

## Market Segment Specialization Program



# Commercial Banking

**NOTE:** Only Chapter 17 contains revised material on Automobile Lease Payments. All other materials remain exactly as printed July 1997.

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.



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## INTRODUCTION

### **FORMATION OF THE GROUP**

The Detroit District formed a Financial Group in 1986 when it recognized the need to improve the quality of the examinations of both banking and insurance returns. Approximately one half of the agents in the group specialize in the audit of banks and savings and loans. The other agents specialize in the examination of life and casualty insurance companies.

There is no formal specialized training for agents who audit financial returns. The agents learned to examine banks by studying the banking research services, by reviewing the ISP digest, and by working together. They regularly share with each other what they learn. Additionally, close contact is maintained with the National Banking ISP, Savings and Loan ISP, and National Office personnel. The Detroit District provides resources to attend ISP meetings and out-service seminars. They have also funded subscriptions to bank tax research services and several banking trade publications.

Our Financial Group audits banks, savings and loans, and mortgage companies of all sizes, including several which are included in the Coordinated Examination Program (CEP). Industry issues and substantial "general" issues can be found in returns of any size but are more prominent in cases where assets exceed one billion dollars.

Through specialization, the group significantly improved the quality of bank examinations because of:

1. Improved communication
2. Consistency in issue development
3. More efficient use of audit time.

This audit specialization guide was developed from information available in the financial group, from the Banking Industry Specialist, and from Internal Revenue Agents from around the country. Even though commercial banking is specifically addressed in this guide, many of the issues and techniques are appropriate for use during the audit of savings and loans, mortgage companies, and finance companies.

## **UTILIZATION OF THE COMMERCIAL BANKING GUIDE**

The Commercial Banking Guide is intended to be a tool to assist Internal Revenue Agents who are not familiar with auditing bank returns. It is useful as a reference during pre-audit planning to identify potential issues. It will also assist you, the examiner, in knowing the types of records and techniques necessary to identify and develop the issues. Also, familiarity with terminology unique to banking will enable you to communicate more effectively with the taxpayers and representatives throughout the audit process.

This guide should not be used as your sole source of technical information, nor should complete reliance be placed on the suggested audit techniques. It is important to understand the merits of an issue so you can assess how much time and documentation is needed to develop the issue. The technical treatment of issues often changes over time due to legislation, court cases, Revenue Rulings, etc. You may determine the current position on an industry issue by contacting the Banking Industry Specialist, Appeals ISP Coordinator, or Industry Counsel. Above all, continue to use your imagination and initiative to identify and develop new issues which can be shared with the rest of us.

We hope you find this guide useful. If you would like clarification of an examination technique listed in the guide or have suggestions for improvements, you may contact the Michigan District Market Segment Specialization Program Coordinator. Technical questions can be directed to your District ISP Coordinator. Questions on significant industry issues should be directed to the Commercial Banking Industry Specialist who is the focal point for all coordinated and other significant industry issues.

## Chapter 1

### GENERAL OVERVIEW OF THE BANKING INDUSTRY

#### **DEFINITION OF A BANK**

Generally, the income and deductions of a banking entity are computed in the same way as those of other corporations. They are also subject to the same federal income tax rates that apply to other corporations. The term "bank" in recent years has become increasingly blurred, but is usually applied to any establishment engaged in the various functions associated with a bank. These functions include the receiving, collecting, lending, and servicing of money. IRC sections 581 through 585 provide special rules directly applicable to the taxation of banks.

Section 581 of the Internal Revenue Code provides us with a technical definition of a bank.<sup>1</sup>

#### **EXTRACT**

##### IRC section 581

For purposes of IRC sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

After reading the above paragraph you realize that the above definition of a bank is superficial. You will recognize a bank when one is assigned to you. The examination of a bank is different in some ways, as you will find out later in this guide. Yet, in many other ways, bank examinations are similar to other examinations that you have already come in contact with.

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Banks may also engage in a broad range of securities dealing activities that could give rise to issues not discussed in this guide.

Essentially, banks are categorized into two very broad groups: Commercial banks and noncommercial bank institutions, such as savings and loan associations, mutual savings banks, and credit unions.

Commercial banks are broken down into three separate classifications based on the authority which chartered the bank:

1. National Banks

These are banks which are chartered by the Comptroller of the Currency and operated under the supervision of the Federal Government. National banks are required to be members of the Federal Reserve system and to carry deposit insurance through the FDIC.

2. State Member Banks

These are banks which are chartered and regulated by their respective state banking departments and have elected to join the Federal Reserve System. All member banks are required to carry deposit insurance and follow the regulations of the FDIC, similar to that of a national bank.

3. State Nonmember Banks

These are banks that are chartered by the state banking departments and have not elected to join the Federal Reserve System. All nonmember banks are subject only to the state banking department regulations. The actual number of State nonmember banks is relatively small.

For tax purposes, banks receive yet another designation. A bank is treated as being a **large bank** if, for any taxable year after December 31, 1986, the total assets of the bank exceed \$500 million, or the bank is part of a controlled group and the group's average total assets exceed \$500 million. The large bank category will be specifically discussed later in this guide.

This MSSP guide is being written principally to address the issues unique to the commercial banking industry, not those dealing with the examination of a Saving and Loan Association (S&L) or a Credit Union. An S&L, while similar to a bank in that it receives deposits and makes loans to its customers, is not the same as a bank. Savings institutions, also known as thrifts, are defined in the IRC section 591(b) (mutual savings banks), IRC section 7701(a)(19) (domestic building and loan associations) and IRC section 7701(a)(32) (cooperative banks). The rules governing an S&L are covered under IRC sections 591 through 597 and deal primarily with rules applicable to mutual saving banks, cooperative banks, or similar associations covered



under federal or state law. To qualify as a savings and loan association, at least 60 percent of the total assets of such an entity must consist of qualifying assets, such as loans for residential real property. These entities qualify for benefits not available to a bank. Credit unions do not have capital stock. They are organized and operated for mutual purposes and are exempt from tax under IRC section 501(c)(14). They also are not covered under this guide.

See Exhibit 1-1 at the end of this chapter for a copy of a flow chart titled "**How banks make money.**" This chart provides a somewhat simplistic view of the operations of a bank. However, it also provides a basic understanding of the flow of money through the bank and how the bank makes money from its customers' money. This basic information is essential during the examination of a bank.

## **INDUSTRY REGULATION**

The banking industry is highly regulated. There are numerous state and federal laws that govern the industry. The enforcement of these banking laws is the responsibility of various regulatory agencies, such as the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Company (FDIC), the Office of Thrift Supervision (OTS), and each particular state's governing authority.

Regulations of the OCC, the FRB, the FDIC, and the OTS are codified in Title 12 of the Code of Federal Regulations. The various agencies clarify their policies and provide guidance through the issuance of advisory letters, bulletins, manuals, news releases, etc. They also issue written guidance to the particular banks during their examinations.

There has been significant legislation enacted relating to financial institutions in the past few years. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) increased the powers of the regulators. It also provided for the regulation of additional entities that were related to financial institutions. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) was enacted in 1991. The FDICIA provided for far reaching reforms of regulatory auditing and accounting standards. It also provided for supervisory actions to be taken when an institution's capital level decreases below acceptable levels. Additionally, the FDICIA provided additional capitalization to the FDIC's Bank Insurance Fund.<sup>2</sup> Title III of the Omnibus Budget Reconciliation Act of 1993 created a national deposit preference.

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AICPA Audit Risk Alert, Depository Institutions Industry Developments -- 1992, pp. 5-12.

FIRREA and FDICIA deal primarily with the regulation of the banking industry, rather than with tax law. However, there are some tax provisions included in FIRREA and FDICIA. These will be discussed later in this guide.

Banks are required to file reports of condition (balance sheets) and reports of income (income statements) with the regulatory agencies. Nationally chartered banks file their reports with the Comptroller of the Currency. The Federal Reserve receives reports from state member banks. Insured nonmember banks file with the FDIC.

Banks are examined frequently by one or more regulatory agencies. In the past, the supervisory agencies conducted their examinations independently. This would result in a bank being examined by several different agencies. Recently, the FDIC and the OTS have been performing joint examinations. Additionally, the FDIC and the Conference of State Bank Supervisors have reached agreement on having cooperative examinations.

The bank examiners' reports are considered the property of the respective regulatory agencies. The banks are prohibited from providing copies of the reports to anyone outside the bank without permission. Although most of the agencies are part of the Treasury Department, the IRS has had difficulty securing complete copies of examination reports from them. IRC section 4083 provides the procedures for requesting certain portions of the OCC's and FDIC's examination reports which relate to charged off assets and adverse classification of balance sheet items. There has been some success in making arrangements to review the examination reports of the OTS and certain State banking regulators. However, this is not uniformly the case.

A brief description of each of the regulatory agencies is given below.

### **The Office of the Comptroller of the Currency**

The OCC is the primary regulator for national banks. The Code of Federal Regulations, Title 12, section 1.1 states, "The Comptroller of the Currency is charged by the national banking laws with execution of all laws of the United States relating to the organization, operation, regulation, and supervision of national banks and in particular with the execution of 12 U.S.C. 24 which sets forth the corporate powers of national banks. "The OCC also regulates certain activities of banks in the District of Columbia and state banks that are members of the Federal Reserve System.

