IRTA Advisory Memo

February 7, 2017

Proper Reporting of Assets and Liabilities of the Managing Exchange vs. the Exchange Members And IRS 1099 Reporting Requirements Regarding Client/Member Bad Debt Trade Accounts

Background:

When the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) classified barter exchanges as third-party record keepers it required barter exchanges to adhere to the same IRS 1099B reporting requirements that banks and investment firms follow. However, the fundamental legal debtor/creditor relationship in a barter exchange differs from what exists in the commercial banking and investment firm sector. These differences have caused confusion in the barter industry regarding two specific areas:

- The proper reporting of assets and liabilities of the managing exchange vs. the exchange members.
- IRS 1099 Reporting Requirements Regarding Exchange Members' Bad Debt Trade Accounts.

This Advisory Memo will review the history and legal precedent of these issues and provide guidance for handling both. IRTA's guidance on these topics is further substantiated by a December 2nd, 2016 professional opinion from the accounting firm of Manning Silverman & Company, (attached as Addendum "A").

irta's historical recommendations – the managing exchange's assets & liabilities vs. the exchange members assets & liabilities

In October of 1989 IRTA issued guidance regarding asset and liability recognition of the managing exchange vs. the exchange members - with the release of a model managing exchange "Balance Sheet" and a model "Statement of Condition" of exchange members, (attached as Addendum "B & C").

NOTE: *The managing exchange, (i.e., the barter exchange), is typically an incorporated entity, be it a C-Corp, Limited Partnership or Sub-Chapter S Corporation. The managing exchange balance sheet reflects the company's assets and liabilities. In most cases the members of the exchange are not a separate corporate entity, rather, the members have signed a membership agreement with the managing exchange that articulates their rights and obligations, and grants the managing exchange various third-party record keeping responsibilities. Although the exchange members are not an incorporated entity per se, the exchange members collectively have their own assets and liabilities. Because the exchange members typically are not an incorporated entity, their financial report for their assets and liabilities, (which resembles a balance sheet), is called a "Statement of Condition," (Addendum "C).*

The Statement of Condition of the exchange member system, (Addendum "C") clearly categorizes the members' negative trade balances as assets and the members' positive trade balances as liabilities. The exchange members' positive and negative trade balances ARE NOT recorded as assets or liabilities on the managing exchange's balance sheet, (Addendum "B"). Furthermore, trade loans between the members are only listed on the exchange members' Statement of Condition, and ARE NOT listed on the managing exchange's balance sheet.

Relevant Legal Precedent That Recognizes The Separation Between The Managing Exchange's Balance Sheet Vs. The Assets & Liabilities Of The Exchange Members

The Exchange Enterprise v. Commissioner decision of 1987, (see Addendum "D"), further underscores the separation between the managing exchange's books and the books of the exchange members themselves. Exchange Enterprises ruled that the managing exchange could not take the bad debt write-offs of members' accounts on the managing exchange's tax return. The court ruled the managing exchange was not a guarantor of the members' system and did not have any basis for the trade amount they attempted to write-off. The court went on to say, "The members' trading accounts have no direct relationship to the Exchange's books of accounts...the members' accounts represent a separate system which reflect trade balances."

The Exchange Enterprise decision recognized the lack of a "transactional relationship" between the managing exchange and the exchange members, and it noted the effect of closing negative trade balance accounts, when it said:

"Although Exchange was responsible for the overall management of the barter system, it was not a guarantor of the system. The act of closing out the debit and credit balances of members to Exchange's books did not cause Exchange to have "paid or incurred" expenses in operating the barter exchange business. The lack of a transactional relationship between the members' accounts and Exchange's books of accounts renders meaningless the act of closing out the balances. Exchange, in its business capacity, is neither directly enriched by credit balances nor caused detriment by debit balance of other members' trading accounts."

IRTA's 1989 model "Statement of Condition" of the exchange members' system and the model managing exchange's "Balance Sheet" were reviewed by Manning Silverman & Company on December 2, 2016 and were determined to be an accurate outline of the proper accounting for the assets and liabilities of both systems.

