



OFFICE OF
CHIEF COUNSEL

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

NOVEMBER 18, 1998

Office Symbols: CC:DOM:FS:IT&A
Case Number:
UILC #: 166.04-00

Number: **199911003**
Release Date: 3/19/1999

MEMORANDUM FOR: **District Counsel,**
ATTN: Lisa N. Primavera; Jenny A. Moon

FROM: **Deborah A. Butler**
Assistant Chief Counsel (Field Service)

SUBJECT:

Internal Revenue Service National Office Field Service Advice

This Field Service Advice responds to your memorandum dated September 1, 1998. 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: A =
Year 1 =

ISSUE(S):

1. How do a business and investment motives differ, and what factors do courts use in distinguishing between these motives? What was the dominant motive of A in the present case?
2. What indicia have courts set forth in identifying taxpayers in the trade or business of money lending? Does A meet these indicia?
3. Has the purchase of notes been held by courts to be within the scope of the trade or business of money lending? Was A's purchase of the note in connection with the money lending business?

- CONCLUSIONS:
1. A's dominant motive in making loans and purchasing notes was to make a profit. This is evidenced through A's continuous and regular conduct over a number of years, the acquisition of a written obligation with fixed terms from an unrelated party and the prompt enforcement of its rights under the obligation. Such conduct is consistent with a business person, rather than an investor. A therefore meets the requirements for a trade or business.
 2. A satisfies the guidelines set forth by courts for identifying persons engaged in the money lending business. Several facts lead to this conclusion. A has loaned money and purchased notes for many years, A is known in the community as a lender and purchaser of notes and has been approached by borrowers and sellers of notes. In addition, A was in no way related to borrower or to the seller of the note, and took action to enforce its rights under the note.
 3. The purchase of the note falls within the scope of the money lending business. A's purchase of the note was proximately related to his money lending business. It was A's practice to purchase notes in the ordinary course of its business for many years.

FACTS:

We rely upon the statement of facts contained in your memorandum of September 1, 1998. A has been in the money-lending business for many years. A has made loans and purchased extant obligations from other lenders. A is known by the community to be a money lender, and is regularly approached by prospective borrowers and sellers of debt obligations. In year 1, an individual who had heard of A's past money lending activities sold to A a note secured by a second deed of trust. After failing to receive payment from the borrower and to recoup the loss from a foreclosure sale of the first deed of trust, A deducted the note as a business bad debt.

LAW AND ANALYSIS

Section 166(a) and Treas. Reg. § 1.166-1(a) provide that a deduction may be taken for any bona fide debt which becomes worthless in the taxable year. A bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum. Treas. Reg. § 1.166-1(c).

Section 166(d)(2), in defining a nonbusiness bad debt, distinguishes between a business and nonbusiness bad debt. A business bad debt is one which is created, acquired or incurred in connection with a taxpayer's trade or business. I.R.C. § 166(d)(2). A nonbusiness bad debt is any other type of debt. Id. Whereas a business bad debt is deductible in full, a nonbusiness bad debt is deductible only as a short-term capital loss. I.R.C. § 166(a)(1), (d). Prior to the passage of the Revenue Bill of 1942, there was no distinction between the tax consequences of declaring a business and nonbusiness bad debt.

Treas. Reg. § 1.166-5(b) states that distinguishing between a business and a nonbusiness bad debt is a factual question. The regulations set forth a two-pronged test for determining whether a taxpayer is entitled to a bad debt deduction. First, the taxpayer must be engaged in a trade or business; and second, the debt must be proximately related to that trade or business. Treas. Reg. § 1.166-5(b). In United States v. Generes, the Supreme Court held that a proximate relationship between the debt and the trade or business exists if the dominant motive for the loan is related to the taxpayer's business. United States v. Generes, 405 U.S. 93, 103, reh'g denied, 405 U.S. 1033 (1972). The requirement of a dominant motive is designed to prevent taxpayers from using unrelated or weakly related business interests as a vehicle to obtain more favorable tax consequences. Id. at 104. Each bad debt deduction should be examined independently to ascertain the true nature of the transaction from which the deduction stemmed to determine whether it was created or incurred in the taxpayer's trade or business, as well as whether a proximate relationship exists between the debt and the trade or business. Whipple v. Commissioner, 373 U.S. 193, 202, reh'g denied, 374 U.S. 858 (1963); Sitterding v. Commissioner, 20 T.C. 130, 135 (1953).