### **The Federal Reserve Bank**

The Federal Reserve functions as the central bank of the United States. It consists of 12 regional banks. The Federal Reserve is run by a seven member Board of Governors which is appointed by the President. Although the FRB is accountable to

the Government, it is actually owned by banks which have purchased its stock. Banks are required to keep a certain percentage of the amount of their customer deposits in accounts at the FRB to lend money. The FRB sets the discount rate, loans money to member banks, regulates the money supply, and serves as the nation's leading check clearing system. Additionally, it is the primary regulator for state member banks.

### **The Federal Deposit Insurance Company**

The FDIC is a government corporation which insures customer deposits up to \$100,000. It is responsible for the examination of insured state nonmember banks. Banks that are not members of the FRB can still apply for deposit insurance from the FDIC. There are very few uninsured state banks.

### **The Office of Thrift Supervision**

The OTS is the primary regulator for savings and loan associations. It was established by FIRREA in 1989. The OTS replaced the Federal Home Loan Bank Board. If a bank has a savings and loan subsidiary, it will also be examined by the OTS. Otherwise, the OTS would not become involved in the regulatory examinations of a bank.

### **State Regulatory Agencies**

If a state chartered bank is not a member of the FDIC or the FRB, it is subject only to state laws and state banking department regulations. However, all FDIC or FRB member state chartered banks will be subject to examination by federal agencies and by their state. Further, the state regulator may examine other types of institutions, as well as, state chartered commercial banks. For example the Michigan Financial Institutions Bureau (FIB) is responsible for the chartering, regulation, examination, and supervision of state chartered banks, credit unions, and savings and loan associations. It also licenses and supervises the activities of various other types of companies, such as credit card issuers and mortgage companies. The state banking regulator can furnish information regarding the laws for banks operating in the state. It may also be able to provide you with information on a particular state chartered bank that you are auditing regarding merger activity, directed charge-offs, illegal activities, penalties, etc.

IRM 4083 discusses how information can be requested from various government agencies.

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## HOW BANKS MAKE MONEY

### TAKING MONEY IN

Depositors - Most comes from depositors, who put cash into banks for safekeeping in savings and checking accounts and certificates of deposit. Banks pay interest, but this is a cheap, stable source of funds.

Money Markets - Banks can go into the money markets and pay investors for funds. Bankers refer to this as “hot money” because the funds are usually lent on short maturities and can become costly if interest rates jump.

Federal Reserve - Banks also borrow funds from 12 Federal Reserve Banks located throughout the United States in what’s known as the “federal funds” market.

Generating Fees - Banks make money by performing services for customers. They charge a service fee for handling savings accounts. They charge you money for bouncing a check or using your ATM card. Banks also receive fees for managing trust accounts, helping businesses manage cash and servicing mortgage portfolios.

### GIVING MONEY OUT

Lending Money - After taking money in, bankers turn around and loan it out. They make loans to individuals buying new cars, boats and homes, and to businesses to build plants and buy equipment. They lend to developers to build shopping malls and office buildings. The riskier the loan, the more interest they charge.

By charging customers more to borrow money than they pay depositors on their accounts, banks make money. The difference is called “the spread”. There’s an old banking motto known as the 3-6-3 rule: Pay 3 percent on deposits, charge 6 percent for loans and be on the golf course by 3 p.m.

Accounting for bad loans: Not all loans pay off. Some businesses go bankrupt and some people never finish paying off boats or homes. When loans go bad, and can’t be repaid, banks lose the money they can’t recover. This comes out of profits.

Making Investments - In a lousy business climate, banks might want to cut back on lending and sin money into investments that will pay them interest. Banks typically invest in very safe securities, such as mortgage-backed securities and U.S. Treasury securities.

Paying Bills - Banks can’t pocket all the money they take in from interest earned on loans. They have plenty of bills to pay: employee salaries, rent on branch buildings, utilities and other business expenses, including income tax.

### MAKING MONEY, THE BOTTOM LINE

Money left over after all bills are paid and interest payments are made is called profit. If a bank minds its spread, holds costs in check and doesn’t make stupid loans, it should make a profit. Public companies such as Comerica pay some profit to shareholders in the form of dividends.

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## STARTING THE EXAMINATION PROCESS

### INTRODUCTION TO THE AUDIT

The purpose of this guide is to provide the revenue agent with a source of reference for issues which are currently common in the commercial banking industry. The guide should be used by the examiner as an audit tool to assist in recognizing certain issues and other unique areas in the banking industry where adjustments may exist. In addition, the guide provides various general and technical information useful to the examiner during the preliminary stages of an examination. The guide is not intended to be all inclusive, nor was it meant to be cited as an authority for a case.

The information contained in this guide is based upon data gathered from a limited number of examinations over a period of time. The objective of the MSSP project is to evaluate compliance within the commercial banking industry and to determine common areas of adjustments based on our audit results. We have attempted to develop a guide which will assist other examiners based on this experience. The fact that a particular issue is addressed in this banking guide does not imply that the issue must be examined in all cases, or that no other issues exist. There is nothing like the inquisitive and innovative mind of the revenue agent to come up with a new issue.

Before the examiner contacts the taxpayer, some time should be spent to become familiar with the banking industry. A listing of some of the resource and reference materials available to the agent is provided in the Appendix. These books should be used to become familiar with the accounting procedures used by the banking profession and the unique features of a bank tax return. The agent should also review the portion of the guide dealing with the technical issues. This will enable the agent to recognize issues when encountered during the examination. The first meeting with the taxpayer usually establishes the momentum of the examination. Take advantage of this opportunity to learn as much as possible about the methods and procedures used by the bank you are examining.

One thing to keep in mind is that the size of the asset base of a bank does not necessarily correspond to the complexity of the examination. At first, the rather large numbers may seem insurmountable, especially to someone who has no experience with large cases or is used to auditing only manufacturing firms. However, if you take out the amount of interest income and interest expense, the numbers no longer seem so overwhelming.

ISP Coordinated Issue Papers are written to ensure uniform treatment on issues unique to an industry. An issue does not become coordinated until the Assistant Commissioner (Examination) approves the issuance of the coordinated issue paper.

Delegation Order No. 247 (1996-21 IRB 7 (May 20, 1996)) gives case managers in the CEP program the authority to settle coordinated issues with the concurrence of both the Examination and Appeals ISP coordinators. Issues eligible for this authority are those coordinated issues for which Appeals has written approved settlement position.

Issues become coordinated after considering the following factors:

1. Whether the issue is unique to a particular industry
2. Whether the issue is generally applicable to all taxpayers in the industry
3. The complexity of the issue
4. Whether a compliance problem can potentially exist with respect to the issue.

There are currently four coordinated issues in the Commercial Banking area. These issues are discussed later in this guide.

Whenever your case includes an adjustment involving one of the coordinated issues, the Industry Specialists must be contacted in the event the formal position is not followed for any reason. It is recommended you contact the DISP or the ISP to get updates on the coordinated and other significant issues since the IRS position can change.

## **SIGNIFICANT ISSUES**

Significant issues involve areas with considerable examination potential. They are issues which are encountered in the field but are not yet coordinated. The banking ISP has identified eight significant issues which should be considered during all examinations.

Listed below are the eight significant issues along with a brief explanation of each item. Some of these issues are discussed in further detail later in this guide.

### **1. Mortgage Servicing Rights**

The recognition of income on the sale of mortgage pools where the seller separates and retains the mortgage servicing rights. The issue involves the allocation of basis to the rights retained.



**2. SFAS 91**

The current inclusion into income of all fees, and the capitalization of all direct expenses related to the origination of a loan.

**3. Other Real Estate Owned (OREO)**

This issue involves the recognition of gain or loss on the repossession of OREO property, the discount factor used to determine FMV, the write-down of OREO property after it is repossessed, and the handling of OREO expenses where the property is not being used as rental property.

**4. Hedging Gains and Losses**

Are taxpayers properly identifying hedging transactions or should IRC section 1256 apply?

**5. Foreign Tax Credit**

What level of substantiation must the taxpayer provide in order to be allowed a foreign tax credit? Can the taxpayer use "borrower" letters as proof of payment?

**6. Brazilian Foreign Tax Credit**

Is the Brazilian Foreign Tax Credit a creditable foreign tax for U.S. tax purposes and if the tax is creditable, is the Brazilian Central Bank exempt from tax?

**7. Interest Expense (1120F)**

Adjustments which are made to conform the taxpayer's balance sheet to U.S. standards.

**8. Home Office Allocation (1120F)**

What is the proper method for allocating expenses from the parent company to the branch operation?

**RETURN IDENTIFICATION PROCESS**

If a bank return is assigned to you, it will be obvious from a review of the return that it is a bank. Usually, the name of the entity will include the word "bank." If the concern is a holding company, the names on the subsidiary list will reflect whether they are banks. There are several ways that you can secure bank returns:

1. Banking returns can be identified by their business activity codes. The Principal Industry Activity (PIA) codes for bank holding companies and regular banks are 6060 and 6090, respectively.

