Internal Revenue Service

memorandum

Number: **20042302F**
Release Date: 6/4/04
POSTS-116188-03/CC:SB:2:PIT

date: **June 30, 2003**

to: James South, Technical Advisor, Abusive Promotions

from: Edward J. Laubach, Jr. and Julia L. Wahl
Attorneys (CC:SB:2:PIT:POSTS:116188-03:JLWahl)

---

subject: **Timing of Loss:**

UIL 44.60-00

This responds to your request for advice on the proper time for investors in the payphone scheme to deduct losses. This memorandum should not be cited as precedent.

ISSUES

1. Are investors in the payphone scheme entitled to a loss deduction?

2. If so, what is the type of loss to which they are entitled?

3. In what year would they be entitled to the loss?

4. Are amounts which paid to investors in 2001 before filed for bankruptcy taxable or are they a return of capital?

CONCLUSIONS

1. Most investors are entitled to a loss deduction.

2. Most investors will be entitled to a loss under I.R.C. § 165(c)(2) as a loss incurred in a transaction entered into for profit. Taxpayers who invested for the purpose of avoiding taxes might not be allowed a deduction.

3. Investors may generally claim the loss on their tax returns.

4. Amounts which paid investors during 2001 prior to filing bankruptcy are taxable.

FACTS

of , was in the business of placing, selling, and maintaining public payphones in is owned by . , a securities and insurance agent, devised a plan whereby payphones could be sold to individual investors. He approached about his idea in 1997. agreed that this plan was enticing and began selling some of its payphones to individuals looking for a good annual return and tax advantages. Thereafter, formed on , 1998, to market payphones which allegedly complied with the Americans With Disabilities Act (ADA). These payphones had longer cords, volume controls, and other minor improvements which allowed their use by the disabled.

sold the disabled accessible payphones to investors for a price of $ ($ after April 1999) per phone. purchased these payphones new or refurbished from manufacturers at a wholesale cost of $ to $ per phone. For the purchase price, the investor purportedly received ownership of a payphone at a location solely selected by . A purchaser of an payphone had four options upon purchase. The first option required that the purchaser handle all aspects of the phone's maintenance and earnings. Two other options transferred some of the phone's responsibility to . Ninety percent of the purchasers chose Option Four.

Under Option Four, the purchaser of the payphone entered into, in essence, a sale and leaseback agreement with . then assumed total responsibility for collecting the coins from the phone, cleaning and maintaining the phone, accounting for the profits, paying the expenses of the phone, such as the telephone service provider, and issuing a check for the net profits to the owner. Although the owner was supposed to receive percent of the net profits monthly, was, in fact, paying all investors a base amount of $ [1] a month regardless of the phone's location. This payment generated a percent annual return to the purchasers. In addition, the purchaser had the

[1]This base amount was allegedly eliminated in .

right to return the phone to and receive nearly all of his or her purchase price back.[2] Thus, a purchaser under Option Four merely sat back and received a monthly check for $ [3] and could return his phone for nearly all of his investment at any time.

Aside from the economic advantages of the payphone investment, heavily stressed the tax advantages of the payphone, primarily the disabled access credit under section 44. told its investors that they could claim a credit on their tax returns of percent of the purchase price of the phone up to $. In addition, some investors were advised to claim the other half of the purchase price as a section 179 deduction. A tax opinion was provided from which said that the payphone qualified for the section 44 credit although this opinion contained no real discussion how this investment so qualified.

The sale of the payphones has been attacked by several state securities commissions and the SEC. These governmental agencies contend that the payphone investment is a "security" which must be registered with them. On , 2002, the United States District Court for the District of issued a permanent injunction barring from selling unregistered securities. ceased selling the payphone investment in , 2001.

.

In connection with the SEC action, the District Court appointed a receiver for on , 2002 to attend to business and civil matters. had already filed a petition under Chapter 11 of the Bankruptcy Code on , 2001. The receiver has been keeping interested parties informed of the status of the bankruptcy case.

On 2002, the receiver informed investors of the status of the case by letter. He had obtained court approval to

---

[2]This right to return the phone is variously described as a buy back provision or an extended warranty on the phone. Apparently, a $ fee was charged if the phone was returned within three years of purchase.