Background - 1099b Reporting of Bad Debt Accounts

The long-standing IRTA axiom that "the legal liability of redemption of goods and services of trade dollars in a (member) barter system lies with the debtor members collectively. A (managing) barter exchange does not extend credit, the client/members who accept trade dollars do," (see Addendum "E" - IRTA's Advisory Memo of March 3, 2014, titled "Legal Liability for Trade Dollars in a Barter Exchange"). This important axiom further supports IRTA's position that the managing barter exchange "is not like a commercial bank, which makes loans and is liable for demand deposits," and therefore managing exchanges are not subject to banking regulations.

Manning Silverman & Company's December 2, 2016 opinion letter further supports IRTA's axiom that trade dollar lending takes place collectively between the exchange members when it states:

"The legal liability of redemption of goods and services of trade dollars in a barter system lies with the debtor members collectively. The exchange has a managerial role in the extension of credit among members, verifying creditworthiness, collecting delinquencies, etc., but has no credit-extending power of its own."

While TEFRA clearly recognized barter exchanges as third-party record-keepers and mandated exchanges provide IRS 1099B reporting for the barter sales of the exchange's client/members, TEFRA did not address what a managing exchange's reporting responsibilities are when the exchange members' deficit trade accounts are deemed to be a bad debt.

Managing Exchange's Approaches To Defaulted Negative Trade Accounts Of Exchange Members – Manning Silverman & Company Recommendations

Typically, when a managing exchange determines a member's negative trade balance is in default, the managing exchange will close-out the account by entering a "purchase" from its "Bad-Debt Reserve" trade account and a "sale" from the defaulted member's trade account, so as to effectively zero-out the account, (assuming the managing exchange has created and funded a bad-debt reserve account). The bad-debt

reserve account entry on the exchange's computer software will normally automatically generate a 1099B for the defaulted exchange member company, (unless the exchange specifically set the software to not generate a 1099B).

Other managing exchanges have handled the matter differently, by going through a debt forgiveness process whereby the defaulted negative trade balance member is issued a 1099C. Alternatively, other managing exchanges do not issue 1099's in defaulted negative trade balance situations at all.

Manning Silverman & Company's, (see attached Addendum "A") guidance recommends managing exchanges should send 1099B's in defaulted negative trade balance situations.

Manning Silverman & Company was also asked whether the managing exchange's issuance of a 1099B for a defaulted negative trade balance create a nexus between the managing exchange and the exchange members, sufficient to create a debtor-creditor relationship.

Manning Silverman & Company's opinion states that the managing exchange's issuance of the 1099B for a defaulted members' negative trade balance DOES NOT "establish a creditor-debtor relationship between the client/members' and the solo (managing) exchange, IRC Sec. 6045 (a); Reg. Secs 1.6045(c), 1.6045(e).

Manning Silverman & Company's conclusions are consistent with IRTA's emphasis that a managing exchange's third-party record keeping role and tax compliance responsibilities are paramount, and that the trade dollar lending is done collectively between the members. Therefore no debtor-creditor nexus is inferred or created between the managing exchange and the exchange members.

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December 2, 2016

Mr. Ron Whitney
President & CEO
International Reciprocal Trade Association (IRTA)
524 Middle Street
Portsmouth, VA 23704

Dear Mr. Whitney:

At your request, we have researched the issues regarding the issuance of Forms 1099B and/or 1099C when negative trade balances that exist in a barter exchange's accounts are written off as they become uncollectible. Your questions and our responses **(in bold type)** are set forth below

1) Does the scope of TEFRA's authority permit a solo-barter exchange to issue 1099s in a client/member defaulted negative trade balance scenario?

   Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), trade exchanges are classified as third-party record keepers, having the same fiduciary obligations as bankers and stock (securities) brokers. For tax purposes, trade dollars are taxable in the year they are "earned" and reported as such by the exchanges on 1099B forms to the IRS and to the recipients. However, TEFRA does not specifically address negative trade balance accounts. It would appear, however, that the exchanges have the authority to issue the 1099s for the defaulted negative accounts. IRC Section 6045(a); IRC Section 6045(c)(1); Treas. Reg. 1.6045-1(a)(4); Example 4 Treas. Reg. 1.6045-1(a) (13) (b).

