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February 22, 2007

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 1221(a)(4)

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under Section 1221(a)(4) regarding the exception to the capital asset definition for accounts or notes receivable obtained in the ordinary course of trade or business for services rendered or from the sale of property. The comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

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COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 1221(a)(4)

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These comments were prepared by a working group of the Banking and Savings Institutions Committee. Principal responsibility was exercised by Yoram Keinan. Substantive comments were made by Ronald W. Blasi, Linda Carlisle, David Garlock, and Charles Wheeler. The comments were reviewed by John Ensminger, Chair of the Banking and Savings Institutions Committee. The comments were further reviewed by C. Wells Hall III of the Section's Committee on Government Submissions and by Peter J. Connors, Council Director for the Committee on Banking and Savings Institutions.

Although some of the members of the Tax Section who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on applications of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: February 22, 2007

EXECUTIVE SUMMARY

On August 7, 2006, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations¹ (the “Proposed Regulations”) that would interpret section 1221(a)(4)² as not excluding from capital asset treatment notes and accounts receivable obtained by a creditor in an originated lending transaction or purchased by it in a secondary market. As a result, the Proposed Regulations would preclude, for taxpayers not covered by section 582(c) or 475, ordinary income or loss treatment on a sale of such notes and accounts receivable. Furthermore, because the Proposed Regulations would treat such receivables as capital assets, they would preclude the holders from obtaining the efficiencies of tax hedging under sections 1221(b)(2) and 1221(a)(7), and Regulation section 1.1221-2(b), making it difficult or impossible to manage the risks associated with holding the receivables.

We respectfully submit that the Proposed Regulations should not be made final, in particular because they would reverse well-established case law. The Proposed Regulations would reverse the court’s decision in *Burbank Liquidating Corp. v. Commissioner* (“*Burbank Liquidating*”)³. In addition to acquiescing to the decision in 1965, the Service has relied upon *Burbank Liquidating* in a series of revenue rulings treating loans made by commercial lenders in the course of these lenders’ trades or businesses as ordinary assets under section 1221(a)(4) when held by the original lender. Furthermore, the Proposed Regulations would reverse the decision in *Federal National Mortgage Association v. Commissioner* (“*Federal National Mortgage Association*”)⁴. Although the Federal National Mortgage Association (“Fannie Mae”) was not an originator, the court extended the result in *Burbank Liquidating* to mortgages purchased by Fannie Mae, reasoning that Fannie Mae’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.”

While these comments do not address the question whether lending activity or a voluminous purchase of loans in the secondary market constitutes providing a service, we strongly believe that these two types of activities should give rise to ordinary gain or loss treatment if they take place in the course of the taxpayer’s trade or business and the taxpayer is unable to obtain ordinary treatment under any other specific provision.

We believe that without an amendment of section 1221(a)(4), Treasury and the Service should not reverse by regulation the well-established cases of *Burbank Liquidating* and *Federal National Mortgage Association*, and we see no reason why notes and accounts receivable obtained in the course of such a trade or business would be subject to different treatment from that provided by these cases and the Service’s administrative interpretations of them. Finally, we note that if the Proposed Regulations are adopted in their current form, they will be a significant

¹ REG-109367-06, 71 Fed. Reg. 44,600.

² Unless otherwise noted, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”) or, when in the form “.Reg. §,” to Treasury regulations thereunder.

³ *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *acq. sub nom. United Assocs., Inc.*, 1965-1 CB 3, *aff’d in part and rev’d in part on other grounds*, 335 F.2d 125 (9th Cir. 1964) (ordinary loss deduction allowed on the grounds that the mortgage notes were “notes receivable acquired... for services rendered” within the meaning of section 1221(a)(4)).

⁴ *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993).

impediment to certain segments of the lending industry. We do not assert that the Proposed Regulations are invalid as a matter of statutory interpretation; we simply urge Treasury and the Service to reconsider them for the reasons set forth more fully below.

COMMENTS

I. Introduction

The Proposed Regulations would alter the present interpretation of section 1221(a)(4) by excluding notes and accounts receivable obtained by nonbank financial institutions in lending transactions and those purchased in the secondary market by organizations such as Fannie Mae.⁵ These comments are provided in response to the Service's request for comments on the Proposed Regulations.