Although you have stated that it has been established that A was in the trade or business of money lending, you have raised several questions, which shall be addressed below, about the application of the legal principles stated above in the context of a taxpayer engaged in the money lending business. These questions are: what does it mean to be in the money lending business, what is the distinction between an investment motive and a business motive, what factors do courts use in distinguishing between these two motives and whether the purchase of an existing note is within the scope of the money lending business.

1. How do business and investment motives differ, and what factors do courts use in distinguishing between these two motives? What was the dominant motive of A in the present case?

As stated above, the question of whether a bad debt is proximately related to a trade or business involves an inquiry into the dominant motive which the taxpayer had for making the loan. The taxpayer's dominant motive is identified by examining the objective facts surrounding the business transaction, which, as you stated in your memorandum, is a matter of judgment in each case. Kelson v. U.S., 503 F.2d 1291, 1294 (10th Cir. 1974). Although investors and persons engaged in a trade or business share common goals, such as the desire to make a profit, there are characteristics unique to business persons and investors which courts have used to distinguish between taxpayers entitled to a business versus a nonbusiness bad debt deduction.

A taxpayer is engaged in a trade or business where his activities are conducted in good faith, with continuity and regularity, and for the purpose of making a profit or income. Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); Ferguson v. Commissioner, 16 T.C. 1248, 1257 (1951) (trade or business necessitates expending of substantial amount of time and effort, and maintaining books and an office). Whether a person is engaged in a trade or business is a factual inquiry. Higgins v. Commissioner, 312 U.S. 212, 217, reh'g denied, 312 U.S. 714 (1941). Although investors and persons engaged in a trade or business are both motivated by profit, every profit-making activity cannot be characterized as a trade or business. Bettinger v. Commissioner, T.C. Memo. 1970-18, 29 T.C.M. 52, 56. This interpretation of trade or business is also present in the legislative history of section 166. The Committee Reports for the Revenue Act of 1942 distinguish between losses incurred in a trade or business, and those derived from any profit-making transaction, including those not connected with a business. H.R. Ways and Means Committee Rep., No. 2333, 77th Cong., 1st Sess. 76 (1942) 1942-2 C.B. 573. Although a taxpayer may possess a profit motive for his lending activities, such activities may fail to constitute a trade or business if they were not engaged in with such frequency as to rise to the level of a business. Maggee v. Commissioner, T.C. Memo. 1993-305, 66 T.C.M. 105, 112. In Hoogerworf v. Commissioner, the Court held that the taxpayer's lending activities did not fit into the category of a trade or business, which was "narrowly defined" as requiring "the expenditure of a substantial amount of time and effort", since his activities were neither consistent nor regular. Hoogerworf v. Commissioner, T.C. Memo. 1976-185, 35 T.C.M. 810, 813.

There are several factors which courts have employed to decide whether a taxpayer's money lending activities are sufficiently extensive to constitute a trade or business. These include the number of loans made by taxpayer over the years, the amount of time spent on money lending activities, the maintenance of an office for purposes of engaging solely in the money lending business, the maintenance of

books and records detailing taxpayer's money lending activity, whether taxpayer held himself out to the public to be in the money lending business, whether the taxpayer advertised his loan services, whether taxpayer had a reputation in the community for making loans, the amount of income the taxpayer derived from his money lending activities, and whether the taxpayer indicated that he was in the money lending business on his or her tax return. U.S. v. Henderson, 375 F.2d 36, 41 (5th Cir.), cert. denied, 346 U.S. 816 (1953). Moreover, the amount of a loan is not a determinative factor in assessing whether a taxpayer's activities constitute a trade or business. Deely v. Commissioner, 73 T.C. 1081, 1096 (1980), acq. 1981-2 C.B. 1 (taxpayer who made isolated loans for large amounts of money did not establish that he was in the money lending business). These factors are discussed in greater detail in the response to your next question regarding what constitutes the trade or business of money lending.

In differentiating between business and investment motivations, the Supreme Court, in Whipple v. Commissioner, contrasted dividend income or increased value of a stock which is derived from the successful operation of an entity in which monies are invested, with income derived from the efforts of the taxpayer in running his own business. Whipple, 373 U.S. at 202. A taxpayer must show that his goal was to achieve more than the return of an investor through his own activities. Id. In Maytag v. U.S., the Court made a similar distinction in stating that

one is not engaged in a business simply because he has invested money in it for the purpose of making a profit, and if he lends money to it . . . to protect his investment, and loses the money, he has not lost the money in the business in which he is engaged.