2) Does the issuance of a 1099B or 1099C by a solo-exchange in a client/member defaulted negative trade balance situation create an inference of, or directly establish, a creditor-debtor relationship between the client/members' system and the solo-barter exchange?

   One of the potential pitfalls of issuing a 1099C may create an inference of a debtor-creditor relationship. IRC Section 6050P(a); Reg. Sec. 1.6050P-1(a). However, the issuance of a 1099B by a solo-exchange in a defaulted negative trade balance situation does not appear to create an inference of, nor does it directly establish a creditor-

debtor relationship between the client/members' system and the solo-barter exchange. IRC Sec. 6045(a); Reg. Secs. 1.6045-1(c), 1.6045-1(e).
A barter exchange is not like a commercial bank, which makes commercial loans and is liable for all demand deposits; a barter exchange does not extend credit, the members who accept trade dollars do.

The legal liability of redemption in goods and services of trade dollars in a barter system lies with the debtor members collectively. The exchange has a managerial role in the extension of credit among members, verifying creditworthiness, collecting delinquencies, etc., but has no credit-extending power of its own.

A barter exchange may or may not be a debtor member. A barter exchange, if it is a participant and member of the barter system (as separate from its position as manager of the system) is liable only for its own borrowing (if any) and not for all the trade dollars in the system. The amount of borrowing by a barter exchange is limited by the members through the contracts in use in the barter industry and their willingness to accept the credit(s) of those borrowers.

a) If you conclude that the issuance of a 1099 on a defaulted negative client/member balance does create a creditor-debtor nexus between the solo-barter exchange and the client/member system, is the weight of that creditor-debtor relationship sufficient to advise solo-barter exchanges to not issue the 1099's?

We do recommend the issuance of a 1099B. We do not recommend non-reporting of this issue.

b) If you conclude that the solo-exchange should issue 1099s in a client/member defaulted negative balance scenario, how do you reconcile the fact that to do so is arguably counter to IRTA's axiom that the loan to the defaulting client member was the result of a creditor-debtor relationship ~~is~~ between the client/members themselves and not between the solo-barter exchange and the client/members?

As noted above, we believe that the 3rd party record-keeper has the responsibility to report "earnings" of client/members; this is consistent with the concept that the exchange, as manager, is not a party to the transactions among client/members.

3) If you conclude a solo-exchange should issue 1099s for defaulted negative client/member accounts, which 1099 form should they issue? A 1099B or a 1099C, and why?

Form 1099B should be issued. IRC Sec. 6045(a); Reg. Secs. 1.6045-1(c), 1.6045-1(e

4) Based on your above answers, the same principles can apply to a situation where a solo-exchange "A" is sold to another exchange "B". Hypothetically, solo-exchange "A" has a negative exchange trade balance in the client/member system of -150,000, (i.e., an "Exchange Deficit") and the client/member system itself has -125,000 bad debt reserve balance, (i.e., a "System Deficit"). Should a 1099 be issued to the solo-exchange "A" by the acquiring exchange "B" if and when exchange "B" zeroes-out the "Exchange" and "System" deficits? Reg. Sec. 1.6045-1(b).

   Yes. If you are the acquiring exchange and the exchange you acquired was in the year of write-off you should issue a 1099B.

   a) If your answer to #4 is yes, if exchange "A" has already issued a 1099 for the "Exchange" and/or "System" deficits prior to being acquired by exchange "B", is there any additional reporting obligation of exchange B"?

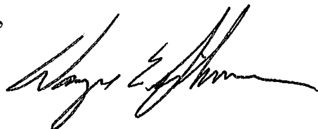
      No. Only one form is required to be issued.

In addition to the questions and answers submitted above you also requested our comments on the Statement of Conditions Schedule for the Trade Exchange System.

We believe that the schedule referenced above would be an acceptable presentation of the Assets and Liabilities of a Client/Member Trade Exchange System.

Please call me if you have any questions.