II. Section 1221(a)(4)

The term "capital asset" is defined in section 1221 as property held by the taxpayer unless specifically excluded.⁶ One of the enumerated exceptions, found in section 1221(a)(4), excludes "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in [section 1221(a)(1)]." Since the court's decision in *Burbank Liquidating*, section 1221(a)(4) has been applied by both the Service and taxpayers to accounts and notes receivable obtained in cash lending transactions.⁷

Before the enactment of section 1221(a)(4) in 1954,⁸ income from accounts or notes receivable acquired for services or inventory was recognized by taxpayers as ordinary income, while a loss on a later disposition of the resulting receivables was treated as a capital loss. As explained in the legislative history to the Internal Revenue Code of 1954, the original purpose of section 1221(a)(4) was to correct the character mismatch by treating the receivables as ordinary assets. The House Report contained the following example:

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

⁵ Prop. Reg. § 1.1221-1(e).

⁶ See generally section 1221(a).

⁷ See *e.g.*, Rev. Rul. 72-238, 1972-1 C.B. 65 (gain realized in a foreclosure proceeding by a creditor bank that purchased mortgaged property at a bid price less than the fair market value of the property is ordinary income); Rev. Rul. 73-558, 1973-2 C.B. 298 (a savings and loan association that exchanged residential mortgages for commercial mortgages having an equal face and discounted value may deduct as an ordinary loss the amount of such discount; the portion of subsequent collections of principal allocable to the discount is includible in ordinary income); Rev. Rul. 80-56, 1980-1 C.B. 154 (a real estate investment trust that engaged primarily in short-term financing activities made a construction loan on which the borrower defaulted; the lender had charged off the bad debt as an ordinary loss under section 166 but later obtained the property in foreclosure proceedings at less than fair market value; the IRS cited section 1221(a)(4) as one of the reasons that the character of the resultant gain was ordinary); Rev. Rul. 80-57, 1980-1 C.B. 157 (REIT that accepted deed in lieu of foreclosure had ordinary income on difference between its basis in the note and the value of the property received).

⁸ Prior to the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. 106-170, 113 Stat. 1860 (Dec. 17, 1999), § 352 the subsections of section 1221 were denominated solely by numbers, such that sections 1221(a)(1) and 1221(a)(4) were denominated sections 1221(1) and (4). For ease of reference, and in accordance with the Service's usage in the preamble to the Proposed Regulations, the references here use the current designations.

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.⁹

Regulation section 1.1221-1(d) sets forth a further illustration of how section 1221(a)(4) works:

[I]f 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.

The preamble to the Proposed Regulations (the “Preamble”) states that the intended purpose of section 1221(a)(4) was to exempt from capital treatment accounts and notes receivable that were received in payment for inventory or services rendered by the holder. Under the Proposed Regulations, section 1221(a)(4) would not apply to originated loans (contrary to *Burbank Liquidating*) if in exchange for the note, the taxpayer provides more than *de minimis* consideration other than services or ordinary property described in section 1221.¹⁰

With respect to the interpretation of section 1221(a)(4) in *Federal National Mortgage Association*, the Service appears to be concerned that this decision has resulted in some taxpayers claiming ordinary losses on the grounds that their purchases of receivables such as mortgage-backed securities provide liquidity to the market.¹¹ As we suggest below, *Federal National Mortgage Association* should be limited to its facts. Thus, only major market participants such as Fannie Mae (the former Federal National Mortgage Association), Freddie Mac (the former Federal Home Loan Mortgage Corporation) (mortgages), and Sallie Mae (SLM Corporation) (student loans) could be viewed, under the reasoning of that case, as providing the service of market liquidity. The rationale for the case is discussed further below.

III. Proposed Regulations

The Proposed Regulations reflect the view that the long-accepted exclusion from capital treatment under section 1221(a)(4) of notes and accounts receivable acquired by a creditor in a

⁹ See preamble to the Proposed Regulations, quoting from H.R. Rep. No. 1337, 83d Cong., 2d Sess., A273-4 (1954).

¹⁰ The Preamble notes that in *Burbank Liquidating* and revenue rulings relying on it, “a lending transaction was sometimes thought of as rendering a service to the borrower.” The Preamble states that such an approach “strains the language of the statute” when notes “are not issued by borrowers solely or even predominantly for services rendered. Rather, the notes are, for the most part, issued by the borrower to the lender in exchange for money.”

