

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B03

PLR-135953-06

Date:

December 22, 2006

LEGEND:

Taxpayer

A

Newco

Corp B

C

D

E

F

Lender 1

Lender 2

Lender 3

Lender 4

Lender 5

Lender 6

Accounting Firm

Date a

Date b

Date c

d

Date e

f

g

Date h

Date i

Date j

k

Date l

Date m

Date n

Date o

p

q

[

Date s

Dear _____ :

This responds to your letter requesting a ruling on the federal income tax treatment of whether certain payments are deductible, under section 166 of the Internal Revenue Code, as a business bad debt.

REQUESTED RULING:

Whether payments, pursuant to a written agreement, made by Taxpayer to A are deductible, under section 166 of the Code, as a business bad debt in the taxable year the payments became uncollectible?

APPLICABLE FACTS:

In Date a, A contacted the Taxpayer with a business proposition regarding the acquisition and management of Corp B, a manufacturer of C. A formed Newco for the purpose of acquiring Corp B with D, an employee of Corp B. Based upon Taxpayer's extensive consulting and business expertise, A envisioned that Taxpayer's business acumen would be a solid fit with the proposed acquisition of Corp B.

In Date b, Taxpayer visited Corp B's headquarters to evaluate the proposed business opportunity. Corp B's major customers were E and F who had Corp B prototypes in place and expressed strong interest in installing Corp B equipment nationwide. The Taxpayer reviewed Corp B's technology and determined that the sales outlook was quite strong. After identifying certain Corp B's systems and procedures that required transformation, the Taxpayer agreed to consult to develop an improved business plan. Based upon A's request, Taxpayer agreed to defer upfront consulting fees and accept deferred monetary compensation for his services.

Pursuant to the consulting arrangement, A informed Taxpayer about the status of borrowing money to purchase Corp B. In Date c, A informed Taxpayer that A approached Lender 1 for the purpose of borrowing money to purchase Corp B. Lender 1 had performed due diligence in Date c on Corp B and was ready to loan the requested funds to A, but required a letter of credit (a "LC") to cover the risk associated with meeting the loan's first year interest payments. A explained to Taxpayer that he was currently unable to obtain a LC on his own because of his inadequate financial position and asked the Taxpayer to consult on arranging a LC. A also stated that if Taxpayer

would use his personal resources to try to secure a LC, then Taxpayer would be paid deferred compensation and a d ownership interest in the acquired business (the "Ownership Interest") as payment for Taxpayer's consulting services and for assistance in trying to arrange a LC.

In Date b, 1, Taxpayer contacted Lender 2 and Lender 3, but was unsuccessful in obtaining a LC. With the delay in arranging an LC and no current funding from Lender 1, A asked Taxpayer for financial support to pay current business costs being incurred by Corp B. As a result, in addition to agreeing to deferred compensation, on Date e Taxpayer also agreed to lend A \$f at g percent interest (collectively, additional amounts Taxpayer lent A are hereinafter referred to as the "Loan")(collectively, the deferred compensation agreement and the Loan, including later amendments, are hereinafter referred to as the "Agreement"). The Agreement required A to immediately repay the borrowed amount to Taxpayer upon receiving private financing, or if private financing did not materialize, then under the Agreement A was required to use settlement proceeds from an existing lawsuit to repay Taxpayer.

In Date h, A approached Lender 4 to arrange a LC. Fees were paid to Lender 4, but no LC was issued. In Date i, A also approached Lender 1 and Lender 1 agreed to have one of its associated finance companies, Lender 5, issue a LC after being paid a fee and on the condition of receiving a favorable due diligence letter. Accounting Firm issued a new due diligence letter advising Lender 1 that Corp B could not substantiate its purchase orders. As a result, Lender 5 did not issue a LC.

In Date j, Lender 1 was again approached to provide funding. Lender 1 reconsidered the matter but required a new due diligence letter. Due diligence was performed, but the report on Corp B was negative. As a result, Lender 1 did not issue a LC and decided it would no longer consider issuing a LC for the purchase of Corp B. Later that year, A approached Lender 6 for funding and Taxpayer paid a \$k application fee. Lender 6 did not issue a LC.

In Date l, Taxpayer informed A that he was terminating their business relationship and his consulting services. A continued to approach numerous other potential funding sources during Date m and Date n to revive the project, but all efforts provided fruitless. Subsequently A filed for bankruptcy under Title 11 of the U. S. Code. In Date o, A was discharged from all debts, including Taxpayer's debt, in bankruptcy proceedings under Chapter 7 Discharge of Debtors. By Date s Corp B was in receivership.