Sincerely,



Manning Silverman & Company
Wayne E. Silverman, CPA

Managing Exchange Balance Sheet

(AKA The Trade Exchange Balance Sheet)

Prepared by IRTA, October 1989

Assets

Cash		xxx
Receivables	xxx	
A/R Transaction Fees	xxx	
A/R Trade Dollars	xxx	
Merchandise Receivables	xxx	
Less: Allowance for doubtful accounts	<xxx>	
NET RECEIVABLES		xxx
Inventory (at lower of cost or market)		xxx
Prepaid Expenses		xxx
Notes Receivable – Current Portion		xxx
Other Current Assets		xxx
TOTAL CURRENT ASSETS		XXX
Furniture, Fixtures & Equipment	xxx	
Less Accumulated Depreciation	<xxx>	
Notes Receivable, Net of Current Portion		xxx
Other Assets		xxx
TOTAL ASSETS		XXX

Current Liabilities

Accounts Payable (cash)		xxx
Accounts Payable (trade Dollars)		xxx
Notes Payable (cash) – current portion		xxx
Notes Payable (trade dollars) – current portion		xxx
Payroll Taxes		xxx
Other Current Liabilities		xxx
TOTAL CURRENT LIABILITIES		XXX

Long Term Debt (cash) – less current position	**xxx**
Long Term Debt (trade dollars) – less current position	**xxx**
TOTAL LIABILITIES	**XXX**
<u>Stockholders' Equity</u>	
Common Stock $________ par value	
________ shares authorized	
________ shares issued and outstanding	**xxx**
Retained Earnings	
Total Stockholders' Equity	**XXX**
Total Liability and Stockholders' Equity	**XXX**

Statement of Condition of the Exchange Members
(AKA The Trade Exchange Client/Member System)

Prepared by IRTA, October 1989

Assets

Current:

Total negative members balances or revolving accounts…..................xxx

Less estimated allowance for doubtful accounts

(not provided for in the Bad Debt/Loan Loss Reserve Account)…………………………..xxx

Trade dollar loans, current portion…………………………………………………xxx

Inventory owned by system, at cost or market, whichever is lower…..xxx

TOTAL CURRENT ASSETS…………………………………………XXX

Non- Current:

Trade dollar loans, less current portion…………………………………………..xxx

Less estimated allowance for doubtful accounts

(not provided for in the Bad Debt/Loan Loss Reserve Account)…………………………..xxx

House accounts with negative balances…………………………………………..xxx

TOTAL ASSETS………………………………………………………….XXX

Liabilities

Current:

Total positive member balances…………………………………………………………xxx

Total positive house accounts…………………………………………………………….xxx

Other system liabilities………………………………………………………………..…….xxx

TOTAL CURRENT LIABILITIES……………………………………XXX

Non-Current:

Bad Debt/Loan Loss Reserve Account……………………..……………………………….xxx

TOTAL LIABILITIES……………………………………………………….XXX

System Deficit, (surplus)……………………………………………………………………………….XXX

Total Liabilities & system Deficit…………………………………………………………………..XXX

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1987 TC Memo 414

T.C. Memo. 1987-414

Exchange Enterprises of Salt Lake, Inc.
v.
Commissioner.

Docket No. 4552-85.

United States Tax Court.

Filed August 24, 1987.

R. La Mar Bishop, 136 E. South Temple, Salt Lake City, Utah, for the petitioner. David L. Miller, for the respondent.

Memorandum Findings of Fact and Opinion

GERBER, Judge:

Respondent, in a statutory notice of deficiency dated November 28, 1984, determined a $23,881 income tax deficiency for petitioner›s taxable year ended September 30, 1981. After concessions, the central issue for our consideration is whether petitioner, a barter exchange, acquires a basis or has an ownership interest in members› trade units so as to be entitled to: (a) Deduct, as a bad debt, uncollectible negative balances in inactive members› barter trade unit accounts; or (b) deduct, as an ordinary and necessary expense, the negative balances of inactive members› barter trade units. A second issue involves whether petitioner is entitled to deduct, as a «conversion» loss, the difference between either the value or face amount of its own trade units and a lesser amount of cash received in exchange for the trade units.

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Findings of Fact

Petitioner, Exchange Enterprises of Salt Lake, Inc. (Exchange) was a Utah corporation with its principal place of business in Salt Lake City, Utah, both at the time of the filing of its petition and during the taxable year in issue.[1] Exchange›s books were maintained and its income and expenses reported pursuant to the accrual method of accounting. Ross Rigby was the president and majority shareholder of Exchange. Exchange was a licensee of Exchange Enterprises, Inc., a Utah corporation which designed a barter leasing contract or a licensing agreement allowing independent barter brokerage companies in various cities to use the name «Exchange Enterprises» and provided an operations manual and other aids to the operation of a barter exchange.

