Capital Idea!

By Richard C. Morris • Wood & Porter • San Francisco

On August 7, 2006, the IRS issued proposed regulations under Code Sec. 1221 massaging the definition of capital assets. The proposed regulations solely concern accounts and notes receivable. Specifically, they clarify the circumstances in which accounts or notes receivable are acquired for services rendered within the meaning of Code Sec. 1221(a)(4).

Code Sec. 1221(a)(4)

Code Sec. 1221 defines a capital asset as all property held by a taxpayer unless specifically excepted. Code Sec. 1221(a)(4) treats accounts or notes receivable as ordinary assets if they are acquired in the ordinary course of trade or business for services rendered or from the sale of property described in Code Sec. 1221(a)(1).

Of course, all M&A Tax Report readers know this. Code Sec. 1221(a)(4) has been part of the Code for over half a century. Congress enacted it as part of the 1954 Code to correct what it perceived to be a character mismatch problem. Before its enactment, the value of accounts or notes receivable acquired for rendering services or selling inventory was taken into account by a taxpayer as ordinary income, but gain or loss on a later disposition of the receivables was given capital treatment. Code Sec. 1221(a)(4) corrected this mismatch by treating the accounts or notes receivable as ordinary assets.

The legislative history confirms this limited focus by referring explicitly to accounts and notes receivable acquired "in payment for" inventory or services rendered by the holder. The House Report states that:

> Paragraph (4) is a new provision which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1), that is, stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. This will change present law treatment, for example, as follows: If a taxpayer acquires a note or account receivable in payment for inventory or services rendered, reports it as income and sells it at a discount, then this amendment will provide ordinary loss treatment. Under present law such loss treatment is only allowed if the taxpayer is also, in effect, a dealer in such accounts or notes. Alternatively, the taxpayer may sell the account or note for something more than the discounted value that was originally reported. Under present law this difference would be capital gain unless the taxpayer is such a dealer. The amendment will cause such gain to be ordinary income. [H.R. Rep. No. 1337, 83d Cong., 2d Sess., A273-74 (1954).]

A long-standing regulation interpreting Code Sec. 1221(a)(4) also confirms this limited focus. Reg. §1.1221-1(a) states that the term "capital assets" includes all classes of property not specifically excluded by Code Sec. 1221. Reg. §1.1221-1(d), which addresses the Code Sec. 1221(a)(4) exclusion, repeats the statutory language of Code Sec. 1221(a)(4) and then interprets it to apply as follows:

> Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously

reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

Expansion of Code Sec. 1221(a)(4)

Notwithstanding what appears to be a concise and limited exclusion from capital asset characterization, Code Sec. 1221(a)(4) has been applied more expansively. The initial expansion occurred with respect to notes obtained in loan originations. In *Burbank Liquidating Corp.*, 39 TC 999, Dec. 26,025 (1963), *acq. sub nom., United Assoc., Inc.*, 1965-1 CB 3, *aff'd in part and rev'd in part on other grounds*, CA-9, 64-2 USTC ¶9676, 335 F2d 125 (1964), the Tax Court held that mortgage loans originated by a savings and loan association in the ordinary course of its business were ordinary assets under Code Sec. 1221(a)(4) in the hands of that association. The reason is that they were notes receivable acquired for the service of making loans. The IRS acquiesced in that decision. Then, it relied upon *Burbank Liquidating* in a series of revenue rulings, treating loans made by commercial lenders (including banks and REITs) as ordinary assets under Code Sec. 1221(a)(4) when held by the original lender. [*See* Rev. Rul. 72-238, 1972-1 CB 65; Rev. Rul. 73-558, 1973-2 CB 298; Rev. Rul. 80-56, 1980-1 CB 154; Rev. Rul. 80-57, 1980-1 CB 157.]

Historically, a lending transaction was sometimes thought of as a rendition of services to the borrower. [*See* Rev. Rul. 70-540, 1970-2 CB 101; Rev. Rul. 69-188, 1969-1 CB 54; Rev. Rul. 68-6, 1968-1 CB 325.] According to the IRS, that characterization, however, does not justify treating notes acquired by an originator in a lending transaction as ordinary assets under Code Sec. 1221(a)(4). Such treatment strains the language of the statute, because the notes are not issued by borrowers solely (or even predominantly) for services rendered. Rather, for the most part, the notes are issued by the borrower to the lender in exchange for money.