2. In Michigan District, for example, the Planning and Special Projects (PSP) unit automatically receives all financial institution returns for activity codes 215 and above. These returns are segregated from the other tax returns and are classified by revenue agents who specialize in examining banks.
3. The *American Banker* newspaper provides an annual list of the largest 100 bank holding companies and the largest 300 commercial banks in the United States. *Crain's Detroit Business*, a weekly publication, ranks Michigan banks by assets each year. Business publications for many other major cities would likely provide similar lists. These can be reviewed to identify bank returns which are located in your examination area.
4. State banking regulatory agencies can be contacted to obtain information on banks under their authority. In Michigan, the Financial Institutions Bureau distributes two publications each year which summarize the activities of Michigan banks. These are titled "19XX Annual Report-Financial Institutions Bureau" and "Annual Report-19XX Data Analysis, 19XX Enforcement Activity." They provide information on loans, assets, merger activity, capital, minority loans, deposits, etc. of the various banks.
5. When our group was formed, one of the agents requested to be put on the mailing lists of the publicly held financial institutions in Michigan. Our group receives annual reports, quarterly reports, 10K's, press releases, etc., from these banks. The group's banking agents also clip articles from local newspapers and publications. This information is compiled in planning folders under each entity's name. This way we are able to keep aware of potential issues that might warrant examination of a particular bank. We have also found this information helpful in planning the examination of banks which have been selected for examination.

In summary, usually banking returns will be easily identified when they are received. If you are interested in obtaining additional returns, there are several sources. PSP can use PIA codes to identify bank returns. The *American Banker*, local business publications, and the State banking authorities can be consulted for lists of banks in your area. Local banks may be contacted for information that they provide to the public.

## **PRE-AUDIT PLANNING**

As with any journey, the audit must begin with a first step. A comprehensive pre-audit analysis is one of the most important steps in any examination. It sets the stage for the scope of the audit, the issues, and any unusual items to be examined. Since this is a banking guide, the normal pre-audit steps encountered in all examinations are not detailed. Rather, only those areas which have an impact on a bank examination will be discussed.

1. When you are assigned a bank to examine, take some time to read this guide and review any other available reference material. You cannot properly classify a return, or determine the audit potential of a case without first knowing what to look for.
2. A thorough review of the tax return must be made to determine which issues exist. It is important to remember that not all banks are worth auditing, so make sure that you have some potential issues in your case. Normally, banks with an activity code of 215 or above are automatically sent out to the district. Therefore, returns may be sent out to the group which have no significant tax potential. In those cases, it is a waste of valuable time and resources to examine these returns.
3. After you decide to examine a particular return, it is very important to determine up-front all of the businesses the bank operates. In many cases, it cannot be easily determined from just looking at the return. It is common practice for a bank to bury a business within the main operating subsidiary of the bank. The answer to each of the questions below will have a big impact on the scope of your examination. Determine at the very onset of the audit the answers to the following questions.
  - a. Does the bank have a mortgage servicing department?
  - b. Does the bank operate or engage in any type of leasing activity?
  - c. Does the bank operate a securities or brokerage department for trading stocks and bonds for individual or corporate customers?
  - d. Does the bank engage in interest rate or commodity hedging?
  - e. Does the bank own or operate any institution acquired from the FDIC or RTC?
  - f. Does the bank have any foreign operations?
  - g. Does the bank regularly purchase from or sell securities to customers in the ordinary course of a trade or business?

A positive answer to any of these questions will lead you to potential issues which will be discussed later. Review those areas of the guide to determine whether that particular issue should be examined.

4. Read the company's annual reports and the Securities and Exchange Commission (SEC) filings for answers to the above questions, while at the same time looking for other areas of potential examination. The information included in these documents is extremely helpful in understanding the business operations of the taxpayer. If the bank has stock that is publicly traded, you can call the bank and request copies of these reports from them. This information is readily available to potential investors.

5. Consider going to the public library to do some research on the bank to determine any other activities the bank may be involved in along with any recent articles on the bank which may have tax implications.
6. Banks can become very cyclical if their investments are not diversified. A bank that loans heavily to the automotive industry, for example, may incur significant losses in an auto industry downturn. Always ask the taxpayer to provide you with the current outlook for the bank. If significant loan losses are anticipated in the near future, this may affect the examination potential, and therefore, the scope of the examination. For tax years beginning after December 31, 1986, and before January 1, 1994, banks using the specific charge-off method of accounting for bad debts are entitled to carryback NOL's for 10 years for losses related to bad debt deductions.
7. Contact your District ISP Coordinator for information on banks in your area.

## **SPECIALIZATION WITHIN THE IRS**

### **INVOLVING SPECIALISTS IN AN EXAMINATION**

One of the objectives of a revenue agent is to know how to identify a potential issue and to know when to seek assistance from a trained specialist. During pre-audit planning, determine which of the available specialists will be needed for the bank examination. Usually, it will be evident from a review of the return which referrals should be made. However, sometimes you will not know until after the examination has begun. Once you realize a specialist is needed, a referral should be made as soon as possible. The specialists available for your examination are discussed below.

#### **Engineer**

IRM 42(16)2.2 states engineering referrals are mandatory on all corporate returns with assets of at least \$10,000,000. Assistance can also be requested whenever there is a significant valuation issue. An engineering referral is made on Form 5202. Informal consultations with engineers are usually available at any time.

We have found engineering assistance to be particularly valuable when a bank has acquired the assets of another institution. If the bank revalued acquired assets, engineers can be used to determine whether the values and lives that were assigned to assets such as servicing rights, buildings, etc. were accurate. Usually, the acquiring bank will have paid an amount in excess of the value of the purchased tangible assets. This premium may be allocated among intangible assets such as: Core deposits, covenants not to compete, goodwill, etc. Banks will attempt to allocate as much of the premium as possible to depreciable and amortizable assets. Therefore, it is important that an IRS engineer reviews these valuations to determine whether they are acceptable. The core deposit and intangible issues will be discussed thoroughly in a later chapter.

Banks often have expensive buildings for their headquarters. We used an engineer on one of our cases to assist in determining whether the taxpayer properly allocated payments to its contractor for construction of a new headquarters building. The bank brought in engineers from another state to value the assets during the construction process. They took the position that a number of the assets were not structural components of the building and could be depreciated over shorter lives. The IRS engineer reviewed their studies to determine which assets should have been considered part of the building.

IRM 42(13)3.3 requires an examiner to request the assistance of a computer audit specialist (CAS): 1) whenever the Examination Return Chargeout states there is a record retention agreement on file or 2) if the tax return has an activity code of 219 or above. Banks have a large asset base relative to their business activity. Therefore, you may not actually need the assistance of a CAS just because a referral is mandatory. At the beginning of the examination, discuss with your bank whether they can easily provide hard copy documents. If so, this should be mentioned on Form RC-C-Gen 4-873, Request for ADP Assistance, so the CAS manager can decide whether or not to accept the referral.

If a CAS is assigned to your bank, there are a number of ways he or she can assist you. The specialist can review, analyze, and understand the taxpayer's flow of documents through the bank's accounting system. If the bank uses a service bureau, the CAS may be familiar with their system from another exam. Once the CAS evaluates the system, he or she may enter into a record retention agreement with the taxpayer to keep the necessary machine-sensible records for use in current and future examinations.

The CAS is also a specialist in statistical sampling. Statistical sampling can be used when examining line items on the return. It may also be used when reviewing loans written off as bad debts or loans where the taxpayer has stopped accruing interest. (These issues will be discussed later in this guide.) To reduce the sampling error, a large sample must be drawn. It can be very time consuming to review the related documentation. Practically speaking, we have found examiner's judgment in selecting loan samples to be superior to the use of statistical sampling because we have found significant adjustments in substantially less time.

There has been a lot of merger and acquisition activity between banks in recent years. Because of these changes in business form, companies may revalue their assets. A CAS can work with an engineer to determine whether software or other assets were properly valued.

Probably the most important functions the CAS can perform are the various computer applications. See Exhibit 3-1, "Computer Specialist Assistance." This exhibit was written by a CAS who is experienced in the examination of financial institutions. You and the CAS who is assigned to your audit should review this exhibit. Much of the exhibit is designed to be used by the CAS when performing the computer applications or securing a record retention agreement. Therefore, you need not be too concerned with those portions of the exhibit.

### **Financial Products Specialist**

Banks often participate in a number of complicated financial transactions. A review of the Glossary may have exposed you to some new terminology such as: Arbitrage, basis points, collateralized mortgage obligations, etc. A trained financial products specialist will be familiar with this terminology and with the mechanics, accounting, tax law, and audit issues of the financial products industry.

The annual report, of publicly held banks, usually has an area which discusses the bank's various financial transactions. The annual report should disclose whether the bank is a party to any interest rate futures, caps and floors, or forward contracts. Many banks also enter into interest rate swap agreements to hedge against fluctuations in the interest rates. They may also enter into repurchase agreements and reverse repurchase agreements.

Do not be concerned if you do not understand the nature of these financial instruments. Your goal should be ascertain whether or not your bank is involved in any of these transactions. The tax manager or tax preparer with whom you are working is likely to be as unfamiliar with this area as you are. The financial products specialist will probably need to interview the bank employee responsible for these types of transactions. The specialist should be able to review the bank's financial products to determine the nature of gains and losses, whether transactions should be treated as sales versus financing transactions, whether any items should be marked-to-market, etc.