Exchange operated as a central clearing house or brokerage for members and it maintained a list of members and the types of goods and services available from each member for trade to other members. Only members were entitled to use the services of Exchange. Members were required to pay an initial membership fee of $25 and annual dues of $125.[2] Members could buy or sell goods or services to or from other members only by using trade units (sometimes referred to as barter credits), instead of cash, as the medium of exchange. Exchange maintained the members› accounts on the basis of trade units and recorded trade units «earned» and «spent» by members. Exchange maintained two separate sets of records. Exchange›s general ledger contained its balance sheet and profit and loss accounts. In addition, Exchange maintained a subsidiary-type ledger of members' accounts reflecting the credit or debit balances of each member. The members' accounts ledger did not have a direct corresponding control account in Exchange's set of general ledger accounts.[3] Trade units, for internal accounting and bookkeeping of members› accounts, were assigned a one dollar «valuation» (face value).[4]

New members advised Exchange of the types of goods and services they had available. Pursuant to the operating manual, the exchange operator should attempt to seek out different members with varying goods and services to avoid duplication and provide variety. The vast majority of goods traded were new and many of the members were retailers. The membership agreement required goods and services to be exchanged at the provider-member›s prevailing price (full retail price).[5] Each time a member›s goods or services were traded to another member, their account was increased (credited) by the number of trade units negotiated between the members. Likewise, the account of a member who received the goods or services was reduced (debited) by the number of trade units negotiated. The recipient›s (buyer) account was also reduced (debited) by an additional ten percent of the trade units paid (price), which constitutes a commission and was credited to Exchange›s trading account. All transactions between members were required to be cleared or approved in advance by Exchange which issued a «purchase

number.» The provider (seller) of the goods and services was required to submit documents to Exchange, signed by the recipient (buyer), within seven days of the transaction to insure that the accounts were properly credited and debited. Exchange did not take physical possession of goods that were exchanged between members. The rules and regulations and a sample Membership Agreement Contract are attached hereto as Appendix A.

If a member wished to «purchase» an item but did not have sufficient trade units, Exchange would frequently authorize the purchase and debit the member›s account for the negotiated number of trade units and the ten-percent commission, even if a deficit or negative (debit) balance resulted.[6] At the time a

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member's ledger account became negative, Exchange did not transfer trade units from any account to make up or balance the negative balance. Nor did Exchange set up a "loan" account or accounts receivable or payable regarding members' negative balances. Exchange did not obtain promissory notes from members who had negative balances. Although Exchange permitted members to enter into transactions which resulted in or increased negative balances, Exchange made no express guarantee regarding these negative balances at the time the individual transactions were approved.[7]

Exchange, for Federal tax purposes, reported income and expenses based upon barter exchange trade units at 50 percent of face. Accordingly, the income generated by the ten-percent commissions received from buyers was reported at $0.50[8] for each $1.00 of trade units reported.[9] For the taxable period in question, Exchange determined that member›s net credit balances totaling 35,940 trade units were «dead accounts» (inactive) and this amount was reported in Exchange›s income at the 50-percent discount.[10]Exchange also determined that certain members' accounts with net debit balances totaling 84,546.66 trade units were worthless and uncollectible and claimed a deduction against income at the 50-percent discount. Respondent allowed $4,500 of the claimed bad debt deduction[11] and disallowed the remaining $37,723 as unsubstantiated.[12] At trial, we received petitioner›s schedule of the individual accounts that were written off as «bad debts,» but the books and records[13] of petitioner did not reflect more than $2,576.80 of these accounts with debit balances. Petitioner›s witnesses stated that the bad debt accounts were removed from the books after they were written off as bad debts. Attempts were made, mostly after the taxable year in question, to collect on some of the credit balance accounts, but these attempts were apparently not very successful.

