provides for how the identification must be made. So if X qualifies as a dealer in securities for one or the other of the accrued management fees or the working capital advances, then X could be a dealer in securities for both under section 475. But both the working capital advances or the accrued management fees must meet the definition of a security under section 475.

Related Parties

Another issue is the effect on section 475 of the accrued management fees and loans between related parties. Section 475 allows for related parties to be treated as customers so the fact that X, Y and the partnerships are related does not automatically take X out of the application of section 475. However, the relationship of the various parties does raise

serious questions about whether there is a bona fide debt. As discussed above, this is an area worth pursuing.

Issue 2 - Relationship between Section 475 and Section 166

As a general rule, any debt that becomes worthless within the taxable year is allowed as a deduction under section 166(a)(1). Under section 166(b), the basis for determining the amount of deduction for any bad debt under section 166(a) is its adjusted basis as provided in section 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 section 166(b). Normally, the amount of gain or loss recognized under section 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 section 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 section 475(a)(2). Instead, the debt would be deductible under section 166.

The proposed regulations only apply to tax years beginning after January 1, 1995. However, the principle espoused in the proposed regulations should be applied to earlier tax years subject to the mark to market rules under section 475.

Whether the principle found in the proposed regulations is applied here, the same debt should not result in a bad debt deduction under section 166 and a loss deduction under section 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

Another potential issue involves the discharge of indebtedness upon the sale of the partnerships. Income from the discharge of indebtedness is included in gross income. I.R.C. ' 61(a)(12). Thus, the partnerships would potentially have income in the year the debts attributable to both the management fees and working capital cash advances were discharged. Income from the discharge of indebtedness is excludable from gross income under section 108(a)(1)(B), if the discharge occurs when the taxpayer is insolvent.

In addition, with respect to the canceled management fee receivables, the tax benefit rule requires a taxpayer, who previously deducted an amount, to include that amount in income in a subsequent year in which there was an event Afundamentally inconsistent@ with the prior deduction. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 372 (1983); Frederick v. Commissioner, 101 T.C. 35, 41 (1993). However, tax benefit income may be excluded under section 111(a), which provides that the Arecovery@ of an amount deducted in a prior taxable year will not be included in income under the tax benefit rule if the deduction did not reduce the amount of tax in the prior year. See Frederick, 101 T.C. at 41. Under Treas. Reg. ' 1.702-1(a)(8)(i), the income attributable to the tax benefit rule is separately stated and passed through to the partners. Thus, the tax benefit rule is applied at the partner level.[1] But see Haughey v. Commissioner, 47 B.T.A. 1 (1942).

If an amount is potentially subject to both section 111(a) and section 108, the amount should first be examined under the tax benefit rule to see if any of the income is excluded and then any income not excluded should be examined under section 108. Rev. Rul. 70-406, 1970-2 C.B. 16, and Rev. Rul. 67-200, 1967-2 C.B. 15, deal with prior law, but still provide the ordering rule. The income attributable to the cancellation of the management fee receivables should be subjected to this two-part examination under sections 111(a) and 108.

Under section 108(d)(6), the insolvency exception as well as certain other exclusions are applied at the partner rather than the partnership level. Brickman v. Commissioner, T.C.

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[1] See William S. McKee et al., Federal Taxation of Partnerships and Partners, ' 9.02[2][c] (3rd ed. 1997).

Memo. 1998-340. Thus, X will have discharge of indebtedness income from each partnership equal to X=s proportionate share of partnership. This is true even if the partnership is insolvent. See Gershkowitz v. Commissioner, 88 T.C. 984 (1987).[2]

However, under section 108(d) (7) (A), the insolvency exception as well as certain other exclusions are applied at the corporate level for a Subchapter S corporation. Nelson v. Commissioner, 110 T.C. 114, 121 (1998). As a result, if X is itself insolvent or meets any of the other exclusions under section 108(a)(1), it may be able to exclude from gross income some or all of the discharge of indebtedness income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This case needs further development to determine whether the accrued management fees or the working capital loans meet the requirements of section 475. In addition, further development of this case may indicate that there is no real indebtedness, but rather a sham structure due to the relationship of X, Y and the related partnerships and S corporations. All documents involved in this transaction must be examined to determine whether there is bona fide indebtedness or whether X or Y ignored the documentation. [redacted] We recommend further examination of the issues.

Other facts that need to be developed include [redacted] These facts are necessary in determining the substance of these transactions and whether there is genuine indebtedness.

[2] The discussion in the foregoing paragraph is also subject to the partnership provisions. See Fred T. Witt, Jr. & William H. Lyons, AAn Examination of the Tax Consequences of Discharge of Indebtedness,@ 10:1 Virginia Tax Review 1, 75-76 (1990), which discusses the interplay between section 108 and certain partnership provisions, including their impact on allocation of income and timing issues.

Management Fees

According to the request, there are restrictions in the management agreements that prohibited payment. [redacted] This information is also important in looking at whether there is indebtedness.

If X elects out of the exception for sellers of nonfinancial good or services, it must be determined whether X meets the dealer definition under section 475. [redacted]

Working Capital Advances

As we noted above, the real issue is whether these loans could be considered to be made in the course of X's trade or business. X's trade or business appears to be in owning and managing nursing homes. X does not appear in the business of making loans. If the loans are necessary to provide cash flow to maintain the nursing homes, there is an argument that the loans are made in the ordinary course of X's business. [redacted]

Due to the fact that all of the related partnerships and S corporations are owned by Y, and Y is the sole shareholder of X, there is significant concern as to the arms-length standard in these transactions. Particularly, no payments seem to occur and forgiveness of indebtedness appears to occur. All of these adjustments flow through to Y. If there is no real indebtedness, then there can be no security for purposes of section 475. [redacted]

If you have any further questions, please call (202) 622-7870.

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