Maytag v. U.S., 289 F.2d 647, 650 (Cl. Ct. 1961), disapproved on other gds., Whipple v. Commissioner, 373 U.S. 193 (1963), reh'g denied, Whipple v. Commissioner, 374 U.S. 858 (1963). A loan may thus be made for investment motives when a taxpayer's goal is to increase or protect the value of his stock in the debtor company or to protect his existing investment in a company. See Kelly v. Patterson, 331 F.2d 753 (5th Cir. 1964); Jones v. Commissioner, T.C. Memo. 1997-368; Weber v. Commissioner, T.C. Memo 1994-341. Therefore, a taxpayer seeking a business bad debt deduction must show that the activity from which the loss was derived was separate from the amount taxpayer would have received as a return on his investment in a company. Bettinger, 29 T.C.M. at 56.

You point out in your memorandum, citing the court's discussion in Henderson, that since investing is a motive for those engaged in the business of money lending, there is no real distinction between business and investment motives. As a trade or business is not established by every person who engages in profit-making activities, not every investor is engaged in the money lending

business. The extent to which taxpayer devotes himself to money lending activities, and conducts a business according to the factors mentioned above, define the distinction between business and investment motives. The Henderson court highlighted several factors, such as the absence of loan terms, the non-payment of principal or interest and lack of security, which led it to conclude that the taxpayer's actions did not resemble those of a taxpayer engaged in the money lending business. Henderson, 375 F.2d at 41, 42. The court emphasized the taxpayer's passive role in Henderson, in that she chose not to secure her rights to interest or repayment, and any return she would receive would depend solely upon the success of the corporation. Id. The court relied upon these factors in denying the taxpayer a bad debt deduction.

Even though a taxpayer's personal investment activities may be extensive and occasionally involve loans of large amounts of money, courts have consistently held that these activities do not rise to the level of a trade or business of money lending. Higgins, 312 U.S. at 218. In Smith v. Commissioner, a business bad debt deduction was disallowed where although taxpayer managed, invested and made loans to a number of corporations, he did not regularly engage in money lending. Smith v. Commissioner, 203 F.2d 310, 312 (2nd Cir.), cert. denied, 346 U.S. 816 (1953). Similarly, the Court in Estate of Bounds v. Commissioner, noted that the taxpayer made loans for investment purposes, and distinguished between a taxpayer engaged in a trade or business, and an investor by observing the level and degree of lending activities. Estate of Bounds v. Commissioner, T.C. Memo. 1983-526, 46 T.C.M. 1210, 1213. In Eberhart v. Commissioner, the Court held that taxpayer presented insufficient evidence that he was in the money lending business by merely making isolated loans, maintaining records of his loans and reporting interest income. Eberhart v. Commissioner, T.C. Memo. 1977-155, 36 T.C.M. 660, 663. The Court held that these factors were insufficient to establish a business of money lending, and furthermore, that it would be natural for an investor to engage in these activities. Id. See also Ferguson v. Commissioner, 253 F.2d 403, 406 (4th Cir. 1958) (extensive personal investment activities cannot establish trade or business of money lending); Campbell v. Walker, 208 F.2d 457, 461 (2nd Cir. 1953) (denial of deduction where bad debt loss occurred in course of taxpayer's personal investment); Deely v. Commissioner, 73 T.C. at 1093 (taxpayer's management of own investments can never constitute a trade or business); Marks v. Commissioner, T.C. Memo. 1983-574, 41 T.C.M. 1408, 1411 (single loan to company insufficient to show that taxpayers were in the money lending business); Mayo v. Commissioner, T.C. Memo. 1957-9, 16 T.C.M. 49, 56 (taxpayer involved in investing and money lending to a number of businesses was not found to be engaged in a trade or business where activities lacked continuity and frequency). Thus, a taxpayer must show a frequent and continuous pattern of lending activities to prove that he is in the money lending business.

Another distinction between business and investment motives can be found by focusing on the type of benefit or return which the taxpayer expected from the loan, and how the taxpayer would have benefitted from loan had it not become worthless. If the source of a taxpayer's return is dependent largely or solely on the future profits of the corporation to which the loans were made, this is another indication that the taxpayer was engaged in investment activities, rather than in the business of lending money. Hudson v. Commissioner, 31 T.C. 574, 583 (1958); Bettinger v. Commissioner, 29 T.C.M. at 58. Where a taxpayer advanced monies to several corporations, and the return on the monies he invested was derived largely from sale of his stock in the corporation, the Court held that the taxpayer was an investor, and not in the business of lending money. Post v. Commissioner, T.C. Memo. 1979-419, 39 T.C.M. 311, 335. If the loan produced an increase in the value of the stock and capital gains upon its sale, this is indicative of a nonbusiness motive. Osterbauer v. Commissioner, T.C. Memo. 1995-490, 70 T.C.M. 988, 991. If, on the other hand, the result is to increase a taxpayer's income, the motives are more likely to be business related. Id. Moreover, the success or failure of the loans must have some direct effect on the business of the taxpayer to be considered a business bad debt. Hunsaker v. Commissioner, 615 F.2d 1253, 1256 (9th Cir. 1980). Accord Lundgren v. Commissioner, 376 F.2d 623, 629 (9th Cir. 1967) (anticipated benefit to taxpayer's business must be real and direct); Williams v U.S., 12 AFTR2d 6157, 6160 (M.D. Fla. 1957) (to determine whether loans were proximately related to business, one factor to examine is whether taxpayer expected a direct, and not remote or speculative, benefit from them).