A $16,658 «conversion loss» was claimed on Exchange›s income tax return for the taxable year ended September 30, 1981. Exchange used the term «conversion loss» to cover situations where trade units were sold for an amount of cash which was less than the face or internal bookkeeping value of $1.00. A common situation where this occurred involved employees who were permitted to convert each $1.00 of salary money into $2.00 of trade units.[14] Also members who did not have goods or services to sell were permitted to purchase trade units for $0.50 cash for each $1.00 trade unit. Exchange would claim the 50-percent difference against its income. During the taxable year ended September 30, 1981, Exchange sold 33,316[15] trade units for $16,658 cash. The trade units sold were from

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those which Exchange had already reported in income for Federal income tax purposes.

Opinion

The central issue involves whether petitioner is entitled to claim bad debt or business expense deductions under sections 166 or 162[16] for the debit (negative) balances in inactive barter exchange members› accounts. Section 166 permits deductions for partially or wholly worthless debts which become worthless within the taxable year. The amount of the deduction under section 166(b) is the adjusted basis set forth in section 1011. Section 1011 refers us to section 1012 which provides that basis shall be cost.[17] Section 162 allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year. In this context, we must decide whether petitioner either had a basis in the negative balances in inactive members› accounts or whether the existence of such account balances could be considered as «paid or incurred» by petitioner. Petitioner bears the burden of proving it is entitled to a bad debt or business deduction. *New Colonial Ice Co. v. Helvering* 4 USTC ¶ 1292, 292 U.S. 435 (1934); *Welch v. Helvering* 3 USTC ¶ 1164,290 U.S. 111 (1933); Rule 142(a).

Petitioner argues that it is the guarantor of the barter system and is responsible for negative balances in inactive accounts, therefore it is entitled to either a bad debt or business expense deduction for the negative account balances of inactive accounts. Respondent argues that petitioner is not a guarantor of the negative balances and that petitioner had no basis in and/or did not «pay or incur» the negative balances of inactive members› accounts. We agree with respondent.

To better understand the parties› arguments, we must do so in the context and parlance of the business activity and transactions of petitioner. The essence of a barter transaction is the trading of goods or services without the use of money.[18] The obvious advantage of the use of money lies in its universal acceptability as a standard or medium of exchange. Conversely, simple barter transactions generally lack that universal quality and also lack divisibility.[19] Petitioner›s business objectives are to provide a barter marketplace and a medium of exchange which includes divisibility. This was to be accomplished by attracting

barter members with different goods and services and by providing a system of barter credits to be used as the medium of exchange. Members of the barter exchange compensated petitioner for its services by means of a one-time membership fee, annual dues and a ten-percent fee (paid in barter credits) on each barter transaction (which was paid by the «buyer»).

Each barter exchange member contracted with the exchange and agreed, essentially, to conduct their barter transactions through Exchange by means of barter credits. There was no written or express contractual relationship between Exchange members. Additionally, there was no written or express contract between Exchange and the members as to guarantees of the viability of the barter system.[20] When a member wished to «purchase» goods or services, but had no trade credits in their account, Exchange would usually permit the member to establish and maintain a debit or negative balance in the member›s trade account. Members who were permitted to create debit balances did not expressly obligate themselves to «repay» the negative balance in their account. Exchange did not loan its earned trade credits to members with debit balances. Accordingly, the integrity of the trade credit system was lessened by Exchange›s permissiveness. When a member›s account became sufficiently inactive, Exchange closed out the debit or credit balance to itself, which, in the year in question, resulted in Exchange›s claimed deduction.

Exchange›s arguments seeking a deduction as either a business expense under section 162 or bad debt under section 166 are dependent upon the argument that Exchange was the guarantor of the exchange system. Our determination is a purely factual one, inasmuch as we must determine, under these facts, whether Exchange acquired a basis in member accounts or «paid or incurred» a business expense.

Exchange contends that it was the guarantor of the barter exchange. We find no evidence of an express or implied guarantee. Exchange was not expressly named as guarantor and took no steps reflecting that it acted as a guarantor. To

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the contrary, Exchange did not guarantee the value of the trade credits or that goods and services would be available in exchange for the credits. When the debit balances were created, Exchange did not transfer credits from its trading account to cause the members' trade accounts to either balance or to maintain the integrity of the trade credit system. Only after a determination that the member with a debit balance was not going to accumulate sufficient credits to offset the debit balance did Exchange take some action—by writing off the account balance against its income.