Subsequently, the Tax Court further extended the application of Code Sec. 1221(a)(4) in *Federal National Mortgage Ass'n*, 100 TC 541, 49,102 (1993) ("FNMA"), by applying that provision to notes that were purchased in transactions that the court considered closely associated with the process of origination. Although FNMA was not an originator, the court used the *Burbank Liquidating* analysis to extend Code Sec. 1221(a)(4) treatment to mortgages purchased by FNMA. The court justified this result by pointing out that FNMA's purchasing activity was undertaken in accordance with its statutorily defined purpose "to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments." [*FNMA*, 100 TC, at 545 (quoting the Housing Act of 1954, ch. 649, title II, Section 201, 12 USC §1716(a)).] Because of this purpose, the court concluded that the purchases were "a service to the mortgage lending business and the members thereof." [*Id*., at 578.]

Reversal of Fortune

After 40 years of judicial and administrative expansion, the IRS has now determined that the expansion of Code Sec. 1221(a)(4) cannot be reconciled with Congress' stated purpose for enacting the statute way back in 1954. The IRS now believes that the acquisition of notes or mortgages using consideration other than services or Code Sec. 1221(a)(1) property does not generally trigger current ordinary income, and so does not create a potential for the character mismatch that concerned Congress when it enacted Code Sec. 1221(a)(4).

The proposed regulation reflects a conclusion by the IRS that the extension of Code Sec. 1221(a)(4) to notes acquired by a creditor in a lending transaction or to notes purchased in the secondary market is inconsistent with Congressional intent and is unsound as a matter of tax policy. In addition, the interpretation of Code Sec. 1221(a)(4) set forth in *Burbank Liquidating* and *FNMA* impedes effective administration of the tax laws by causing the status of the notes to hinge on judgments as to whether the lending transaction or a subsequent secondary market purchase of the notes provides a service to the borrower or the mortgage lending industry. Reliance on judgments such as this fosters uncertainty and provokes disputes.

Accordingly, the proposed regulation clarifies that an account or note receivable is not described in Code Sec. 1221(a)(4) if, in exchange for the account or note receivable, the taxpayer provides more than *de minimis* consideration other than services or property described in

Code Sec. 1221(a)(1), or if the account or note receivable is not issued by the party acquiring the services or property described in Code Sec. 1221(a)(1). In particular, a note is not acquired for services within the meaning of Code Sec. 1221(a)(4) on the grounds that the taxpayer's act of acquiring (including originating) the account or note receivable constitutes, or includes, the provision of a service or services to the issuer of the account or note receivable, to the secondary market in which accounts or notes receivable of this sort may trade, or to the participants in that market.

Effect on Rulings

The preamble to the proposed regulations states that some of the rulings in this area will be affected. Of the four rulings already mentioned, both Rev. Rul. 72-238 and Rev. Rul. 73-558 are not affected. These two rulings only apply to tax years beginning before July 12, 1969, and were superseded by Section 582(c) of the Internal Revenue Code of 1986. Consequently, they are not determinative with respect to future transactions and have been declared obsolete by the proposed regulations.

The status of the other two rulings mentioned (Rev. Rul. 80-56 and Rev. Rul. 80-57) is less clear. The IRS notes that when final regulations are published, it will then determine whether they should similarly be declared obsolete.

Conclusion

The proposed regulations will only apply to accounts or notes receivable acquired after final regulations are issued. Yet, as with virtually all proposed regulations, the IRS is soliciting comments and will hold a public hearing. Thus, it could be some time before final regulations are issued. Comments are specifically requested from taxpayers in the acceptance finance, debt collection, factoring and personal finance industries on any impact that the proposed regulation may have.

Yet, even if taxpayers and practitioners have to wait, these proposed regulations represent a sea change. Perhaps we will now see the IRS reexamine and/or expand other capital asset definitions. With the current landscape of a significant capital gains preference, these proposed regulations offer relief that I imagine few will not appreciate.

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