Examining the degree of risk and speculation which a taxpayer is willing to accept relating to the monies lent is another way in which business and investment motives may be distinguished. In discussing the difference between a creditor and a stockholder, the Court, in Gilbert v. Commissioner, stated that a stockholder is more willing to hazard a risk with his contributions, whereas a lender seeks a definite obligation with set terms. Gilbert v. Commissioner, 248 F.2d 399, 406, appeal after remand, 262 F.2d 512 (2nd Cir.), cert. denied, 359 U.S. 1002 (1959). In Hunsaker v. Commissioner, a taxpayer made unsecured loans to his father's business. Hunsaker v. Commissioner, 615 F.2d at 1258. In deciding that the debts, which eventually became worthless, were nonbusiness in nature, one factor the court noted was that at the time the loans were made, the borrower was "seriously undercapitalized" and "experiencing cash flow problems", which made the likelihood of attaining a profit a "mere expectation of a future benefit." Id. See also Bettinger, 29 T.C.M. at 57 (taxpayer's continued advancement of funds despite borrower's weak condition was one factor that negated finding of money lending business).

In the present case, A's dominant motive for making loans and purchasing notes was to make a profit. There are several facts which support this position, namely A's continuous and regular conduct of making loans and purchasing extant

obligations over a number of years and the acquisition of a secured obligation evidenced by a written note with fixed terms. Moreover, you stated that A was in no way related to any of the parties involved with the note, including the seller and the borrower. A's prompt enforcement of his rights under the obligation upon nonpayment is yet another factor which weighs in favor of business motives. Viewed as a whole, such conduct is more consistent with that of a business person than an investor.

2. What are the indicia of the trade or business of money lending? Does A meet these indicia?

Courts have allowed bad debt deductions for lenders who are engaged in the trade or business of lending money. Although this question is highly fact sensitive, courts have set forth a number of guidelines by which this determination may be made. First, a standard commonly employed by courts is the frequency and time which a taxpayer has devoted to money lending activities in proportion to his other activities. The "exceptional situation standard," mentioned in your memorandum, provides that a bad debt deduction will be allowed only when the taxpayer's money lending activities are so extensive as to constitute a trade or business. Berwind v. Commissioner, 20 T.C. 808, 815, aff'd, 211 F.2d 575 (3rd Cir. 1954).

Courts' interpretations of whether a taxpayer's activities are extensive enough to place him in the money lending business have been guided by many factors. These include the number of loans made by taxpayer over the years, (Eberhart v. Commissioner, 36 T.C.M. at 663); the amount of time spent on money lending activities (Rankin v. Commissioner, No. 58,385 (T.C. Memo. 1953)); the maintenance of an office for purposes of engaging solely in the money lending business (Fuller v. Commissioner, 21 T.C. 407, 412 (1953); Carraway v. Commissioner, T.C. Memo. 1994-295, 67 T.C.M. 3139, 3139-5); the maintenance of books and records detailing taxpayer's money lending activity (Ferguson v. Commissioner, 16 T.C. at 1251), whether taxpayer held himself out to the public to be in the money lending business (Gross v. Commissioner, 401 F.2d 600, 603 (9th Cir. 1968); Kushel v. Commissioner, 15 T.C. 958, 960 (1950)); whether the taxpayer advertised his loan services (McCracken v. Commissioner, T.C. Memo. 1984-293, 48 T.C.M. 248, 251, 252); whether taxpayer had a reputation in the community for making loans (Carpenter v. Erickson, 255 F.Supp. 613, 615 (D. Or. 1966); the amount of income the taxpayer derived from his money lending activities (Rollins v. Commissioner, 32 T.C. 604, 614 (1959), aff'd, 276 F.2d 368 (4th Cir. 1960); Scrivani v. Commissioner, T.C. Memo. 1992-467, 64 T.C.M. 523, 528); and whether the taxpayer indicated that he was in the money lending business on his or her tax return (Deely v. Commissioner, 73 T.C. at 1087; Zivnuska v. Commissioner,

33 T.C. 226, 239 (1959); Carraway v. Commissioner, T.C. Memo. 1994-295, 67 T.C.M. 3139, 3139-5). Courts have not required that all these factors be present for a taxpayer to be in the money lending business, but have examined each case on its own to assess the scope and nature of taxpayer's overall lending activities. U.S. v. Henderson, 375 F.2d at 41.