There are financial products groups in each region. Questions concerning financial products can be directed to the Chief, Technical Field Support, Illinois District, or the Chief, Financial Industry Studies, New York. The Office of Financial Products and Transactions is headquartered in Washington, D.C. This office is responsible for providing any assistance relating to financial products issues. The office provides technical support and performs on-site visits to develop financial products aspects of cases.

### **International Examiner**

Most smaller banks do not participate in international operations. Therefore, it is likely that your bank would not have any issues requiring the assistance of an international examiner. However, many banks do have branches in foreign countries, issue securities outside of the United States, make loans to foreign countries, invest in foreign securities, etc.

There are several ways to identify international issues. "International Issue" may be stamped on the front of the tax return. The tax return will often include Form 5471, Information Return with Respect to a Foreign Corporation; Form 5472, Information Return of a Foreign Owned Corporation; Form 1118, Computation of Foreign Tax Credit; or other international forms. The annual report may discuss international activity. Lastly, the taxpayer should be asked whether it has any foreign branches, loans to foreign countries, foreign securities, etc.

It is often very difficult to obtain documentation for foreign banking transactions. Therefore, it is very important to determine early in the examination whether assistance is needed from an international specialist. If so, a referral should be made on Form 2962. IRM 42(10)0 discusses international examinations and provides the referral criteria and procedures.

<http://www.getirshelptoday.com>  
The international tax specialist will advise the bank to determine whether there are any tax consequences. Often, the bank will be deducting bad debts prematurely or deferring foreign source income. The specialist will determine the effect of any adjustments on the taxable income of the bank and may need to recompute the foreign tax credit. One of the banking Coordinated Issue Papers discusses foreign withholding taxes.

### **Employee Plans Specialist**

A bank will usually have at least one retirement plan for its employees. Often, employee plans specialists will independently contact the taxpayer to review its plans prior to an examination by a revenue agent. If the bank's plans were not previously examined, Form 4632-A, Employee Plans Referral Checksheet, should be completed. If assistance is needed, Form 4632, Employee Plans Referral should be used. IRM 45(10)0 provides additional information regarding referrals.

If a referral is accepted, the employee plans specialist will evaluate whether the requirements of the employer's plan(s) have been met. Since taxpayers sometimes deduct amounts in excess of what is needed to fund the plan, the specialist may also calculate the allowable deduction.

### **Employment Tax Specialist**

Some districts assign employment tax specialists to review the employment tax issues on the larger companies. The specialist may review information reporting documents, employment tax returns, Forms W-4, etc. He or she may also look at issue areas such as: Employee reimbursement policies, medical reimbursement plans, meal reimbursements, etc. The procedures for making referrals to the employment tax groups vary between districts.

The package audit requirements are essentially the same for banks as they are for any other taxpayer. An exception is made for the review of Forms 4789 that are filed by federally regulated banks. (This is the form the bank is required to file if a customer deposits at least \$10,000 of cash in one or more related transactions.) Per IRM 1229, the banking regulators are given specific authority to verify that banks are complying with the filing requirements for these forms. The IRS generally does not have jurisdiction in this area.

Banks file numerous Forms 1099 because of the interest and dividends that they pay to their customers. In addition, they file Forms 1098 and 1099 to report mortgage transactions. They retain copies of this information on magnetic tape, rather than on hard copy. In lieu of reviewing these Forms 1099, we generally ask the taxpayer to provide a letter explaining its policy on issuance of Forms 1099 for interest and dividends. Forms 1099 for subcontractors, rent, etc. should still be inspected by the agent. Also, the taxpayer's use of Form 1099-A for abandoned property should be reviewed for accuracy and timeliness. Forms 1099-C (post-'93) and 1099-G (pre-'94) for cancellation of indebtedness should also be reviewed.



<http://www.getirshelptoday.com>  
Banks receive a notice issued by the IRS to inform taxpayers of errors in the reporting of names and social security numbers on Forms 1099. Rev. Proc. 9-37, 1993-2 C.B. 477 (modifying Rev. Proc. 92-2, 1992-1 C.B. 776) provides guidance on notifying customers that their taxpayer identification numbers are incorrect. It is effective for B Notices sent on or after September 1, 1993. The penalties from this notice may be waived if the taxpayer has used due diligence when obtaining this information from the customer. Generally, the bank will correspond directly with the IRS Service Center regarding the penalties.

### **Insurance Specialist**

Banks may elect to include certain types of insurance companies as part of their consolidated returns. An insurance company must have been a member of the affiliated group for the 5 taxable years preceding the taxable year for which the election was made. Unless the bank makes a valid election, a separate return must be filed for the related insurance company.

The examination of insurance companies is very difficult. As with banks, there are special code sections that relate only to them. Insurance companies file their returns on Form 1120L or Form 1120PC, rather than on Form 1120.

Although most districts do not have a separate group that specializes in the examination of insurance companies, they usually do have particular agents that have experience in this area. If your bank has an insurance company, consider consulting with an insurance specialist to determine whether there is any audit potential. The life insurance industry specialist is located in New York. The casualty insurance industry specialist is located in Boston.

### **Economist**

IRM 42(12)0 discusses the economic assistance program and the various ways that an examiner may use an economist in analyzing and evaluating the economic factors in his or her case. The economist can assist the examiner with the value of intangible assets, industry and trade practices, the value of functions performed, profit ratios, the value of a closely held business, etc. There are economists assigned to some of the district offices in the key regions. Form 9276 is used to request economic assistance. Generally, referrals should be limited to issues where the potential deficiency is at least \$500,000.

### **District Counsel and Industry Counsel**

Usually, there is ongoing litigation affecting banking issues. District Counsel receives pending issue reports from the Office of the Associate Chief Counsel (Domestic). They should be able to provide information regarding the current status of any court cases that might affect your examination issues.

There are also banking and savings and loan industry counsel who are responsible for overseeing court cases directly related to financial institutions. These attorneys should

be contacted with the <http://www.getirshelptoday.com> also want to be made aware of cases that may need to be litigated in the future. Sometimes they are looking for litigation vehicles for particular issues.

## **MARKET SEGMENT SPECIALIZATION PROGRAM**

The IRS' Market Segment Specialization Program (MSSP) focuses on developing examiner expertise through the examination of particular market segments. An industry, a profession, an occupation, or an issue may be selected as a market segment. Once the market segment is identified, qualified examiners are selected to accumulate information about all aspects of that industry's business activities. Returns of the industry are examined in an effort to gain knowledge and to identify industry-wide issues. Based on the knowledge and understanding gained through this process, audit procedures and techniques are incorporated into a written guide to be shared with other districts. The techniques guide provides examiners with information on how the industry operates, its accounting/business practices, common procedures within the industry, sources of information, and unique tax issues.

Specialization puts the Service on a level playing field with both the taxpayer and the practitioner community. MSSP increases the educational level of the examiner while increasing job satisfaction and the self-confidence level of the examiner. In this process, the public image of the IRS is also strengthened. MSSP increases the efficiency and effectiveness of the Service through the development of issues of merit while providing a high degree of consistency in the treatment of those issues. MSSP provides a resource for other examiners to consult to avoid the immeasurable duplication of effort when each agent has to "reinvent the wheel." Specialization is a powerful way for the IRS to acknowledge and respond to the unique business practices of an industry. Such an approach maximizes IRS resources, thus increasing the overall productivity of the Service.

Each District has an MSSP Coordinator who has information on all the market segments in the MSSP program. He or she would be one of your first contacts to obtain industry information. The local MSSP Coordinator receives current updates to the audit guides and industry issues. In addition, there is an MSSP bulletin board that can be accessed to receive industry information. To obtain access to this bulletin board, contact your local MSSP Coordinator.

MSSP has both similarities and differences with ISP. While all examinations have audit techniques and specific tax issues as major components, the primary emphasis of MSSP is development of uniform and effective examination techniques. The major emphasis of ISP is the uniform identification, development, and resolution of tax issues in larger examinations. The MSSP is directed at the general program and examination of all types and sizes of returns. Both programs emphasize knowledge of the industry and its business and accounting practices. They also treat communication with the industry's customers and representatives as an integral part of the process.

The Market Segment Specialization Program IRM Handbook can be referenced for additional information on MSSP.

Commercial banking is included in the Industry Specialization Program (ISP). ISP was established to ensure uniform and consistent treatment of issues nationwide. It also helps to provide for better identification and development of issues. Each industry in the program has released Coordinated Issue Papers and a list of potential issues for use by revenue agents. The Industry Specialist for Commercial Banking is located in New York City. The National Industry Specialist is generally only contacted if an issue has significant nationwide impact, if a Request for Technical Advice is submitted on industry issues, for approval of resolution of a coordinated issue on a basis different than that in the Coordinated Issue Paper, or for Coordinated Examination Program cases.

Each district also has an industry coordinator who is an excellent resource for information on all the industries in the ISP. He or she would generally be your first contact to obtain industry information. The district industry coordinator receives current updates to the Coordinated Issue Papers and industry issues. Contact him or her to obtain copies of the current ISP Coordinated Issue Papers.