¹¹ In T.A.M. 2006-51-033 (Aug. 31, 2006), dollar-rolled mortgage-backed securities (“MBS”) acquired by the taxpayer were, under a Form 906 Closing Agreement, treated as ordinary over a three-year period. However, two years preceding the period covered by the Closing Agreement were not covered by that Agreement, and the Service determined that the dollar-rolled MBS were not acquired in the ordinary course of trade or business for services within the meaning of section 1221(a)(4). Nevertheless, the Service granted administrative relief, “based on the totality of the circumstances including but not limited to equitable considerations,” and permitted the taxpayer to retain the ordinary treatment. The technical advice also noted that the Proposed Regulations under discussion in this comment are to be applied prospectively upon the issuance of final regulations.

cash lending transaction, or of notes purchased in the secondary market, is inconsistent with Congressional intent and unsound as a matter of tax policy. Further, the Preamble indicate that the interpretation of that section, as established through case law, causes the status of the notes to hinge on judgments as to whether the lender in the lending transaction or a subsequent secondary market purchaser of the notes provides a service to the borrower or the mortgage lending industry, which, the Preamble asserts, fosters uncertainty and disputes.¹²

The Proposed Regulations provide that an account or note receivable is not described in section 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 section 1221(a)(1),¹³ or if the account or note receivable is not issued by the party acquiring the services or property described in section 1221(a)(1).¹⁴

The Proposed Regulations specify that a note or account receivable is not acquired for services under section 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. Only if a lender separately invoices reasonable fees for services it renders to the borrower in connection with a lending transaction, and if the lender receives, as evidence of the obligation to make payment of those fees, an account or note receivable that is separate from the debt instrument that was originated in the lending transaction, do the Proposed Regulations allow that the lending involved does not prevent the separate account or note receivable from being described in section 1221(a)(4).¹⁵

In the Preamble, the Service separately made obsolete Revenue Rulings 72-238 and 73-558, applying those revenue rulings only to tax years beginning before July 12, 1969.¹⁶ According to the Preamble, the Service will determine whether Revenue Rulings 80-56 and 80-57 should similarly be rendered obsolete once the regulations are finalized.¹⁷ The Proposed Regulations apply to accounts or notes receivable acquired after the date the regulations appear as final in the Federal Register.¹⁸

As a result, the Proposed Regulations would administratively overrule both *Burbank Liquidating* and *Federal National Mortgage Association*, discussed below, as wrongly decided on the grounds that the note or account receivable must be obtained *in return for services* and that lending (*Burbank Liquidating*) or purchasing (*Federal National Mortgage Association*) cannot be the service provided.¹⁹ While it is unclear whether lending activity or continuous and voluminous purchases of loans in the secondary market constitute the provision of service, we

¹² Preamble, 71 Fed. Reg. 44,601.

¹³ Prop. . Reg. § 1.1221-1(e)(1)(i).

¹⁴ Prop. . Reg. § 1.1221-1(e)(1)(ii).

¹⁵ Prop. . Reg. § 1.1221-1(e)(2).

¹⁶ 77 Fed Reg. 44,601 (“Effect on Other Documents”).

¹⁷ *Id.*

¹⁸ Prop. . Reg. § 1.1221-1(e)(3), 71 Fed. Reg. 44,602.

¹⁹ The difference between the two cases is that while in *Burbank Liquidating*, the “service” was provided by the lender to the borrower itself, in *Federal National Mortgage Association*, the “service” was to third parties (the public or other participants in the market).

believe that these two types of activities should give rise to ordinary treatment if they take place during the ordinary course of the taxpayer's trade or business. Thus, the line of *Corn Products Refining Co. v. Commissioner* ("*Corn Products*"),²⁰ and *Arkansas Best Corp. v. Commissioner* ("*Arkansas Best*"),²¹ described below, should continue to hold that the effective stock in trade of a lender is its loans, and the appropriate treatment is ordinary.

