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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-109367-06

RIN 1545-BF52

Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the circumstances in which accounts or notes receivable are “acquired . . . for services rendered” within the meaning of section 1221(a)(4) of the Internal Revenue Code. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 6, 2006.

Outlines of topics to be discussed at the public hearing scheduled for November 7, 2006, must be received by October 17, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-109367-06), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-109367-06). The public hearing will be held in

the auditorium of the New Carrollton Federal Building, 5000 Ellin Road, Lanham, Maryland, 20706.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, K. Scott Brown (202) 622-3920 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, email: Kelly.D.Banks@irs.counsel.treas.gov.

SUPPLEMENTAL INFORMATION:

Background and Explanation of Provisions

I. Section 1221(a)(4) Language, Legislative History, and Regulations

Section 1221 defines a capital asset as all property held by a taxpayer unless specifically excepted. Section 1221(a)(4) treats 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) as ordinary assets.

Congress enacted section 1221(a)(4) in 1954 to correct 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. Section 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 specific problem being addressed by the enactment of section 1221(a)(4) was described in the House Report:

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).

The longstanding regulation interpreting section 1221(a)(4) also confirms this limited focus. Section 1.1221-1(a) of the Income Tax Regulations states that the term capital assets includes all classes of property not specifically excluded by section 1221. Section 1.1221-1(d), which addresses the section 1221(a)(4) exclusion, repeats the statutory language of section 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.

II. Expansion of Section 1221(a)(4)

Notwithstanding the above, section 1221(a)(4) has been applied more expansively. The initial expansion occurred with respect to notes obtained in loan originations. In 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), the Tax Court held that mortgage loans originated by a savings and loan association in the ordinary course of its business were, in the hands of that association, ordinary assets under section 1221(a)(4) because they were notes receivable acquired for the service of making loans. In addition to acquiescing to the decision, the Service relied upon Burbank Liquidating in a series of revenue rulings treating loans made by commercial lenders (including banks and REITs) as ordinary assets under section 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). See §601.601(d)(2) of this chapter.

Historically, a lending transaction was sometimes thought of as rendering a service 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). That characterization, however, does not justify treating notes acquired by an originator in a lending transaction as ordinary assets under section 1221(a)(4). That treatment strains the language of the statute because the 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.

Subsequently, the Tax Court further extended the application of section 1221(a)(4) in Federal National Mortgage Association v. Commissioner, 100 T.C. 541 (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 section 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 T.C. at 545 (quoting the Housing Act of 1954, ch. 649, title II, section 201, 12 U.S.C. 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.

The expansion of section 1221(a)(4) cannot be reconciled with Congress' stated purpose for enacting the statute. Acquisition of notes or mortgages using consideration other than services or section 1221(a)(1) property generally does not trigger current ordinary income and so does not create a potential for the character mismatch that concerned Congress when it enacted section 1221(a)(4).

The proposed regulation reflects a conclusion by the Treasury Department and the IRS that the extension of section 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 section 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 disputes.

Accordingly, the proposed regulation clarifies 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), or if the account or note receivable is not issued by the party acquiring the services or property described in section 1221(a)(1). In particular, a note is not acquired for services within the meaning of 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.

Effect on Other Documents

Rev. Rul. 72-238 and Rev. Rul. 73-558 are not determinative with respect to future transactions because these rulings apply to taxable years beginning before July 12, 1969, and were superseded by section 582(c) of the Internal Revenue Code of 1986. Accordingly, simultaneously with the publication of

these proposed regulations, those rulings are being declared obsolete. When final regulations are published, the IRS will determine whether Rev. Rul. 80-56 and 80-57 should similarly be declared obsolete.

Proposed Effective Date

These regulations are proposed to apply to accounts or notes receivable acquired after the date the final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rule making will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS invite comments on the proposed effective date, on the impact of the proposed regulation on hedging practices of lending

institutions or other taxpayers to which section 582(c) does not apply, and on appropriate measures to deal with that impact. 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. The Treasury Department and the IRS also specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 7, 2006, beginning at 10 a.m. in the auditorium of the New Carrollton Federal Building, 5000 Ellin Road, Lanham, MD, 20706. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 17, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is K. Scott Brown, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1221-1 is amended as follows:

1. Paragraph (e) is redesignated as (f).
2. A new paragraph (e) is added.

The addition reads as follows:

§1.1221-1 Meaning of terms.

* * * * *

(e)(1) An account or note receivable is not described in section 1221(a)(4)

if--

(i) In acquiring the account or note receivable, the taxpayer provides more than de minimis consideration other than services or property described in section 1221(a)(1); or

(ii) The obligor under the account or note receivable is a person other than the person acquiring the services or property described in section 1221(a)(1).

(2) In particular, an account or note receivable is not described in 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. If a lender, however, separately invoiced reasonable fees for services that the lender rendered to the borrower in connection with a lending transaction and if the lender received 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, then this paragraph (e)(2) does not prevent the separate account or note receivable from being described in section 1221(a)(4).

(3) This paragraph (e) applies to accounts or notes receivable acquired after the date the final regulations are published in the **Federal Register**.

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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.