Internal Revenue Manual (IRM) 42(14)0 describes the Industry Specialization Program. IRM 42(14)5.23 requires that at the beginning of each examination of a taxpayer included in the ISP, a letter be sent to the taxpayer or its representative. Along with this letter, the taxpayer is to receive copies of the IRM section and the ISP Coordinated Issue Papers for the industry. The banking industry specialist recommends that we provide the taxpayer with copies of both the banking and the savings and loan Coordinated Issue Papers. Exhibit 3-2 contains the sample letter.

It may seem unusual that we are required to inform the taxpayers at the onset of the examination at what areas we will be looking. However, you will find that most banks are aware of the issues and it is helpful to begin discussing their treatment of these items very early in the examination. There are currently four coordinated banking issues: Interest on nonperforming loans, core deposits, gain or loss on foreclosed property, and gross-up net loans. These will all be discussed later in this guide.

The four coordinated savings and loan issues are: Accrued interest on nonperforming loans, core deposit intangibles, validity of Treas. Reg. section 1.593-A(b)(5)(vi), and interest income on the sale of foreclosed property. The first two issues are discussed in this guide. The last two issues would be applicable to a bank only if it has a savings and loan subsidiary. The Industry Specialist for Savings and Loans is located in Los Angeles.

## **SUMMARY**

As soon as you identify a potential issue that requires the assistance of a specialist, a referral should be made. Sometimes the specialists may be able to assist each other. Therefore, it is important that you frequently communicate with them so you can determine how they can help you and each other.

## COMPUTER SPECIALIST ASSISTANCE

### **Purpose and Utilization**

Given the volume and complexity of bank accounting records, auditing techniques often should include CAS support to convert the massive quantity of data into analytical reports. The taxpayer's files are more convenient to review by using computerized reports. The large banks are virtually impossible to examine without the assistance of a Computer Audit Specialist (CAS).

Once a Computer Audit Specialist assistance referral is accepted, it is important to quickly identify which taxpayer data files are needed to provide maximum support for the revenue agent's audit plan. These files should be requested via an Information Document Request (IDR). A sample of an IDR follows.

Sample Information Document Request

Form 4564 Rev. 6/88	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number				
TO: Name of Taxpayer and Co. Div. or Branch		Subject Computer Records				
Please return Part 2 with listed documents to requester identified below.		<table border="1"> <tr> <td data-bbox="1045 474 1222 611">SAIN No.</td> <td data-bbox="1222 474 1515 611">Submitted to:</td> </tr> <tr> <td data-bbox="1045 611 1222 695">Dates of Previous Requests</td> <td data-bbox="1222 611 1515 695"></td> </tr> </table>	SAIN No.	Submitted to:	Dates of Previous Requests	
SAIN No.	Submitted to:					
Dates of Previous Requests						

Description of Documents Requested

Subject Entities:

- 1. (Name & EIN)
- 1. (Name & EIN)

1. Please provide the following 19XX magnetic files in the flat sequential format on reel-to-reel 6250 bpi tape for the above subject entities:

- 1. File Description: General Ledger Transaction History
- 2. File Description: Chart of Accounts
- 3. File Description: Accounts Payable Monthly Transaction Detail
- 4. File Description: Vendor Master

2. Please provide a file dump (10-20 records) for the above listed files.

3. Please provide a file-layout for the above listed files

Response Date:

Information Due By _____ At Next Appointment [ ] Mail In [ ]		
FROM:	Name and Title of Requester	Date
	Office Location	

The following are basic applications, with a brief explanation, of how they may be utilized as banking examination audit tools.

### **APPLICATIONS**

Since the bank's files are usually voluminous, strip the consolidated general ledger by company (each legal entity within the consolidated group) prior to any runs.

1. General Ledger Compare (GLC): The GLC lists each GL account with year end totals for two or three years. The differences are reflected in dollars or percent. The revenue agent (RA) can quickly focus in on accounts with significant changes or unusual trends.
2. Stratification: The stratification is used in conjunction with the GLC. The transaction volume by dollar ranges and monthly distribution for the questionable accounts are shown on the stratification.

This report provides the revenue agent with convenient access to general ledger history which can be analyzed on-site or off-site.

The stratification may be modified for specific "Journal Entry Selections." This may best be accomplished by incorporating an internal sort for journal entry numbers (journal entry number - primary and account number - secondary). Select only the journal entry codes relative to accruals and deferrals. (Request journal voucher and source code listings from taxpayer.) This report will show the distribution of each affected account's accrual or deferral transactions only.

There are several commercial banking potential issues based upon improper accruals and deferrals.

3. Account Selection: After analysis of the stratification, a report can be developed showing all the available, relevant detail for each selected account.

To identify fragmented invoices, sort the general ledger transaction file by invoice number sequence. Invoices, in excess of a specified monetary value, can be printed. Invoices from certain vendors, or invoices charged to certain accounts may also be a selection criteria.

4. W-2 Employment Tax: This program identifies employees whose Federal income tax withholding was under a certain percentage of their gross wages. This application can be performed in lieu of a W-4 check.

5. Data Transfer from Hardcopy or Tape to MICRO (PC): The following are two of several methods to accomplish downloading:
  1. Taxpayer's files stored on magnetic media in ASCII or EPCIDIC format may be transferred by direct access/transfer and converted via software such as Data Junction into Enable database or spreadsheet.
  2. Taxpayer's files stored on hard copy may be scanned to create magnetic files.

Using the Enable database, the CAS or RA can produce reports. As an alternative, the scanned files may be uploaded to a mainframe for CAS applications.

Frequently, commercial banks do not have sufficient Accounts Payable volume for mainframe maintenance. Instead, they are entered on a PC in Lotus 123 and stored on a floppy disk. Since revenue agents do not have Lotus 123 software, the data may need to be transferred or converted to ASCII. CAS support reports or RA reports can then be generated using Enable's spreadsheet or database software.

### **COMPUTER AUDIT SPECIALIST ASSISTANCE BY ISSUE**

1. Core Deposits

- a. Data Transfer from Hardcopy to MICRO (PC):

Banks will usually have a hard copy printout of their calculation of the value of the core deposits.

To accomplish the downloading, the bank's printout of deposit base valuation calculations may be scanned into ASCII format, edited to delete unnecessary titles and fields, and imported to enable spreadsheet or database. Then, the engineer will be able to crunch numbers to correct CORE values, analyze taxpayer's computations, and generate reports as needed.

- b. Statistical Sample:

A sampling plan may be devised to analyze the customer bank accounts used as the basis to compute the value of the CORE deposit intangible. Some examples of items to consider are listed below:

- 1) Determine whether intercompany accounts were included in the computation.

- 2) Identify accounts opened between the date of acquisition and date of final merger. (These are accounts of the acquiring bank.)
- 3) Determine whether accounts used to manage travelers checks were included in the computation.
- 4) Determine whether the average balance rather than the balance at the date of acquisition was used.
- 5) Identify whether accounts with small balances are used. (These have no value in determining core deposit intangibles.)

2. Loan Servicing Rights:

To compute the value of the basis which should be allocated to retained servicing rights, there has been a Lotus spreadsheet developed which includes complex formulas. It is necessary for the CAS to make the following adjustments to the spreadsheet for the Revenue Agent's independent use.

- a. Column B Line 21 is the first month of the mortgage term. From here down to the last month of the term, a formula to generate the correct date relative to the "Sales Date" must be input as in the following examples:

Month 1 A:B21:(D4) @if(@Month(D8)+1=2,@date value(D8+28),@if (@month(D8)+1=4\*or\*@month

(d8)+1=6#or#@month(D8)+1=9#or#@month (D8 )+1= 11, @date value (D3+30), @date value (D8+31)))

Month 2 A:B22:(D4) @if(@Month(B21)+1=2,@date value(B21+28), @if (@month(B21)+1= 4#or#@month

(B21)+1=6#or#@month(B21)+1=9#or#@month (B21) +1=11, @date value (B21+30),@date value (D8+31)))

Month 3 A:B23:(D4) @if(@Month(B22)+1=2, @date value (B22+28), @if (@month B22)+1= 4#or#@month

(B22)+1=6#or#@month(B22)+1=9#or#@month (B22) +1=11, @date value (B22+30), @date value (D8+31)))



- b. Expand columns to accommodate large dollar amounts.
  - c. Add column to summarize yearly total of the net spread.
  - d. Add column to summarize yearly total of the OID income.
  - f. Reduce size in print option, change font, and print using Lotus Sideways.
  - e. Condense: "PKZIP new filename. ZIP old filename." (PKZIP is Detroit District's standard for data compression software. We have a site license for the program. You can download it from the District Bulletin Board System (BBS).)
  - f. Save to 3 1/2" high density disk.
  - g. To reverse compression: "PKZIP new filename. ZIP"
3. Fee Income:

The combination of stratification and account selection applications may assist the revenue agent in determining whether fee income such as VISA fees were booked as income upon receipt or amortized. The revenue agent will usually request detail from selected liability accounts to test both sides (debit and credit) of entries. The Journal Voucher Number normally can show all accounts related to one transaction.

The Stratification is used to identify the liability accounts, the Account Selection gives significant detail which includes journal voucher code or source code, and the Journal Voucher Selection shows all related accounts.