IV. *Corn Products*

In *Corn Products*, the taxpayer, a manufacturer of corn products, in order to protect itself against the risk of fluctuations in the price of corn, engaged in the purchase and sale of corn futures. The taxpayer argued that the corn futures were capital assets and the profits and losses from their sale were entitled to preferential tax treatment under the capital asset provisions. The Supreme Court held that the futures transactions constituted "an integral part of its manufacturing business" and the gains and losses were to receive ordinary tax treatment. Specifically, the Court stated that:

Congress intended that profits and losses arising from the every-day operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by [section 117, the predecessor of section 1221] applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from ... excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term "capital assets" in [section 1221]. See *Hort v. Commissioner*, 313 U.S. 28, 31 (1941); *Kieselbach v. Commissioner*, 317 U.S. 399, 403 (1943).

Thus, the Court concluded that in order to effectuate the basic Congressional purpose, "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."

The Supreme Court indicated that even if technically a certain type of asset is not enumerated as one of the exceptions to "capital assets" under previous section 117, ordinary treatment should apply to profits and losses arising from the every-day operation of the taxpayer's trade or business. As explained below, the Supreme Court in *Arkansas Best* similarly indicated that the exceptions to the definition of "capital assets" ought to be interpreted broadly. In our view, even though *Arkansas Best* also limited the scope of *Corn Products*, the interpretations given to section 1221(a)(4) by the courts in *Burbank Liquidating* and *Federal National Mortgage Association* remain valid and sound from a tax policy perspective. Stated differently, even though it is arguable that, under the original legislative purpose of section 1221(a)(4), certain originated and purchased loans obtained in the course of a trade or business would not necessarily be subject to section 1221(a)(4), it is our view that from a policy perspective, as

²⁰ *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

²¹ *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

articulated in *Corn Products*, taxpayers that hold notes and accounts receivable as part of their core every-day business should be allowed ordinary treatment.

V. *Burbank Liquidating*

In *Burbank Liquidating*, the Tax Court held (and the Circuit Court affirmed) that mortgage loans originated in the ordinary course of the taxpayer's business were, in the hands of the holder, ordinary assets under section 1221(a)(4) because they were notes receivable acquired *for the service of making loans*. The court stated that:

[W]e believe that the mortgage loans made in the ordinary course of its business are “notes receivable acquired ... for services rendered” and thus... are ordinary rather than capital assets. Certainly, the business of a savings and loan company could properly be described as “rendering the service” of making loans. Therefore, we hold that [taxpayer's] loss on the sale of its loans is deductible as an ordinary loss.²²

Treating accounts receivable obtained as a part of a lending business as ordinary business assets is consistent with the purpose of section 1221(a) as described in *Corn Products*, namely to allow ordinary treatment for assets acquired in the course of the taxpayer's every-day business.²³ Ever since the decision was issued in 1963, many loan originators as well as the IRS have relied on *Burbank Liquidating* in treating the loans held as part of their lending business as ordinary assets.

VI. *Arkansas Best*

In *Arkansas Best*, the Supreme Court confirmed that all assets are capital unless they are described as ordinary in section 1221. As noted above, however, the Supreme Court reaffirmed the statement in *Corn Products* that “the definition of ‘capital asset’ must be narrowly applied and its exclusions interpreted broadly.”²⁴ In other words, the Supreme Court has confirmed that while the ordinary treatment should be reserved only to the enumerated exceptions, these exceptions should be interpreted broadly.

VII. *Federal National Mortgage Association*

In *Federal National Mortgage Association*, the Tax Court held that Fannie Mae's mortgage loans were ordinary assets under section 1221(a)(4). The Tax Court explained that mortgages purchased by Fannie Mae constituted ordinary assets under that section because Fannie Mae provides a “service” to the market by virtue of providing liquidity. The Tax Court reasoned:

²² 39 T.C. at 1009.

²³ See *Ardela, Inc. v. Commissioner*, 28 T.C.M. 470 (1969), where “taxpayer's loans fell beyond the language and legislative rationale of § 1221(a)(4)” because the taxpayer did not lend money in the ordinary course of its trade or business. In *Ardela*, the note involved derived from the sale of depreciable assets, furniture and equipment, and not from the lending of money. Nor was the taxpayer in the business of selling such assets, so that the transaction could not be brought within the scope of section 1221(a)(1).

²⁴ We believe that even though *Arkansas Best* restricted the significance of *Corn Products*, it should not result in capital treatment for accounts and notes receivable obtained in the course of a trade or business. For a discussion of this issue, see Edward D. Kleinbard and Suzanne F. Greenberg, *Business Hedges After Arkansas Best*, 43 Tax L. Rev. 393, 393-94 (1988).