The act of closing out the credit and debit balances of inactive members› accounts to Exchange›s profit and loss accounts is inapposite. The members› trading accounts have no direct relationship to Exchange›s books of accounts. To the extent that Exchange maintains a member›s trading account, it may be listed as an asset on Exchange›s books, but the members› accounts are not subsidiary to Exchange›s books. The members› accounts represent a separate system which reflect trading balances. Inactive accounts with credit balances are to the benefit of all the members of the barter exchange. Conversely, inactive accounts with debit balances are to the detriment of all the members of the barter exchange. To the extent that Exchange maintains a trade credit account, Exchange, in the broadest sense, has been benefited or harmed by balances in inactive members› accounts. Exchange›s source of income is dependent upon the success or failure of the barter exchange and the existence of debit balances may, ultimately, have some bearing on Exchange›s source of revenue, but there is no direct relationship to Exchange›s books of accounts.[21] Accordingly, we find that Exchange was not a guarantor of the barter exchange.[22]

Exchange›s inclusion in income of credit balances and deduction from income of debit balances of inactive members› accounts does not provide a basis in members› accounts. Moreover, petitioner has failed to show a debtor-creditor relationship with members; that the debt, if any, is a valid and enforceable obligation; and that the amount owed, if any, is fixed and determinable. Section 1.166-1(c), Income Tax Regs.; *Lieberfarb v. Commissioner* Dec. 31,997, 60 T.C. 350, 353 (1973). Also see *Zimmerman v. United States* 63-2 USTC ¶ 9566, 318 F.2d 611, 612 (9th Cir. 1963). Petitioner is not entitled to a bad debt deduction for failing to show a basis in members' accounts, *Oates v. Commissioner* 63-1 USTC ¶ 9426, 316 F.2d 56, 58 (8th Cir. 1963), affg. a Memorandum Opinion of this Court Dec. 25,436(M), and failing to show the existence of a debtor-creditor relationship. Petitioner also failed to prove the purported debts became wholly or partially worthless during the taxable year ended September 30, 1981.

Although Exchange was responsible for the overall management of the barter system, it was not a guarantor of the system. The act of closing out the debit and credit balances of members to Exchange›s books did not cause Exchange to have «paid or incurred» expenses in operating the barter exchange business. The lack of a transactional relationship between the members› accounts and Exchange›s books of accounts renders meaningless the act of closing out the balances. Exchange, in its business capacity, is neither directly enriched by credit balances nor caused detriment by debit balance of other members› trading accounts. If, for example, Exchange took the credit balances from inactive accounts and used them to acquire goods and services, Exchange would be required to report income to the extent it was enriched. *Wright v. Commissioner* Dec. 41,252(M), T.C. Memo. 1984-287. If, on the other hand, Exchange offset debit balances in members› accounts with Exchange›s trade credits which had been earned and subjected to Federal tax, deductions may have been available.[23] These postulations are, unfortunately not what occurred, and petitioner is not entitled to a deduction for the debit balances in members› accounts.[24]

Petitioner, during the taxable year ended September 30, 1981, sold 33,316 trade units from its credit balance of trade units (which had been

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previously subjected to tax and for which petitioner had a basis) for $0.50 each. For purposes of this case, the parties have agreed that petitioner's trade units had a value of $0.67. The trade units sold had been previously subject to Federal income tax and accordingly, petitioner had a basis in them. Accordingly, petitioner is entitled to deduct $5,663.72 as a loss from conversion of its trade units to cash during the taxable year.[25]

To reflect the foregoing,

Decision will be entered under Rule 155.

International Reciprocal Trade Association

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March 3, 2014 Revision

LEGAL LIABILITY FOR TRADE DOLLARS IN A BARTER EXCHANGE

Trade dollars are defined by modern commercial barter exchanges as "a unit of account denoting the right to receive, or the obligation to pay, in goods or services available within a barter system." This "valuable right" is founded on the contract between a trade exchange and its clients whereby clients agree to accept trade dollars in payment for goods and services. In the U.S., written pronouncements of the highest accounting and tax authorities have likewise held that trade dollars are a "valuable right." Therefore, trade dollars are assets to their owners.