4. SFAS 91:

Generally, SFAS 91 requires lenders to net nonrefundable fees and direct costs associated with generating a loan, and defer and recognize the excess over the life of the related loan as an adjustment to yield. SFAS 91, section 5. The statement provides that similar loans may be aggregated for purposes of recognizing fees, costs, premium, and discount so long as the resulting amount does not differ materially from a loan-by-loan computation. SFAS 91, section 4.

The stratification may be used to help identify possible Balance Sheet accounts which relate to such costs. Once such accounts are identified, the account selections may identify specific entries for further investigation for potential issues such as improper accruals of income.

5. General Expenses:

The following expenses are often selected for an in-depth review. Stratifications and Account Selections are used to show transaction volume and unusual items:

- a. Commission expense
- b. Bad debts
- c. Contingent liabilities expensed in error
- d. Building expense
- e. OREO or REO expenses (Other Real Estate Owned) - costs related to property the bank has repossessed or foreclosed upon
- f. Leasing
- g. Merger and acquisition costs.

**Record Retention Agreement**

In addition to the regular files requested to be retained, (that is, general ledger, accounts payable, vendor master, and W-2 Payroll Master File) retention of the following files should be considered for commercial banks:

Extract from Mortgage Loan Accounts' Records

File Content: This file will contain taxable year end information for Mortgage Loans and Mortgage-backed Securities sold with servicing retained. This file will include the following: Current Principal Balance, Current Escrow Balance, Current Interest Rate, Current Principal Payment, Current Interest Payment, Pre-Calculated Interest, Escrow Payment, Original Amount, Current Year-to-Date Interest, SWAP Lock Principal Amount, Current Pre-Paid Interest, Interest Change Date, First Payment Date, Last Payment Date, Balloon Type, Balloon Terms, Balloon Loan Maturity Date, Secondary Market Code, Percent Sold, Interest Method, Payment Frequency, Loan Instrument, Loan Type, Property Classification, Loan-To-Value Ratio, and Pass Through Rate to Investor.

Extract from Asset Account & Accumulated Account

File Content: This file will contain Real & Personal Property information such as Cost Basis, Description, Asset Code, Placed-In-Service Date, Useful Life, Current Year Depreciation, Prior Year Accumulated Depreciation Method, ITC, and Disposition (that is, Gains, Losses, and ITC Recapture).

Extract from Sale of Mortgage Backed Securities

File Content: This file will contain Owner at Sale Date, Pool Number, Agency or other entity sold to, Mortgage Term, Type of Mortgage (fixed, variable, etc.), Weighted Average Mortgage Rate, Weighted Average Coupon Rate, Guarantee Fee, Mortgage Principal at sales date, Sales Date, Mortgage Date, Maturity Date, Mortgage Group Number, Effective Yield or Discount Rate, Sales Price, Gain/Loss on Sale, SFAS 65 Servicing Gain, Book Amortization of the Servicing, Tax Servicing Gain if different from books, Tax Amortization if different from books, and Deferred Fee for sales in month originated.

Extract from Secondary Market Mortgage Backed Securities

File Content: This file will contain Pool Number, Purchase Date, Face Amount, Type, Date, Maturity, Rate, Factors for 4 Months, Outstanding Balance, Original Discount, Cusip Number, Original WAC, Original WAM, Calculated Remaining Term, Purchased Contractual Term, Historical or Estimated Payments.

Extract from Escrow File

File Content: Monthly history for each mortgage loan escrow account, that is, Date & Amount of Monthly Escrow Deposits and Payments.

Extract from Investment Package Reports

File Content: Monthly data of investment portfolio that is, Premiums, Discounts, Amortization, Interest Earned, Names of Securities, Dates Acquired, Dates Sold, Sales Amounts, and Acquisition Costs.

The above file contents are examples of what have been agreed upon in prior record retention agreements by the revenue agent, taxpayer's information systems personnel, and the computer audit specialist.

It has been found that mortgage and investment data files are usually maintained on a separate database with numerous data fields. The revenue agent and CAS should review the fields to determine which of them may be needed for adjustment calculations. Once these data fields are selected, it is requested they be retained in a flat sequential fixed-length format on magnetic tape reel-to-reel, 3.5" diskette, or 5.25" diskette.

Bank mergers may require special consideration. It will be important to ensure data files from newly acquired companies are accessible and retainable by the acquiring company as soon as the acquired company becomes a legal affiliated group member. Record Retention Agreements should be updated to include the computer records of the acquired company.

INTERNAL REVENUE SERVICE

Department of the Treasury

Person to Contact:

Telephone Number:

Name and Address

Refer Reply to:

Date:

As I stated on the telephone, ABC Bank's Federal income tax return for the year ended December 31, 19XX, has been assigned to me for examination. This letter is to confirm our appointment for June XX, 19XX, at 8:00 a.m., at your office. I have attached a list of documents that I will need to start the audit.

I have also enclosed copies of Publications 1 and 556 which explain the examination process and your appeal rights. At our initial appointment, I can answer any questions you may have regarding this.

The banking industry is part of our industry specialization program. The Internal Revenue Service has an industry specialization program to ensure uniform and consistent treatment of issues on an industry-wide basis throughout the Nation. To better acquaint you with this program, I have enclosed a copy of our Internal Revenue Manual procedures. Also, enclosed are descriptions of the issues currently being coordinated in the banking industry. I would appreciate it if you would review these issues and provide me with your comments and recommendations. We would also like additional suggestions as to other potential issues that may benefit from consideration on an industry-wide basis. I am available to discuss and answer questions concerning the Industry Specialization Program with you.

Please call me if you have any questions. Otherwise, I will plan to meet with you at the scheduled appointment mentioned above.

Sincerely,

Internal Revenue Agent

Enclosures:

## Chapter 4

### INTEREST ON NONPERFORMING LOANS

#### INTRODUCTION

For financial accounting purposes, banks are required to stop accruing interest income when payments on loans become delinquent. For tax purposes, the requirement is much more stringent. The bank cannot stop accruing the interest income on a loan until (1) the bank has been given specific instruction by a regulatory agency that the underlying loan should be charged off as a bad debt or (2) the interest has been shown to be uncollectible on loans that have not been charged off. If interest was properly accrued, but subsequently becomes uncollectible, it is charged off as a bad debt rather than eliminated as an accrual. Banks and the IRS often disagree as to when interest accrual should cease. Since this is a coordinated issue, it needs to be considered during every bank examination.

Historically, banks will stop accruing interest once a loan is 90 days delinquent. Recently, bank regulators have allowed institutions to exercise more judgment in determining when accrual should stop. Interest can continue to be accrued if the collateral for the loan is sufficient, if collection efforts are being made, and if there is a reasonable expectation of collecting the delinquent interest. However, for small accounts, such as unsecured credit card receivables, most institutions still use a cut-off period to stop interest accrual.

For tax purposes, a bank must generally determine on a loan by loan basis the interest on that loan is collectible. The interest on certain loans in nonperforming status are more likely to be accruable for income tax purposes than for regulatory purposes; this is especially true if the interest on the loan is OID. The key distinction between book and tax reporting is that interest must be uncollectible for tax nonaccrual purposes and not merely delinquent as for regulatory nonaccrual purposes. Some examples of loans that would be accruable for tax purposes are listed below:

1. Loans placed in nonperforming status based upon the lapsing of time, such as, 30, 60, or 90 days
2. Loans with partial write-offs
3. Loans with sporadic payments of interest or principal
4. Loans to borrowers who are in default on other loans
5. Highly leveraged transaction loans.

## EXAMINATION TECHNIQUES

1. The accrual for tax purposes often continues longer than accrual for book purposes; this is especially true if the interest on the loan is OID. Therefore, review the M-1 schedule to determine whether there is an M-1 adjustment on the tax. If not, you will probably have an issue. If there is an M-1 adjustment, you will still want to analyze the taxpayer's interest accrual method to ensure it is consistent with the IRS position.
2. Review the bank's annual report to see whether it discusses the corporation's policy regarding the accrual of interest on delinquent loans. It will usually list the amount of interest that would have been accrued if the loans were not in default. This amount provides an indication of the potential amount of the adjustment. However, nonaccrual of a portion of this interest will probably be allowable for tax purposes. Therefore, you will need to request specific information from the taxpayer to determine the amount of interest that should be accrued.
3. Ask the taxpayer to explain the bank's policy for nonaccrual of interest and whether the bank stopped the accrual of interest differently for books than for tax reporting. Also, ask what criteria the bank used to determine when accrual should cease.
4. A sample IDR (see Exhibit 4-1) shows the type of information that can be requested to develop this issue. Request the account balances for interest on nonperforming loans. Also, request lists of the specific loans that were in nonaccrual status at year end. Since it is important to know the current status of these loans, request the bank's most current list of loans in nonaccrual status. Each bank maintains its records differently, inquire as to how you can determine whether the loans were eventually written off or brought current.
5. You need to evaluate the taxpayer's policy for determining when the accrual of interest should stop for tax purposes. Some banks will do a loan by loan analysis to determine when the accrual of interest should stop. There is less audit potential for these taxpayers than for banks which have no book/tax difference. If the bank has analyzed each loan to determine the collectability of its interest, sample the loans to determine whether nonaccrual is proper. Banks which do not have any book/tax differences will often have significant audit potential.