Given petitioner's [Fannie Mae's] mandated purpose, the restrictions on its behavior, and its actual operation, we believe that petitioner's acquisition of mortgages is designed to enhance the efficiency of the secondary market in mortgages. On this basis, we hold that the mortgages in its portfolio fall within section [1221(a)(4)].

The Tax Court thus extended the holding in *Burbank Liquidating* by concluding that the section 1221(a)(4) exclusion included mortgage loans that were purchased in transactions that the court considered closely associated with the process of origination.²⁵ In effect, the language in section 1221(a)(4) regarding "services rendered" is met if the service is the addition of liquidity to the mortgage market, which is indirectly a service to market participants.²⁶

The case was decided 13 years ago. Since then, the Service has never officially expressed any intention to issue regulations or any other guidance that is inconsistent with the case. Since 1993, some taxpayers have argued that by purchasing mortgage-backed securities, they provide liquidity to the market, and should be awarded ordinary treatment in accordance with the court's decision in the Fannie Mae case. For taxpayers that clearly are not comparable to Fannie Mae, this is an unwarranted interpretation of the decision.²⁷

VIII. Section 582(c)

Banks that are subject to section 582(c) will generally not be directly affected by the Proposed Regulations. Section 582(c) provides ordinary treatment for banks and other financial institutions on the sale or exchange of most debt instruments, namely bonds, debentures, notes, certificates, and other evidence of indebtedness.²⁸ However, not all financial institutions are covered by section 582(c). Those entities that do not fall under any of the enumerated categories in section 582(c)(2) must seek an alternative provision to be allowed ordinary treatment. Section 1221(a)(1) (inventory) may not be available to all taxpayers engaged in the lending business, and such taxpayers that are not considered "banks" under section 582(c) could be significantly affected by the Proposed Regulations.²⁹

²⁵ *Federal National Mortgage Association*, 100 T.C. at 545 (quoting the Housing Act of 1954, ch. 649, title II, section 201, 12 U.S.C. § 1716(a)). The court held that the purchases were "a service to the mortgage lending business and the members thereof". *Id.*, at 578.

²⁶ Section 1221(a)(4) does not state that the "services rendered" must be rendered to the borrower. A purchaser of receivables provides liquidity to the market by performing a service to a seller from which it buys but also provides a service to other sellers by allowing them to freely transfer their receivables for competitive prices.

²⁷ See *Bielfeldt v. Commissioner*, 231 F.3d 1035 (7th Cir. 2000), *aff'g* T.C.M. 76 T.C.M. 776 (1998), *cert. den.* 534 U.S. 813 (2001), where the taxpayer alleged that his purchase of government debt enhanced liquidity of that market and that he was entitled to ordinary treatment under section 1221(a)(4). The Seventh Circuit found that the taxpayer's trading activity provided a benefit (increasing liquidity and tightening spreads) for the government debt market, but the court also found that the taxpayer was a trader and a speculator, not a dealer, and labeled his section 1221(a)(4) argument "frivolous." The opinion, and that of the Tax Court, focused primarily on section 1221(a)(1), finding that the taxpayer did not have customers, as required under that provision.

²⁸ See section 582(c)(1).

²⁹ In general, the standard for section 1221(a)(1) is very close to the standard under section 475 (discussed below) and many lenders fail to satisfy both standards.

IX. Section 475

The Code provides ordinary treatment for debt instruments held, other than as investments, by security dealers (section 475(a)) and electing security traders (section 475(f)).³⁰ Further, if gain or loss is recognized before the close of the year, for example because the dealer or trader disposed of the security during the year, and the mark-to-market rules of section 475(a)(2) would have applied if the security were held at the close of the year, then ordinary treatment is available so long as the security is held in connection with the dealer or trader activities. Thus, lenders that are subject to mark-to-market accounting under section 475 (either dealers or electing traders) are unlikely to be directly affected by the Proposed Regulations because their gains and losses from the sales of loans will be ordinary by virtue of these two Code sections. For many taxpayers, given the breadth of both sections 475(a) and 475(f), this is a viable option provided that in the case of taxpayers originating loans, more than a negligible amount are sold or where less than such amount are sold, the taxpayer elects to be treated as a dealer, and its systems provide the necessary data for mark-to-market accounting.³¹

For originating lenders such as loan and finance companies, the costs of implementing a mark-to-market system could be substantial. This would not put such lenders on a level playing field with banks or even with broker-dealers that, given the sophistication of their pricing models and GAAP accounting requirements, are better equipped to use mark-to-market tax accounting.

