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Memorandum

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to: LB&I Team 1362
HMP Territory 4, Cincinnati, OH
Attn: Revenue Agent Sherri Belkofer

from: Associate Area Counsel (LB&I)
Cincinnati Group 2

subject:

Characterization of Amounts Received on the Sale of I.R.C. § 166 Impaired Real Estate Mortgage Investment Conduit Regular Interests

This memorandum responds to your request for legal advice on the characterization of the amounts received on the sale of real estate mortgage investment conduit (REMIC) regular interests with respect to which a partial worthlessness deduction under I.R.C. § 166 had been taken in a prior taxable year. We have relied on the facts set forth below for our opinion. If you believe that we should consider additional facts or if the facts have been stated incorrectly, you should notify us since this could change our opinion. You should not cite this memorandum as precedent.

DISCLOSURE STATEMENT

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ISSUES

1. Whether the Taxpayer, upon the sale of REMIC regular interests with respect to which a partial worthlessness deduction had been taken under section 166, has a recovery within the meaning of Treas. Reg. §§ 1.166-1(f) and 1.111-1 and the tax benefit rule in the year of sale.

2. If the Taxpayer has a recovery, what is the character of the recovery?

3. How should amounts received by the Taxpayer upon the sale of REMIC regular interests, which were previously deducted as partially worthless bad debts under I.R.C. § 166, be ordered and allocated for purposes of Treas. Reg. § 1.111-1(a)(2)?

CONCLUSIONS

1. The Taxpayer must include the amount of recovery of the prior partially worthless bad debt deduction in gross income in the year of sale.

2. The character of the recovery is ordinary.

3. Under Treas. Reg. § 1.111-1(a)(2), the Taxpayer must allocate the amount received upon sale of the REMIC regular interests first to the Taxpayer's remaining adjusted basis, then to the amount previously deducted as partially worthless, i.e. the recovery amount, and lastly to the amount of gain, if any. Under general tax principles, the gain would be capital gain. However, under these facts, this gain will be ordinary income to the extent provided by I.R.C. § 860B(c).

FACTS

On July 30, 2013, the Internal Revenue Service published a document entitled "I.R.C. § 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Company" (LB&I Control No. LB&I-4-0712-009)(hereinafter "the Directive"). The Directive provided that LB&I examiners should not challenge an insurance company's partial worthlessness deduction under I.R.C. § 166(a)(2) for the amount of the Statement of Statutory Accounting Principle (SSAP) 43-R credit-related impairment charge-offs of eligible securities as reported on its Annual Statement.

In accordance with the Directive, the Taxpayer, an insurance company, claimed a partial worthlessness deduction under I.R.C. § 166(a)(2) for eligible securities in 20   and accordingly adjusted the basis of the securities.[1] The eligible securities were REMIC regular interests. Examination is currently auditing the 20   and 20   tax years. In these years, the Taxpayer sold certain REMIC regular interests that it had previously written down. Most of the dispositions resulted in a net loss, but five of the REMIC regular interests that were sold resulted in an amount received that exceeded the Taxpayer's adjusted basis in the regular interests at the time of sale. The Taxpayer reported the excess of the amount received over adjusted basis from these dispositions as capital gain.

LAW AND ANALYSIS

Recovery of Bad Debts in General

Treas. Reg. § 1.166-1(f) addresses the recovery of bad debts. Specifically, it provides that

> Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of §1.111-1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

Treas. Reg. § 1.111-1(a) addresses the recovery of certain items previously deducted or credited. Treas. Reg. § 1.111-1(a)(2) defines recovery. Specifically, it provides that

> Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection <u>or sale</u> of a

[1] The facts do not address whether the Taxpayer's prior charge-off included accrued but unpaid interest nor whether there is accrued but unpaid interest as of the sale date. <u>See</u> <u>e.g.</u>, Treas. Reg. §§ 1.61-7(d), 1.446-2(e) and 1.1275-2(a).

> bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a 'recovery.' Furthermore, the term 'recovery' does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not included. (Emphasis added.)

The Taxpayer's Partially Worthless Bad Debts

Treas. Reg. § 1.166-1(f) provides that "[a]ny amount attributable to the recovery during the taxable year of a bad debt, or a part of a bad debt, which was previously deducted, shall be included in gross income for the taxable year of recovery," unless specifically excluded by Treas. Reg. § 1.111-1. Neither the statute nor Treas. Reg. § 1.166-1(f) specifically defines the word "recovery." Under the judicially created tax benefit doctrine, in the context of bad debt deductions, a recovery means that a taxpayer has received amounts attributable to a debt for which the taxpayer had previously claimed a bad debt deduction. See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983); see also West Seattle National Bank of Seattle v. Commissioner, 288 F.2d 47 (9th Cir. 1961); and Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952). This interpretation is consistent with the definition of recovery provided under Treas. Reg. § 1.111-1(a)(2), which defines recovery as including certain amounts received from the sale of a bad debt. Thus, if a taxpayer sells a bad debt, which was previously deducted as partially worthless, for an amount in excess of its adjusted basis, then the taxpayer has received, among other things, a "recovery" within the meaning of Treas. Reg. §§ 1.111-1(a)(2) and 1.166-

1(f).

As noted, the Taxpayer took a partial worthlessness deduction on the REMIC regular interests in 20   pursuant to the terms of the Directive. Subsequently, the Taxpayer sold those securities in 20   and 20   for an amount in excess of the Taxpayer's remaining adjusted basis in the securities. Therefore, the amounts received by the Taxpayer from the sale of the REMIC regular interests are included in gross income, unless otherwise excluded by Treas. Reg. § 1.111-1.