6. Your next step will be to review a sample of the files for loans where interest accrual has stopped. Once payments are delinquent on a loan the bank will establish a file which may contain these items: correspondence with the borrower, property appraisals, the borrower's financial statements, bank internal memoranda regarding collectability, copies of lawsuits, original loan application, statements regarding third-party guarantors, prospectus, bankruptcy records, history of the customer, statements from regulators, memoranda of meetings with the borrower, etc. The following are some items to consider when you are reviewing the loan files:

a. The appraisals in the loan file should show whether the value of the loan collateral is greater than the outstanding interest and loan balances. If so, the taxpayer should continue to accrue interest. Sometimes the debt may be collectible, but the accrued interest will not be. Accrual would not be necessary in those cases. Outside appraisals should be given more credibility than in-house valuations. Ensure that the taxpayer is using market value, not distressed value. The latter is the price the property would sell for if the owner had to sell it immediately.

If the loans are small and there is not any collateral, consider whether the bank's policy regarding nonaccrual of interest is reasonable. It is not always productive to do a case by case analysis of these loans.

b. The loan file should contain information on whether the borrower is continuing to make payments. Even though the borrower may have missed some payments, the loan and interest may be collectible in full. Interest accrual should continue as long as it can be collected.

c. The bank may have initiated legal action against the borrower. Often the bank will anticipate being paid in full once the lawsuit is settled. There should be paperwork in the loan file discussing this activity. Accrual should continue if the borrower has assets which can be used to pay off the loan.

d. The loan file should contain documentation for the restructuring or the renegotiation of loans where the borrower is having difficulty making payments. The bank may stop interest accrual even though the borrower will be able to make full payment under the new terms. Interest should be accrued for tax purposes under the terms of the new agreement. Refer to the discussion of IRC section 1001 later in this guide.

7. Information on foreign loans should be requested from the taxpayer. If the loan is guaranteed by a foreign government, payment of the interest should be reported unless an Allocated Transfer Risk Reserve (ATRR) report has been issued. However, banks often stop accrual of interest on foreign loans when they are delinquent.

8. The taxpayer for tax purposes must continue to accrue interest on loans not charged off until, on a loan by loan basis, the taxpayer substantiates that interest is uncollectible in accordance with Rev. Rul. 80-361, 1980-2 C.B. 164.
9. A taxpayer for book purposes will not accrue interest on a loan that is past due 90 days. In addition, the taxpayer will reverse the unpaid interest that was accrued since the beginning of the quarter or the year. The taxpayer for tax purposes, however, should not reduce interest by the accrued but unpaid amount. Unpaid interest that has been accrued as income and becomes uncollectible must be charged against the bad debt reserve or charged off under IRC section 166. As you will read later, large banks cannot use the reserve method and beginning in 1996 thrifts cannot use the IRC section 593 reserve method. However, this issue may affect banks and thrifts in tax years for which a reserve method was used. Therefore, even if you agree that the nonaccrual of interest is proper, you should determine that previously accrued interest was properly charged off.
- 10 GAAP and RAP generally provide that payments are to be applied first to principal if the loan is in nonperforming status. It is common for banks to also apply the payments on delinquent loans to principal, rather than to interest for tax purposes. However, some banks allocate delinquent payments to interest income for book reporting, but to principal for tax reporting. A bank may prefer to allocate these payments to interest for several reasons. First, it increases the book income that is reported to the shareholders. Second, often the bank charges interest on the principal, but not necessarily on the interest. Lastly, in the event the bank has to obtain a judgment against the borrower, the court is less likely to dismiss principal than interest. Often the tax department is not aware that the payments have been allocated differently for books than for tax.

There should be documents in the loan file indicating how the payments have been applied. If not, obtain a payment history from the taxpayer. If the loan documents indicate that the delinquent payments should be applied first to interest, but the taxpayer has applied them to principal, an adjustment should be made for the unreported interest.

11. It is important to keep in mind that interest on nonperforming loans is a timing issue. The collectibility of the interest is usually resolved in one of three ways within a relatively short period of time:
  - a. The borrower may become current in payments. If so, any nonaccrued delinquent interest would be reported by the taxpayer in the year of payment. Therefore, if you have made an adjustment in the earlier year, the taxpayer should reverse the interest in the subsequent year.



- b. The loan may be charged off. If the loan has become uncollectible, the interest will also be uncollectible. Therefore, any unpaid interest that was accrued by the bank will be deductible in the year of the charge-off.
  - c. The loan may still be delinquent. The amount of nonaccrued interest for a subsequent year may include the balance from the prior year. Therefore, if you are making this adjustment for 2 years, be sure to include the same interest only once.
12. You can read the following article for further information on this subject: Koslov, "Tax Consequences of Managing a Bank's Nonperforming Assets," *Journal of Bank Taxation*, 1989.

## LAW

The Coordinated Issue Paper for accrued interest on nonperforming loans discusses the law in detail. Revenue Ruling 80-361, 1980-2 C.B. 164, which is discussed therein, provides guidelines as to when interest accrual should stop. Contact your district ISP coordinator for a copy of the Coordinated Issue Paper.

After the Coordinated Issue Paper was issued, another court case was decided in favor of the Government regarding the accrual of interest on delinquent loans. In *European American Bank and Trust Co. v. United States*, Cl. Ct. No. 135-82T, 92-1 U.S.T.C. ¶ 50,026 (Fed. Cir. 1992), *aff'g* 20 Cl. Ct. 594 (Cl. Ct. 1990), the Federal Circuit decided that whether the principal on a loan was likely to be repaid was irrelevant to whether the bank could avoid tax on interest income. The bank had applied delinquent payments to principal even though the loan documents provided that the payments were to be first applied to interest. The court said that income should be accrued unless there is no reasonable expectation that it will be paid.

## SUMMARY

This issue is directly related to the bad debt issue that is discussed later in this guide. Often, the examination of the nonaccrual of interest and the charge-off of a loan is considered at the same time. When a debt is determined to be worthless, the accrued but uncollected interest will also be charged off. The facts must be considered for each loan to determine whether accrual should continue. It is not appropriate to use blanket criteria, such as a set number of days, to determine when accrual should stop on delinquent loans.

This issue should be considered during every bank examination. It is important to put the taxpayer on the proper method for accruing interest since this is a permanent timing adjustment. Judgment should be used when determining which accounts and how much deferred interest will be reviewed.

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SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564</b> <b>Rev. 6/88</b>	Department of the Treasury Internal Revenue Service <b>INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>				
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>  Please return Part 2 with listed documents to requester identified below.		<b>Subject</b> <b>Interest on Nonperforming Loans</b>  <table border="1"> <tr> <td data-bbox="1044 520 1193 636"> <b>SAIN No.</b> </td> <td data-bbox="1193 520 1510 636"> <b>Submitted to:</b> </td> </tr> <tr> <td data-bbox="1044 636 1193 703"> </td> <td data-bbox="1193 636 1510 703"> </td> </tr> </table> <b>Dates of Previous Requests</b>	<b>SAIN No.</b>	<b>Submitted to:</b>		
<b>SAIN No.</b>	<b>Submitted to:</b>					

**Description of Documents Requested**

1. Please provide a written explanation of the bank's tax policy regarding nonaccrual of interest on delinquent loans. For example, is there a particular cut-off period that is used, such as 90 days? Is the policy different for commercial loans than for noncommercial loans? Is the interest that has accrued prior to the cut-off period reversed?
2. Please provide a complete list of all year end account balances for interest on nonperforming loans. Accounts for foreign, commercial, and noncommercial loans should be included and broken down by category.
3. Please furnish a list of the particular foreign and commercial loans in nonaccrual status as of the end of 19XX. Include any loans on which interest has been suspended while the loans are being restructured. Include information regarding the type of loan, the borrower, the collateral, the balance of the loan, the amount of delinquent interest, etc.
4. In addition to the examination year reports, please provide a current list of loans in nonaccrual status. (A list from 19XX would assist me in determining the current status of the nonperforming loans which originated in the audit years.)
5. Some of the loans will be listed on the earlier year's nonaccrual lists, but will not be on the subsequent year's list. Please document whether the loans were completely written off, whether the loans became current, or whether the loans were renegotiated.
6. Is it company policy to automatically apply payment made on a delinquent loan to a reduction in principal even if the customer has designated the payment as past due interest? Please provide a written response.
7. M-1 adjustments were made to increase book income for interest that was accrued for tax, but not for book. Please provide copies of the M-1 workpapers which explain these adjustments.

<b>Information Due By</b> _____ <b>At Next Appointment</b> [ ] <b>Mail In</b> [ ]		
<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

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## Chapter 5

### CORE DEPOSITS AND COVENANTS NOT TO COMPETE

#### CORE DEPOSITS

An institution that acquires a bank will typically pay more than the excess of the banks' assets over its liabilities. A portion of this excess amount is attributable to an intangible asset called "core deposits." Core deposits are the deposit base of demand and savings accounts which are generally expected to remain with the bank in the future. Since the depositors have done their banking at the acquired institution for a period of time, it is expected that they will continue to bank there. The bank pays its depositors a lower interest rate than it would pay for borrowed funds. Therefore, this available inexpensive source of funds has value.