If trade dollars are assets, they must be the liability of someone. Many people unfamiliar with the barter industry, including some traders, believe trade dollars are the liability of the barter exchange which manages the barter system. That this notion is erroneous can be readily demonstrated.

A barter system is a network of reciprocal trading partners. This network is established by written contract between the barter exchange and its members. This written agreement establishes, among other things, the terms and procedures whereby members make purchases and sales to and from each other. When sellers accept trade dollars in payment, they are extending credit to the other members of the network. The other members collectively have the obligation to fulfill the trade dollars of any member by selling goods and services to the member.

If businessperson A goes to businessperson B and purchases the product or service of B "on account", B has extended credit to A. In commercial law this is known as "open book credit". B simply records on his books a receivable due from A.

A commercial barter exchange is based on the same idea, except that, rather than B's doing the bookkeeping, the barter exchange acts as a third-party record keeper for all parties who join the barter system. The barter exchange keeps the books which reflects the purchases and sales of the members. The advantage of this system is that it enables multilateral trade to take place, therefore overcoming the disadvantages of conventional two-party barter.

In a barter exchange, A purchases from B, paying with trade dollars. B has extended credit to the members collectively, because the barter is incomplete and B has not yet been paid in goods and services. B may spend his trade dollars with anyone, looking to members as a group to provide him with fulfillment goods and services.

In sum, members who hold trade dollars (have net positive balances) are collectively owed goods and services by those who have borrowed from the system (have net negative balances). The legal liability to fulfill trade dollars rests on the members collectively who owe the system. Trade dollars are not the liability of the exchange, but of all members (including, perhaps, the exchange) who have spent more trade dollars than they have earned, and have thus borrowed from the system.

As trade dollars circulate throughout the system, and the debtor or creditor status of the membership continually changes, no single debtor (including the barter exchange) can be singled out as the liable party for any particular trade dollars. All that can be said is that the debtor members collectively owe the creditor members collectively.

Thus, legal liability for the fulfillment of trade dollars lies with the network of members, specifically with those who are in deficit in their account and owe goods and services to others in the barter system. The soundness of the trade economy depends on the creditworthiness of the debtor members and their contractual obligation to repay. It is expected that they repay their borrowing by making sales of their product or service to other members, thereby earning trade dollars and liquidating their indebtedness. If they fail to repay, loan losses must be absorbed by the entire barter network. This is done by charging a loan loss reserve account, which is owned not by the barter exchange but by the members of the barter network collectively. Loan losses reduce the supply of goods and services available within the trade system, and must be controlled through prudent credit extension.

Trade dollars have value because of the willingness and obligation of the members of the barter network to accept them as a means of payment and hold trade dollar balances. Members consent to accept and hold trade dollars because of their confidence that they are exchangeable for goods and services. Trade dollars are “backed” by (1) the goods and services of members of the barter network who have a contractual obligation to accept them as payment up to the prescribed limit, and (2) the obligation of the members who owe trade dollars to repay their debt.

Over time, some members may increase their borrowing to finance larger purchases. In this way, the number of trade dollars in circulation expands to finance a larger volume of trade. The legal liability to fulfill the outstanding trade dollars rests, as always, with the debtor members of the system. The loan loss reserve established by the exchange, through deduction from each member’s account, ensures there are at all times sufficient trade dollars to pay the indebtedness of the doubtful accounts.

A barter exchange is not like a commercial bank, which makes commercial loans and is liable for all demand deposits. A barter exchange does not extend credit, the members who accept trade dollars do. A barter exchange, as one of the members of the barter system, is liable only for its own borrowing (if any) and not for all the trade dollars in the system. The amount of borrowing by a barter exchange is limited by the members through the contracts in use in the barter industry.

In sum, the legal liability of redemption in goods and services of trade dollars in a barter system lies with the debtor members collectively. A barter exchange may or may not be a debtor member, and is liable only to the extent of its own borrowing. A barter exchange does not extend credit, only the members of the network collectively do. The exchange has a managerial role in the extension of credit among members, verifying creditworthiness, collecting delinquencies, etc., but has no credit-extending power of its own.