In several where courts found taxpayers to be in the business of money lending, and thus entitled to a business bad debt deduction, courts carefully scrutinized the above factors to determine whether taxpayers' activities were so extensive as to constitute a trade or business. In Carpenter v. Erickson, the Court held that the taxpayer was in the money lending business where taxpayer financed and guaranteed loans for seven entities and persons for a six year period, was known in his community as a money lender, and had no relationship with the individuals or ownership interest in the entities with whom he dealt. Carpenter v. Erickson, 255 F.Supp. at 614. Similarly, in Serot v. Commissioner, the Tax Court cited fifty-five loans totaling \$1,200,000 made within a period of ten years, voluminous records memorializing these loans, reputation in his community as a money lender, devotion of forty to fifty hours per week to lending activities and absence of relationship to borrowers as sufficient evidence to establish taxpayer's business as a money lender. Serot v. Commissioner, T.C. Memo. 1994-532, 68 T.C.M. 1015, 1022, 1023. The Court reached this conclusion despite the fact that the taxpayer's records were somewhat disorganized and not completely accurate and the failure of taxpayer to advertise. In Cushman v. United States, the Court found taxpayer's money lending activities extensive enough to constitute a business where twenty-one loans were made over eight years, taxpayer maintained an office at home and employed a full-time secretary. Cushman v. United States, 148 F.Supp. 880, 884, 886 (D. Ariz. 1956). See also Ruppel v. Commissioner, T.C. Memo. 1987-248, 53 T.C.M. 829, 833, 834 (taxpayer made one hundred and twenty-four loans with seventy-six entities over ten years, was known in community as money lender, had no interest in borrowers' companies, and kept books and records); McCracken v. Commissioner, 48 T.C.M. at 252 (loans to twelve borrowers totaling \$620,000 over course of fifteen years, twenty-year reputation as money lenders, maintenance of separate bank account, books and records, lack of relationship to borrowers indicated existence of loan business); Jessup v. Commissioner, T.C. Memo. 1977-289, 36 T.C.M. 1145, 1151 (taxpayer held to be in money lending business despite fact that he did not maintain office, advertise or devote more than twenty-five hours per week to loan activities); Minkoff v. Commissioner, T.C. Memo. 1956-269, 15 T.C.M. 1404, 1408, 1409 (substantial number of loans and amounts of money loaned placed taxpayer in money lending business); Estate of Cone v. Commissioner, T.C. Memo. 1954-56, 13 T.C.M. 512, 513 (money lending business established where numerous interest bearing loans memorialized by notes over a period of fifteen to twenty years were made).

Another way in which courts have examined whether a taxpayer is in the money lending business is through a review of the terms and conditions of the loan from which the deduction is derived, as well as other loans which the taxpayer has made. In reviewing the terms and conditions of a loan, the courts have considered whether the loan was interest bearing, whether the terms of the loan were written, whether the loans were made with any expectation of repayment by the lender and borrower, the debtor's ability to obtain money from other creditors, the degree of speculation involved and whether the creditor made any efforts to enforce the loans upon non-payment. Scriptomatic v. United States, 555 F.2d 364, 367 (3rd Cir. 1977). If the taxpayer fails to establish basic terms of interest, maturity or security, then courts are not likely to view his activities as constituting a money lending business. See generally Sekulow v. Commissioner, T.C. Memo. 1980-564, 41 T.C.M. 582, 584, 585. It is important to note that one of the problems which spurred the amendment creating the distinction in tax consequences between business and nonbusiness deductions was the abuse of the bad debt deduction by persons who loaned money even though they not expect to be repaid. H.R. Ways and Means Committee Rep. No. 2333, 77th Cong., 2d Sess. 45 (1942) 1942-2 C.B. 408, 409.