X. Hedging

Generally, a “hedging transaction” is defined in section 1221(b)(2) as any transaction that is entered into in the “normal course” of a taxpayer’s trade or business “primarily to manage” any of the following: (i) risk of price changes or currency fluctuations with respect to “ordinary property” that is held or to be held by the taxpayer; (ii) risk of “interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer,” or (iii) other risks that the Service identifies in published guidance.³² Thus, hedging of capital assets is not treated as a hedge for tax purposes.³³

If the Proposed Regulations are adopted, many loans will be treated as capital assets for those affected taxpayers discussed above. Thus, not only will losses on the sale of loans be capital, thereby reducing the potential tax benefit from the losses, the more significant impact may be that these assets will no longer qualify as ordinary assets for purposes of the tax hedging rules. As a result, hedges of such loans will no longer qualify for tax hedging treatment and may result in both timing and character mismatches for the taxpayer.

³⁰ Section 475(d)(3)(A). Under section 475(d)(3)(B), if the security is held other than in connection with the holder’s activities as a dealer in securities, section 475(d)(3)(A) does not apply to provide for ordinary treatment.

³¹ Reg. § 1.475(c)-1(c)(1).

³² Section 1221(b)(2), Reg. § 1.1221-2(b).

³³ Of course, a holder of a capital asset can economically hedge it, but it would not qualify as a tax hedge under Reg. § 1.1221-2(b).

XI. Character of Debt From a Policy Perspective

Loans differ from other assets in one important respect, in that the owner of a loan has a right to a fixed principal amount and interest at a fixed or floating rate,³⁴ and nothing more. Thus, for a taxpayer that originates or purchases a loan for that fixed principal amount, there is a significant limit on the ability to derive a gain from the appreciation in value of the loan. It is true that a fixed-rate loan can increase in value temporarily as a result of a decline in interest rates, but that gain can be realized as a capital gain only by selling the loan before it matures; the value returns to the fixed principal amount as the loan approaches its maturity date.³⁵ While some bond funds and other traders try to derive gains by selling appreciated bonds before they mature based on interest rate fluctuations,³⁶ this behavior is highly unusual among those in the lending business. Thus, in general, the returns to lenders are almost entirely in the form of ordinary interest income.

Losses, on the other hand, arise when the borrower defaults and is unable to pay. Lenders and purchasers of loans are compensated for taking this risk by the interest rate charged on the loan. The higher the default risk, the higher the interest rate. Thus, if loan losses are treated as capital losses, lenders suffer a character mismatch. This mismatch is particularly unfair because many lenders have no reliable source of capital gains to offset against the losses.

Fortunately, even under current law, treating loans as capital assets does not necessarily mean that loan losses will be capital losses. A taxpayer can in many cases obtain ordinary loss treatment for loans that become wholly or partially worthless under section 166(a) even on loans that are capital assets. This section does not apply, however, to loans that are “securities” within the meaning of section 165(g)(2)(C),³⁷ and does not apply to losses on sales of loans that have declined in value but have not become completely worthless. Thus, a lender holding a distressed loan that is a capital asset but not a security is placed in the odd position of realizing a capital loss if it sells the loan to a third party but obtaining an ordinary deduction if the loan becomes wholly worthless or if it writes the loan down and claims a deduction for partial worthlessness. The latter point is particularly important because many lenders make a business practice of selling delinquent loans to other business that specialize in distressed debt.

Accordingly, if the Proposed Regulations are adopted, the primary effect on many non-bank lenders will be to discourage taxpayers from the practice of selling delinquent loans at a loss. We can find no policy justification for construing the Code to produce this effect. Taxpayers who continue to sell may be able to claim a deduction for partial worthlessness under section 166(a)(2) for loans that qualify under the provision prior to the sale, thereby minimizing or eliminating the capital loss on the sale itself, but it is unclear whether a claim shortly prior to a

³⁴ Contingent payment debt instruments are unusual in the commercial lending world and in any event have a special set of rules dealing with capital versus ordinary treatment in Reg. § 1.1275-4.