Under Treas. Reg. § 1.111-1(a), income attributable to the recovery of a bad debt shall be excluded from gross income to the extent the amount deducted did not decrease the taxpayer's tax liability during the taxable year of the deduction. Treas. Reg. § 1.111-1(a) would only apply to exclude from gross income the amount received by the Taxpayer if the Taxpayer's previous bad debt deduction did not reduce the amount of tax owed in the year the deduction was claimed. In 20 , the Taxpayer claimed partially worthless bad debt deductions attributable to the five REMIC regular interests and these deductions reduced its taxable income by $, and also reduced its tax liability. Thus, Treas. Reg. § 1.111-1(a) does not apply to exclude from gross income any amounts received by the Taxpayer from the sale of those REMIC regular interests.

Because Treas. Reg. § 1.111-1(a) does not apply to exclude any amounts received by the Taxpayer upon sale of the REMIC regular interests, the Taxpayer has received a recovery attributable to a bad debt within the meaning of Treas. Reg. §§ 1.166-1(f) and 1.111-1(a)(2), and this amount must be included in gross income as a recovery of the bad debt. The characterization of this amount is discussed below.

Character of Recovery Amounts from the Sale

If an event in a subsequent taxable year triggers application of the tax benefit doctrine, then the amount of the prior deduction will be included in gross income and characterized as ordinary income. See, e.g., West Seattle Nat'l Bank of Seattle v. Commissioner, 288 F.2d 47 (9th Cir. 1961); Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952); Nat'l Bank of Commerce v. Commissioner, 115 F.2d 875 (9th Cir. 1940). See also Rev. Rul. 85-186, 1985-2 C.B. 84, (citing to Merchants Nat'l and stating, "In appropriate circumstances, if a deduction reduces ordinary income in the year the amount is paid or incurred, and if an event in a subsequent taxable year triggers application of the tax benefit doctrine, the amount of the prior deduction will be included in gross income and characterized as ordinary income."). Therefore, where, as here, a taxpayer uses a partially worthless bad debt deduction under I.R.C. § 166 to offset its ordinary income and in a subsequent taxable year sells that debt, the amount received is properly characterized as ordinary income to the extent of the bad debt deduction. See Merchant's Nat'l Bank, 199 F.2d at 659.

In 20 , the Taxpayer offset its ordinary income by deducting the REMIC regular interests as partially worthless bad debts under I.R.C. § 166. Then in 20   and 20 , the Taxpayer sold the REMIC regular interests, and received amounts in excess of its adjusted basis in the securities. Therefore the amounts received by the Taxpayer from the sale of its REMIC regular interests, attributable to recovery of amounts previously deducted as partially worthless bad debts, are ordinary income in the year of sale.

Ordering and Allocation of Amounts Received from the Sale

As discussed above, Treas. Reg. § 1.111-1(a)(2) defines recovery and describes an ordering rule for allocating amounts received with respect to a bad debt. First, amounts received are to be allocated to the "amount not previously deducted," which is the remaining basis in the debt. Next, amounts received are to be allocated to "the part of such debt which was deducted," which is the recovery amount. Lastly, the regulation allocates any remaining amounts received with respect to the debt to gain which is required to be included in income.

The Taxpayer is required to follow the ordering rule provided under Treas. Reg. § 1.111-1(a)(2). For example, if the Taxpayer sold its REMIC regular interests for $110 after having previously purchased those securities for $100 and having previously deducted $50 as a partially worthless bad debt, the part of the amount received that was not previously deducted is the $50 remaining adjusted basis in the REMIC regular interests. Next, of the remaining $60 of the amount received, $50 is a recovery of the bad debt because that is "the part of such debt which was deducted" and, as discussed above, must be included in gross income and characterized as ordinary income. Lastly, the remaining $10 is "gain" on the sale, and would be capital gain under general tax principles. See also I.R.C. § 1222. Alternatively, if the Taxpayer had sold the interests for $90, the Taxpayer would have $40 of recovery and no gain.

Under the first scenario, the remaining $10 of gain is attributable to the sale of REMIC regular interests. I.R.C. § 860B(c) provides, in part, that gain on the disposition of a REMIC regular interest shall be treated as ordinary income to the extent such gain does not exceed the excess, if any, of (1) the amount which would have been includible in the gross income of the taxpayer with respect to such interest if the yield on such interest were 110 percent of the applicable Federal rate as of the beginning of the taxpayer's holding period, over (2) the amount actually includible in gross income with respect to such interest by the taxpayer. Thus, if there is any gain from the sale of the securities, it might be characterized as ordinary income to the extent required by I.R.C. § 860B(c).

Therefore, under Treas. Reg. § 1.111-1(a)(2), the amounts received by the Taxpayer from the sale of the REMIC regular interests are first a non-taxable return of capital to the extent of the Taxpayer's remaining adjusted basis. Next, any additional amounts received are a recovery of the bad debt deductions that is ordinary income to the extent of the prior deductions under I.R.C. § 166. Lastly, any remaining amounts received are capital gain, subject to I.R.C. § 860B(c).

We have coordinated the above conclusions with the Office of Associate Chief Counsel, Financial Instruments and Products, and the Office of Associate Chief Counsel, Income Tax and Accounting. Please contact Senior Attorney Gary R. Shuler, Jr. at (513) 263-4894 if you have any questions or need additional assistance.

JAMES D. HILL
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By: ______________________________
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