These factors relate more generally to whether monies advanced by a taxpayer constitute a loan, to which section 166 applies, or a capital contribution. As stated in the regulations, a bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum. Treas. Reg. § 1.166-1(c). A capital contribution differs from a loan in that it is an investment placed at the risk of the success or failure of the business. See Recklitis v. Commissioner, 91 T.C. 874 (1988); Hudson v. Commissioner, 31 T.C. 574 (1958); Stark v. Commissioner, T.C. Memo. 1982-639. The issue of whether an advancement is debt or equity is a factual determination which focuses on several factors such as the parties' intent, the relationship between the creditors and shareholders, ability of borrower to obtain a loan from others, the amount of risk involved in the loan and whether there are formal terms such as an interest rate, an obligation to repay and a fixed maturity date. Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3rd Cir. 1968). Where a taxpayer claimed that his monetary advances to a corporation were business bad debts incurred in taxpayer's money lending business, the court held that the advances were not loans, but capital contributions, since the advances were made to an insolvent corporation, and there was no written evidence of a significant amount of the monies he advanced. Zivnuska v. Commissioner, 33 T.C. 226, 235-237 (1959), acq., 1960-2 C.B. 7. In Krause v. Commissioner, taxpayer argued that monies advanced to a corporation constituted business bad debts in conjunction with his money lending business. The Court held that the monies advanced were not loans, but capital contributions, as their repayment was dependent solely upon the earning of future profits. Krause v. Commissioner, T.C. Memo. 1967-68, 26 T.C.M. 358, 359, 360.

Numerous courts have held that where no written indicia of a loan exists, such as an obligation to repay, a date for repayment, security for the loan, or the applicable rate of interest due, the advances constitute capital contributions, rather than loans. In Gross v. Commissioner, the Court held that taxpayer was not in the money lending business where his advancements were not evidenced by a note, terms of interest, dates for repayment or security. Gross v. Commissioner, 401 F.2d 600, 601, 602 (9th Cir. 1968). In Bettinger v. Commissioner, a taxpayer who claimed that he was in the business of lending money was denied a business bad debt deduction where he took no action to collect interest or enforce his notes and loaned money to entities in poor financial condition, to whom other lenders would not make loans. Bettinger v. Commissioner, 29 T.C.M. at 56, 57. The Court held that taxpayer's actions were inconsistent with those of a person in the business of lending money. Id. at 57. Accord U.S. v. Henderson, 375 F.2d at 41, 42 (evidence that taxpayer took no action to enforce repayment, charged no interest and agreed to accept a share of profits from company, if received, indicated that monies advanced were not loans); Farkas v. Commissioner, T.C. Memo. 1985-488, 50 T.C.M. 1085, 1092 (noting that an important distinguishing factor between debt and capital contribution is a provision for interest payments); Cochran v. Commissioner, T.C. Memo. 1955-66, 14 T.C.M. 206, 208 (continued advances to corporation operating at a loss showed intent to place advances at risk of business and recover investment only if company was profitable and thus constituted capital contributions). See also Recklitis v. Commissioner, 91 T.C. at 901, 905 (commenting that it is "extremely improbable that prudent creditor would lend money interest free, unsecured, and for an unspecified . . . time to an entity [in] questionable financial condition"); Estate of Byers v. Commissioner, 57 T.C. 568, 578 (1972), aff'd, 472 F.2d 590 (6th Cir. 1973) (lending activity found not to constitute business, as activity was casual and spontaneous); Estate of Pachella v. Commissioner, 37 T.C. 347, 351, aff'd, 310 F.2d 815 (3rd Cir. 1962) (absence of repayment date or interest rate to be paid indicated that contributions were not loans); Rollins v. Commissioner, 32 T.C. 604, 614 (1959), aff'd, 276 F.2d 368 (4th Cir. 1960) (vague records of advancements, absence of interest payments, collateral and maturity date, and reliance on success of corporation for repayment negated finding of business bad debt); Carraway v. Commissioner, 67 T.C.M. at 3139-5 (loans based on "handshakes," and occasional allowance of services as payment, lacked formality associated with money lending business); Steury v. Commissioner, T.C. Memo. 1985-416, 50 T.C.M. 744, 749 (where no formal repayment scheme existed, and there was no likelihood that funds would be loaned by outside creditor, court held that advances were capital contributions).