³⁵ In contrast, if market rates increase, a holder that sells the loan prior to maturity would recognize a loss on such a loan.

³⁶ Such taxpayers would not be entitled to ordinary asset treatment under the recommendations in this report.

³⁷ Under section 166(e), no deduction is allowed under section 166 for a debt that is evidenced by a security within the meaning of section 165(g)(2)(C). Section 165(g)(1) allows a capital loss for any security that becomes worthless during the taxable year but contains no provision analogous to section 166(a)(2) for partially worthless debt securities.

sale would be respected.³⁸ Hence, the Proposed Regulations may well have the effect of increasing rather than reducing character-related disputes between taxpayers and the Service.

We note that current interpretations of section 1221(a)(4) under the established case law discussed above provide some leeway under which taxpayers may sometimes choose between ordinary and capital treatment of originated or purchased debt, and that this leeway presents administrative problems for the Service. Restricting the holding of *Federal National Mortgage Association* would eliminate the leeway currently available to taxpayers in deciding between capital and ordinary loss treatment. Nonetheless, we believe that the approach of the Proposed Regulations, effectively creating two separate classes of lenders—banks and those using section 475, on the one hand, and finance companies not qualifying or efficiently able to implement section 475 on the other, whose activities are largely identical—is an inappropriate solution.

XII. Summary and Conclusions

In the view of the majority of those participating in the preparation of the comments, the Proposed Regulations should either be withdrawn or significantly revised for the following reasons:

- Financial institutions have been able to rely on more than 40 years of case law and IRS rulings to treat gains and losses from trade or business lending operations and activities as ordinary; those cases and rulings that would be effectively overturned by the Proposed Regulations are sound interpretations of Supreme Court case law and congressional intent.
- The cases and rulings dealing with section 1221(a)(4), although not resolving all issues, have provided a level of comfort to nonbank and non-broker-dealer financial institutions in the treatment of their trade or business lending activities that has allowed them to become significant participants in debt markets.
- Such institutions have been able to take advantage of the tax hedging rules because the loans are treated as ordinary assets, which has increased the efficiency of such operations, and allowed such institutions to be competitive with banks and broker-dealers that are required to treat gains and losses from most lending activities as ordinary and are able to hedge such activities efficiently.
- Congressional intent, insofar as it has been described by the Supreme Court and other courts, does not support treating loan and finance companies, certain operators of credit card systems, real estate investment trusts, and other lending operations differently from similar operations of banks and broker-dealers.

³⁸ Various courts have held that a taxpayer is entitled to a deduction for partial worthlessness under section 166(a)(2) only if the charge-off takes place before the sale and is independent of such sale. In other words, the sale itself cannot be the event that gives rise to the charge-off. *Levy v. Commissioner*, 131 F.2d 544 (2d Cir. 1942), *aff'g*, 46 B.T.A. 423 (1942), *cert. denied*, 318 U.S. 780 (1943); *Mitchell v. Commissioner*, 187 F.2d 706 (2d Cir. 1951), *rev'g* and *remanding* 13 T.C. 368 (1949), *acq.* 1949-2 C.B. 3; *Levine v. Commissioner*, 31 T.C. 1121 (1959), *acq.* 1959-2 C.B. 5; *IDI Management Inc. v. Commissioner*, 36 T.C.M. (CCH) 1482 (1977) (all allowing the partial bad debt deduction); *cf. Von Hoffman Corp. v. Commissioner*, 253 F.2d 828 (8th Cir. 1958), *aff'g* 16 T.C.M. (CCH) 546 (1957) (denying the deduction).

- The Proposed Regulations would require major changes in the tax accounting treatment of those affected institutions that cannot be justified from any sound tax policy perspective.

We believe that the holding in *Federal National Mortgage Association* should be restricted to entities such as Fannie Mae, Freddie Mac, and Sallie Mae. Insofar as other taxpayers have attempted to obtain ordinary treatment for purchased debt instruments by arguing that nearly any purchase of debt renders a service within the meaning of section 1221(a)(4), we believe that this is an unwarranted extension of the case. We appreciate that providing precise limits to *Federal National Mortgage Association* is not a simple matter, but we believe that this is an appropriate area for further study by government and industry.

Although a legislative solution might be optimal, whether or not Congress acts, Treasury and the Service should not reverse 40 years of decisions and rulings by regulation.