[3]For purposes of the passive loss rules of I.R.C. § 469, this income is characterized as portfolio income and is not passive activity gross income. I.R.C. § 469(e)(1)(A). Thus the passive activity loss rules do not apply.

sell property of and hoped to auction the pay telephone routes. The letter included this statement:

> Finally, as for the amount of return to investors, the Receiver believes that the sale of the payphone routes will generate only a nominal return to investors, if any. Additional sums could be distributed if the Securities and Exchange Commission is successful in disgorging assets from the individual defendants in this case. To date, the Receiver has no information that would suggest that such payments will be forthcoming.

One year later, by letter to investors and creditors dated 2003, the receiver described his efforts to market the payphones of and itself. The payphones yielded very little money and there was no interest in . The receiver advised in the letter:

> At present, I do not believe that there will be sufficient money in the receivership to make a payout to the investors or creditors in this case. I am pursuing several avenues that may generate revenue; however, there is no guarantee of success.

DISCUSSION

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

I.R.C. § 165(c) provides that in the case of an individual, the deduction under subsection (a) is limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Section 1.165-1(c) of the Income Tax Regulations provides that the amount of the loss allowable as a deduction shall not exceed the adjusted basis for determining the loss from the sale or other disposition of the property involved, as prescribed by § 1.1011-1. Accordingly, to the extent an investor has claimed a depreciation deduction or an ADA credit with regard to the investment in taxable years that are closed and not audited, the loss deduction will be reduced.

The question may arise as to which of two sections allows the loss deduction: I.R.C. § 165(c)(2), which allows individuals to deduct losses incurred in transactions entered into for profit, or I.R.C. § 165(c)(3), which allows individuals to deduct losses from theft. The distinction matters because I.R.C. § 165(h) limits the deductibility of I.R.C. § 165(c)(3) theft losses but does not limit I.R.C. § 165(c)(2) losses.

From what we have heard about the investor pool, we expect that most investors invested in the payphones with an expectation of making a profit[4]. Also, although the promoters may have engaged in activities that violate federal and state securities laws, the record does not indicate that these actions resulted in theft losses. Accordingly, the investors' losses are allowable under I.R.C. § 165(c)(2) and are not limited by I.R.C. § 165(h).

Investors were promised a minimum 14 percent return on their investments and had a motive other than tax avoidance to invest. Nevertheless, auditors who encounter investors who clearly made the investment solely for the tax benefits and who did not rely on false statements in deciding to invest may determine that no loss is allowable. We stress that based on our knowledge of the typical investor, disallowance of a loss will be the exception rather than the rule.

Having determined that investors will generally be entitled to a loss deduction, we turn to the question of the tax year in which the loss will be allowed.

Section 1.165-1(d)(1) provides that a loss is allowed for the taxable year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year.

We conclude, subject to the exceptions mentioned, that investors in the payphone scheme incurred a deductible loss in 2003[5]. Prior to 2002, the trustee was hopeful

---

[4] If Examiners find investors who clearly made the investment to obtain the bogus tax advantages, no loss should be allowed as discussed elsewhere in this memorandum.

[5] Examiners may encounter investors who have filed lawsuits against third parties such as the individual or firm which sold them the payphone investment. Those investors might not be entitled to deduct the loss until a later year when the suit is resolved. Alternatively, closing agreements could be entered allowing the loss in 2003 if the taxpayers agree to include any future payout in income in the year received.

that a nominal recovery might be made from the sale of assets as evidenced by the his 2002 letter. Thus, he believed that *some* recovery was possible. A year later, in his 2003 letter, the receiver concluded that there would not be sufficient money in the receivership/bankruptcy estate to pay investors anything. The receiver's opinion as one deeply familiar with finances should be given substantial weight. See Premji v. Commissioner, T.C. Memo. 1996-304, aff'd, 98-1 USTC ¶50,218 (10th Cir. 1998).

ADMINISTRATIVE CONSIDERATIONS

Examiners should consider entering closing agreements with investors under audit. The agreements should allow taxpayers to deduct the loss on their returns with the proviso that they will include any ultimate distributions in income in the year of receipt.

Of course, any amounts received from before 2001 (the date of the bankruptcy) are includible in income. Although the receiver informed investors that he would not issue them 1099 forms for amounts paid to them before the bankruptcy during 2001, those amounts **are** taxable and are not a return of capital as stated by the receiver. We found no authority for the trustee's position.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call me at (412) with any questions.

JULIA L. WAHL
Attorney (SBSE)

EDWARD J. LAUBACH, JR.
Attorney (SBSE)

APPROVED:

EDWARD F. PEDUZZI, JR.
Associate Area Counsel