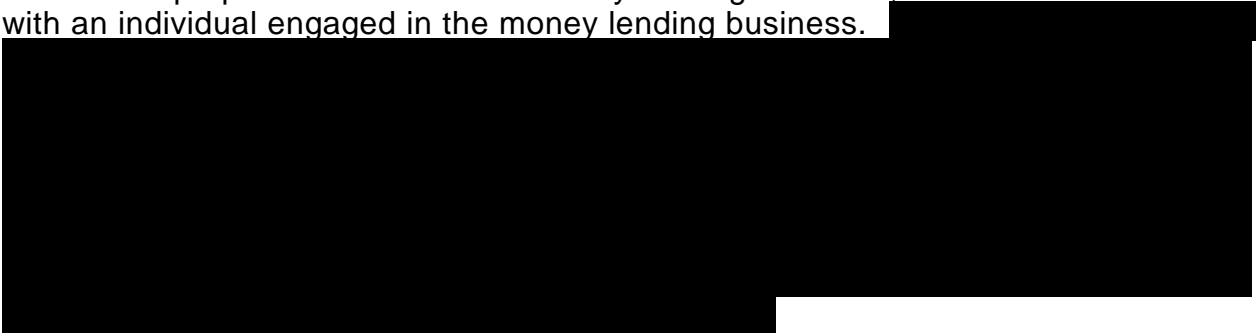
A third and related way in which courts determine if a taxpayer is in the business of money lending is by examining the scope of his or her money lending activity. This entails an inquiry into whether the majority of taxpayer's loans are made to businesses in which taxpayer had an interest, or to persons in some way

related to the taxpayer. As the Supreme Court noted in Burnet v. Clark, where a substantial number of advancements are made to an entity in which a taxpayer has an interest, and the advancements possess the characteristics of informality and lack of security described above, they are often held to be capital contributions whose motivations often stem from the taxpayer's desire to protect his investment. Burnet v. Clark, 287 U.S. 410, 413, 414 (1932). In Post v. Commissioner, the Court rejected the taxpayer's argument that he was in the money lending business, noting that most of his advancements were made to his wholly owned corporation, and lacked terms of repayment. Post v. Commissioner, T.C. Memo. 1979-419, 39 T.C.M. 311, 335. The Court rejected a similar argument in Rollins v. Commissioner, where taxpayer had served as director, officer and general counsel in the group of corporations to which the majority of his advancements were made. Rollins v. Commissioner, 32 T.C. at 614, 615. This fact, along with the absence of interest payments, repayment dates and reliance on profits of company for future repayment, led the court to conclude that the advances were capital contributions, and not business debts. Id. In Palmer v. Commissioner, the scope of taxpayer's lending activity was held to be too narrow to constitute a trade or business of financing corporations, since his lending activity was limited to the company in which he held stock. Palmer v. Commissioner, 17 T.C. 702, 704 (1951). The Court, in Lohman v. U.S., determined that the taxpayer was not in the loan business, where the only "loans" he made were to a company in which he held stock and, moreover, where he did not receive full reimbursement. Lohman v. U.S., 10 AFTR2d 6151, 6152 (N.D. Okla. 1962). The Court characterized these payments as capital contributions. Id. at 6152. Accord Carraway v. Commissioner, T.C. Memo. 1994-295; Lee v. Commissioner, T.C. Memo. 1986-294; Bush v. Commissioner, T.C. Memo. 1968-039; Beeman v. Commissioner, T.C. Memo. 1961-86; Bradley v. Commissioner, T.C. Memo. 1956-189; Funke v. Commissioner, T.C. Memo. 1955-156.

Similarly, where the scope of a taxpayer's lending activity consists primarily of loans to relatives or personal friends, courts have not allowed a business bad debt deduction, as the loans were not made in connection with any trade or business of the taxpayer. [REDACTED] the Henderson case involved a loan between relatives with no written terms, no efforts to collect interest or principal and repayment only in the event that the business became successful. United States v. Henderson, 375 F.2d at 42. See also Doneff v. Commissioner, T.C. Memo. 1991-253; Jessup v. Commissioner, T.C. Memo. 1977-289; Eberhart v. Commissioner, T.C. Memo. 1977-155; Mangrum v. Commissioner, T.C. Memo. 1960-136; Mayo v. Commissioner, T.C. Memo. 1957-9.

A's business as a money lender is supported by the following facts: A has loaned money and purchased notes for many years, A has a reputation in the community as a lender and purchaser of notes, and has been approached by borrowers and sellers of notes. You have presented no evidence that A was in any

way related to the borrowers or to the seller of the note. Furthermore, A took action to enforce its rights under the note, evidencing an expectation of repayment. There are no facts in your memorandum which would indicate that A acquired the note for investment purposes outside of his money lending business, or are inconsistent with an individual engaged in the money lending business.



3. Has the purchase of notes been held by courts to be within the scope of the trade or business of money lending? Was the taxpayer's purchase of the note proximately related to his money lending business?