Before the Loan was discharged, the Loan and associated interest increased to \$p and \$q, respectively. It is represented that if A had received funds under a LC, taxpayer's loan amount of \$p would have been repaid immediately upon receipt of any funding. It is further represented that if the business transaction had culminated successfully, the Taxpayer would have reported \$q of interest income related to the Loan, \$r in self-employment compensation, and the compensation value of the Ownership Interest as

payment for Taxpayer's services. However, based upon the fact that the transaction was unsuccessful, Taxpayer reported \$p as a business bad debt. The scope of this letter is limited to the deductibility of the Loan. It should be noted that no opinion is expressed, or implied, regarding the amount of interest related to the Loan, self-employment compensation, or the compensation value of the Ownership Interest.

LAW AND ANALYSIS

Section 166(a)(1) provides that, with regard to wholly worthless debts, there shall be allowed as a deduction any debt which becomes worthless within the taxable year.

Section 1.166-1(c) of the Income Tax Regulations provides that only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.

Section 1.166-2(a) of the regulations provides that in determining whether a debt is worthless all pertinent evidence is to be considered, including the value of the collateral, if any, securing the debt, and the financial condition of the debtor.

Section 1.166-2(b) provides that where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

Sections 1.166-2(c)(1) and (2) provide that bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt and in bankruptcy a debt may become worthless before settlement or sometimes only when a settlement in bankruptcy has been reached. In either case, the fact that bankruptcy proceedings are terminated in a later year, confirming the worthlessness of a debt does not authorize the shifting of the deduction to such later year.

Section 166(d)(1) of the Code provides that in the case of a taxpayer other than a corporation a deduction under subsection (a) shall not be allowed for any non-business debt. Instead, when any nonbusiness bad debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

The term "nonbusiness bad debt" is defined in section 166(d)(2) of the Code as a debt other than (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Section 1.166-5(b)(2) of the Income Tax Regulations provides that the question whether a debt is a nonbusiness debt is a question of fact in each particular case. The character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided in the subparagraph.

In U.S. v. Generes, 405 U.S. 93 (1972), a taxpayer who was a shareholder and employee of a corporation signed an indemnity agreement for performance bonds in connection with the corporation's business. After making payments under the agreement, the taxpayer sought to deduct the indemnification loss as a business bad debt. The Court stated that "in determining whether a bad debt has a "proximate" relationship to the taxpayer's trade or business, as the Regulations specify, and thus qualifies as a business bad debt, the proper measure is that of dominant motivation, and that significant motivation is not sufficient."

In Litwin v. United States, 983 F. 2d 997 (10th Cir. 1993), the court held that taxpayer was allowed to deduct losses under section 166 as bad business debts, after the taxpayer substantiated that the bad debt losses were proximately related to the conduct of trade or business. In Litwin the taxpayer was an employee and shareholder, the taxpayer's dominant motivation determined whether the transaction was proximately related to the taxpayer's trade or business. After reviewing the size of the taxpayer's investment, the size of the taxpayer's after-tax salary and other sources of gross income available to the taxpayer the court held that substantial evidence supported the finding that the transactions at issue had a business purpose. As a result, the taxpayer was entitled to deduct his losses and expenses as bad business debts.

Bad debts may be deducted to the extent of their worthlessness which is a question of fact, and worthlessness can occur before the debt is due. Standard Oil of N.J. v. Commissioner, 7 T.C. 310, 1321 (1946).

In the instant case, we conclude that the Loan was made in connection with Taxpayer's consulting business and the dominant motivation for making the Loan was to increase the likelihood that Taxpayer would be paid a consulting fee for the following reasons. One, based upon the facts submitted, the proposed business venture continually experienced significant cash flow problems, and as a result, the Taxpayer was required to lend A money in order for Taxpayer to be paid his consulting fee. Two, similar to Litwin, the size and magnitude of Taxpayer's employment compensation package supports the finding that the Loan had a business purpose, and therefore, the Loan was created in connection with Taxpayer's consulting business. Three, providing venture capital to A was consistent with Taxpayer's past business practices and was in furtherance of Taxpayer's consulting business.

RULING:

Based solely on the facts and representations submitted, we conclude and rule as follows:

Loans made by Taxpayer to A are deductible under section 166 of the Code as a business bad debt in the taxable year the payments became uncollectible.

DISCLAIMERS AND LIMITATIONS:

This ruling is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

We express no opinion about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings. In particular, we express no opinion with respect to interest related to the Loan, self-employment compensation or the compensation value of the Ownership Interest.

Under the powers of attorney on file in this office, a copy of this ruling is being sent to your authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

CHRISTOPHER F. KANE
Chief, Branch 3
Associate Chief Counsel
(Income Tax & Accounting)