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Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
MAY 3 1999

Legend

Taxpayer =
Corporation =
Buyer =

Year 1 =
Year 2 =

Date 1 =

A =
B =
C =
D =
E =
F =
G =

x =

Dear

This responds to your letter dated January 18, 1999 requesting a ruling as to the proper treatment of certain amounts received by you as holder of a promissory note, upon the early retirement of the note, in excess of the outstanding principal plus the accrued and unpaid interest.

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Facts

In Year 1, Taxpayer, a shareholder in Corporation, sold his stock to the remaining shareholder (Buyer). The stock sale was agreed to by the parties on Date 1 in consideration for a promissory note given to Taxpayer by Buyer (the "Note"). In accordance with the terms of the Note, the parties acknowledged and agreed that the "purpose and intent of the sale of stock which gives rise to the Note was to pay $C " to Taxpayer. (Both Taxpayer and Buyer are individuals.)

The principal amount of the Note was $A, together with simple interest at a rate of x% per annum. Interest payments under the Note totaled $B. The amount of each installment of principal and each installment of interest was separately listed in the Note along with the due date for each payment. The installment payments of principal and interest totaled $C. According to Taxpayer, the amount of principal payments and interest payments were determined so the parties could achieve the goal of final sales proceeds from principal and interest of $C.

The Note also provided that, in order to ensure Taxpayer receives $C, in the event of any prepayment (whether in part or in full), Buyer would still be required to pay the entire amount of each installment payment. The difference between the amount listed under the column for payments of interest and the amount of interest actually accrued as of the payment date would be re-characterized as a prepayment penalty under the terms of the Note. Thus, the parties' intention was that any prepayment was permitted so long as Taxpayer still received one hundred percent of each installment payment.

The Note also provided that if Buyer sold or otherwise transferred twenty-five percent or more of the stock of Corporation to any person other than each other, their lineal descendants, or one or more trusts for the benefit of themselves or their lineal descendants, then the remaining unpaid installment payments of principal and interest listed under the Note would become immediately due and payable in full. In the event of a transfer causing the Note to become due and payable, the difference between the amount listed under the column for payments of interest and the amount of interest actually accrued as of the payment date would be payable as a prepayment penalty.

In Year 2, Buyer paid the remainder of installment payments due under the Note in preparation of selling Corporation, thereby invoking the prepayment clause in the Note. The remaining installment payments under the Note amounted to $D, which consisted of: $E in outstanding principal; $F in accrued and unpaid interest; and $G as a prepayment penalty.

Issue

Taxpayer requests that the amount $G, received as a prepayment penalty under the terms of the Note, be treated as capital gain.

Law and Analysis

Under section 1222 of the Internal Revenue Code, a capital gain includes only those gains arising from the sale or exchange of a capital asset. (For purposes of this letter, we have assumed that the Note is a capital asset.)

Section 1271(a)(1) provides that amounts received upon retirement of a debt instrument shall be considered as amounts received in exchange for the debt instrument. Under section 1271(b)(1)(A), however, the provisions of section 1271 are inapplicable to any obligation issued by a natural person before June 9, 1997.

The predecessor to section 1271(a)(1) is found in section 1232(a) (repealed in the 1984 Act by P.L. 98-369, Sec. 42(a)(1), effective for tax years ending after July 18, 1984), and provided as follows:

> For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or by any government or political subdivision thereof -
>
> (1) Retirement. Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor . . .

In the instant case, the Note was issued by a natural person prior to June 9, 1997, and therefore section 1271(a)(1) does not provide sale or exchange treatment to the amounts received by Taxpayer upon the prepayment of the Note.

Taxpayer argues that even though section 1232 has been repealed, it is still applicable to the transaction in issue and supports treating the prepayment penalty as capital gain. Section 1232 was repealed effective for taxable years ending after July 18, 1984, and hence does not apply to the retirement of the Note. The repeal of section 1232 was not conditioned upon a taxpayer falling within the provisions of section 1271 or otherwise receiving sale or exchange treatment from another provision of the Code or regulations.

Even if section 1232 were to apply to the early retirement of the Note, it would not give the transaction sale or exchange treatment. By its terms, section 1232(a)(1) only applied to indebtedness issued by a corporation or a government (or political

subdivision thereof). There is nothing to indicate that Congress intended to extend sale or exchange treatment to the retirement of indebtedness issued by natural persons prior to June 9, 1997. In fact, the specific language of section 1271(b)(1)(A) signals a recognition by Congress that, before June 9, 1997, the Code did not provide sale or exchange treatment to the retirement of indebtedness issued by natural persons.

Taxpayer also argues that the prepayment penalty should be treated as a capital gain because it is not the economic equivalent of interest. For support, Taxpayer refers to Prudential Ins. Co. of America v. Commissioner, 882 F.2d 832 (3rd Cir. 1989), rev'g 90 T.C. 36 (1988) and Phoenix Mutual Life Insurance Co. v. Commissioner, 96 T.C. 481 (1991). In Prudential Ins. Co. of America v. Commissioner, the taxpayer was an insurance company that made mortgage loans to corporate and non-corporate borrowers containing prepayment charges upon prepayment of the loan. With respect to its dispute with the Commissioner, the taxpayer conceded that the prepayment charges on mortgage loans to non-corporate borrowers should be treated as gross investment income under section 804(b), and therefore the Third Circuit addressed only the issue of the treatment of prepayment charges on mortgage loans to corporate borrowers. In addition, while the Third Circuit did reject the argument that prepayment charges are interest equivalents, it did not decide that prepayment charges are capital gains. To the contrary, the Third Circuit recognized that some prepayment charges qualify for long-term capital gain treatment while other prepayment charges do not and stated:

> Other, if not most, prepayment penalties still will be treated as gross investment income because they do not qualify for long-term capital gain treatment. For example, for the tax years in question, the taxpayer treated the prepayment penalties received from non-corporate borrowers as gross investment income under section 804(b). Mortgages to non-corporate borrowers do not qualify as capital assets or for capital gain treatment under section 1232.

Id. at 839.

In Phoenix Mutual Life Insurance Co. v. Commissioner, supra, the taxpayer also was an insurance corporation that made mortgage loans to corporate borrowers as part of its investment activities. Upon prepayment, the taxpayer was to receive prepayment premiums in excess of the outstanding principal balances and accrued interest. On the issue in question, the Tax Court stated:

> If such divergent treatment of prepayment premiums on corporate versus non-corporate mortgages does not seem intuitively logical, it must be recalled that such treatment is a result of the common law rule that "retirement" is not a "sale or exchange," and of Congress' decision (in the

Revenue Act of 1934) to single out obligations issued by *corporations* (and governments or political subdivisions) for statutory sale or exchange treatment.

Id. at 494.

Based upon a review of section 1271(a)(1), its predecessor, section 1232(a), and relevant case law, it is clear that amounts received upon retirement of debt issued by natural persons prior to June 9, 1997, do not receive sale or exchange treatment, and therefore do not qualify as capital gain.

Conclusion

Amounts received by Taxpayer upon early retirement of the Note in excess of outstanding principal amounts plus accrued and unpaid interest do not qualify as capital gain, but instead represent ordinary income on the disposition of the Note.

Except as specifically provided otherwise, no opinion is expressed on the federal tax consequences of any particular transaction.

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

Pursuant to the power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely yours,

Assistant Chief Counsel
(Financial Institutions & Products)

By William E. Blanchard
William E. Blanchard
Senior Technician Reviewer,
Branch 3