The purchase of notes by an individual falls within the scope of the money lending business. The Code and Treasury Regulations contemplate worthless debt deductions derived not only from loans originated by a taxpayer, but also from a taxpayer's acquisition of existing loans. In defining a business bad debt, the Code and Regulations state that the debt must be either created or **acquired** in the course of a taxpayer's trade or business. I.R.C. § 166(d)(2); Treas. Reg. § 1.166-5(b)(1) (emphasis added). An example furnished in the regulations, in which an obligation is sold by its original owner to a third party purchaser, illustrates this point. Treas. Reg. § 1.166-5(d), ex. 2. In order for the acquired debt to be a business debt, it must have been acquired in connection with the purchaser's trade or business, and, at the time the debt becomes worthless, the purchaser must be "engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claims is a proximate result." *Id.* The legislative history for section 166 also contains references to the acquisition of debt by a taxpayer, which evidences an intent to include within the statute's scope not only loans created by the taxpayer, but also existing loans which a taxpayer acquires. H.R. Ways and Means Committee Rep. No. 2333, 77th Cong., 2d Sess. 76 (1942), 1942-2 C.B. 431.

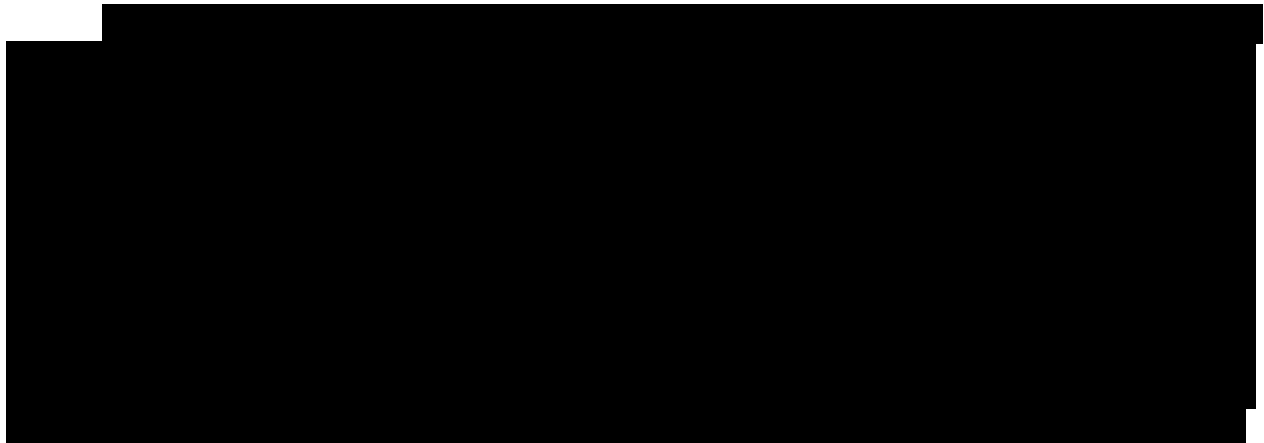
In Kasachkoff v. Commissioner, the Court held that a petitioner who was in the business of acquiring large numbers of secured trust notes from their holders was engaged in a business, and was thus entitled to bad debt deductions on those notes which had become worthless. Kasachkoff v. Commissioner, T.C. Memo. 1960-252, 19 T.C.M. 1393. The Court noted the volume and continuity of petitioner's business, the large amount of time spent on this activity, and the fact that the activity was a major source of his income, in holding that petitioner was in

the business of buying and selling secured second and third trust notes. Kasachkoff, 19 T.C.M. at 1395.

Similarly, in Hutton v. Commissioner, petitioner sought a bad business debt deduction relating to his money lending activities. Hutton v. Commissioner, T.C. Memo. 1976-006, 35 T.C.M. 16. One portion of his money lending activities consisted of acquiring existing notes, an activity in which taxpayer had regularly continuously engaged for a period of years. Id. at 20. The Court held that petitioner's acquisition of notes was part of his business of lending money. Id.

In the instant case, A's purchase of the note was proximately related to A's money lending business, and the loss which A suffered occurred during the time in which it was engaged in that business. The facts of the present case resemble those of Kasachkoff and Hutton, in that A has been in the practice of originating loans and purchasing existing obligations from lenders in the ordinary course of his business for many years, and is known by the community as a money lender and note purchaser. A was not related to the seller of the note or the borrower. It is not evident from the facts that the taxpayer purchased this particular note for any other reason than to make a profit. Thus, the note is proximately related to A's business.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



Assistant Chief Counsel (Field Service)

THOMAS D. MOFFITT

By: THOMAS D. MOFFITT
Senior Technician Reviewer
Income Tax and Accounting Branch
Field Service Division