#### IRC SECTION 197

IRC section 197 was enacted on August 10, 1993. It provides that the capitalized costs of specified intangible assets, now referred to as "IRC section 197 intangibles," are ratably amortized over a 15-year period beginning in the month of acquisition. The 15-year amortization period applies regardless of the actual useful life of the IRC section 197 intangible. No other depreciation or amortization deduction may be claimed on an IRC section 197 intangible that is amortizable under this provision. Proposed Treas. Reg. section 1.197-2 was published in the Federal Register on January 16, 1997.

Any acquired bank's core deposit base is now defined under the provisions of IRC section 197, as a "customer-based intangible." A customer-based intangible refers to the composition of a market, a market share, and any other value resulting from the future provision of goods or services resulting from relationships (contractual or otherwise) with customers in the ordinary course of business.

According to the House Committee Report, typical examples of customer-based intangibles include: The portion of an acquired trade or business attributable to the existence of a customer base, circulation base, undeveloped market or market growth, insurance in force, investment management contracts, or other relationships with customers that involve the future provision of goods or services.

The term "customer-based intangible" includes the core deposit base and any similar asset of a financial institution. Such assets include items such as checking accounts, savings accounts, and escrow accounts.

The amortizable basis is the adjusted basis (for the purpose of determining gain) of an amortizable IRC section 197 intangible. Generally, this is its cost. The adjusted basis of an IRC section 197 intangible acquired from another entity is determined under the present-law principles applicable to the acquisition of tangible property. For example, if a portion of the cost of acquiring an amortizable IRC section 197 intangible is contingent, its adjusted basis is generally increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is amortized ratably over the remaining months in the 15-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

If a taxpayer acquires a trade or business in a transaction treated under present law as an asset acquisition under either IRC section 338(b)(5) or IRC section 1060, the House Committee Report indicates that the purchase price should be allocated among the amortizable IRC section 197 intangibles using the residual method. It is anticipated that the regulations will be modified to treat all amortizable IRC section 197 intangibles as Class IV assets for this purpose.

The new rules are in effect after August 10, 1993. Transitional rules allow taxpayers to elect to apply the new rules to all property acquired after July 25, 1991. Under this election, the 15-year amortization period applies on a retroactive basis. The election is binding on all taxpayers under common control with the electing taxpayer any time between August 2, 1993, and the date of the election.

Alternatively, taxpayers can elect to apply prior law, rather than the new rules, to property acquired under a binding written contract in effect on August 10, 1993, even if the acquisition date is after August 10, 1993. The law for earlier years is discussed below. See Treas. Reg. section 1.197-1T.

### **EXAMINATION TECHNIQUES FOR CASES UNDER IRC SECTION 197**

1. Review the amortization schedule to verify that customer based intangibles (as well as all amortizable IRC section 197 intangibles) are being amortized on a straight line basis over 15 years.
2. An engineer can review the taxpayer's valuation of the acquired bank to ensure that the taxpayer did not overvalue assets with shorter depreciable lives. Proper valuation is also necessary to determine the amount of gain or loss in the event the taxpayer sells a portion of the acquired assets.

**CORE DEPOSITS PRIOR TO IRC SECTION 197**

The Internal Revenue Service recognizes the existence of intangible assets and allows for their amortization over their economic useful life. To be an amortizable intangible asset, it must be separately identifiable and have a reasonably determinable economic life. If the life is indeterminate, the asset is considered goodwill and no amortization is allowed.

Prior to the enactment of IRC section 197, the Code did not specify whether customer-based intangibles, such as core deposits, were intangible assets subject to amortization per Treas. Reg. section 1.167(a)-3. The crux of the issue is determining whether the customer base (core deposit intangible), existent at the time of the acquisition, is a separable asset from goodwill or going concern value. If it is separable, a further determination must be made as to whether it has a determinable useful life and whether its value has been proven.

In the past, the Government's primary position was that the core deposit intangible was non-amortizable as a matter of law. This was explained in both the banking and savings and loan ISP Coordinated Issue Papers on core deposits. Contact your District ISP coordinator to determine the current status of these papers due to the Supreme Court's opinion in *Newark Morning Ledger*.

Because of the Court's decision, it is now especially important to determine whether core deposits are properly lived and valued. Core deposit issues should be referred to engineers or economists for analysis. The engineer will critique the taxpayer's methodology, the reasonableness of the assumptions and conclusions, etc. The engineer will revalue the core deposit intangible, or require the taxpayer to recalculate this intangible based on current and historical data. Cases sent to Appeals without an analysis of the taxpayer's study will be returned as premature referrals.

**INTANGIBLES SETTLEMENT INITIATIVE - PRE-IRC SECTION 197 CASES**

On February 9, 1994, the Service announced the Intangible Settlement Initiative (ISI) which gives taxpayers a one-time opportunity to resolve intangibles disputes in tax years not affected by IRC section 197. Under the settlement initiative, a taxpayer must agree to adjust the basis of its amortized intangibles by the greater of a 50 percent cost recovery adjustment or a 15 percent minimum concession adjustment. The amount of the required concession depends on the position taken on the return. For further information on the Intangibles Settlement Initiative, consult the ISI Handbook, IRS Document 9233 (2-94), Catalog Number 20566N, or contact your District's large case program.

**APPLICATION OF PRE-IRC SECTION 197 LAW TO CORE DEPOSIT INTANGIBLES**

If the taxpayer declines the ISI offer, allowance of amortization turns on whether the taxpayer can establish that it has accurately determined the life and value of the claimed core deposit intangible. See *Newark Morning Ledger Co. v. United States*, 507 U.S. \_\_\_, 113 S.Ct. 1670, 123 L.Ed 2d 288 (1993). The *Newark Morning Ledger* opinion states that the taxpayer's burden is substantial. Whether a taxpayer can meet this burden depends on the quality and reasonableness of the taxpayer's lifing and valuation methods, and the extent to which they conform to valuation methods mandated in the decided cases and sound financial analysis.

The following is a list of pre-IRC section 197 cases which address lifing and valuation of core deposit intangibles:

1. *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd without published opinion*, 900 F.2d 266 (11th Cir. 1990), *aff'd per curiam*, 919 F.2d 1492 (1990).
2. *IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. 496 (1991).
3. *Banc One Corp. v. Commissioner*, 84 T.C. 476 (1985), *aff'd* 815 F.2d 75 (6th Cir. 1987).
4. *Colorado National Bankshares, Inc. v. Commissioner*, T.C. Memo. 1990-495, *aff'd*, 984 F.2d 383 (10th Cir. 1993).
5. *Trustmark Corp. v. Commissioner*, T.C. Memo. 1994-184.
6. *Peoples Bancorporation v. Commissioner*, T.C. Memo. 1992-285.
7. *First Chicago Corp. v. Commissioner*, T.C. Memo. 1994-300.

The Tax Court has generally accepted taxpayer attempts to predict the attrition rate for the acquisition date deposit funds using historical deposit account attrition rates. The Tax Court seems generally willing to assume that the acquisition date pool of core deposits will diminish at the same rate at which the acquired bank's accounts closed, provided that the projected life is based on pre-acquisition account closing or attrition data. The following factors should be considered in evaluating the reliability of the claimed life in a particular case:

1. Use of the acquired bank's pre-acquisition attrition data is preferable to industry estimates or other potentially non-comparable data.
2. A pre-acquisition observation period of at least one year.



3. The taxpayer's methodology must identify and eliminate account closings due to transfers of funds to other accounts maintained by the same depositor.
4. Historical attrition in high balance accounts should be studied and projected separately from smaller accounts since 95 percent of a bank's total deposits are typically found in less than 5 percent of the accounts and these high balance accounts are much longer-lived than smaller accounts.

The core deposit valuation methodology approach, accepted by the Tax Court, is to quantify the value of core deposits as a low-cost funding source by comparing the bank's projected cost to maintain the core deposits of the acquired bank which exist on the acquisition date (interest paid on deposits plus expenses less service fees) to the estimated cost of the next cheapest alternative source of funds. The value of the core deposit intangible is the present value of the cost savings generated as the pool of deposits diminishes over time.

1. The Tax Court has rejected the "income" method of valuing core deposit intangible and has required taxpayers to present a valuation using the "cost-savings" method described above.
2. The alternative cost of funds, which must be used under the cost savings method, is the rate offered on CDs by the acquired bank, the taxpayer, or competitor banks on the valuation date.
3. Core deposits generally consist of business and personal checking accounts and regular savings accounts. Generally, certificates of deposits, money market deposit accounts, Super NOW accounts, NOW accounts, or other accounts bearing interest rates which fluctuate in response to market conditions are not considered core deposits unless the taxpayer proves that such accounts are not interest rate sensitive. Such interest rate sensitive accounts must be excluded in valuing the core deposit intangible.
4. The Service is not bound by contract allocations to core deposit intangible at least where the allocation does not reflect an arm's length bargain between parties with adverse tax interests.
5. Although the deposit in question may not meet the court's definition of an amortizable core deposit, the deposit may still be amortizable. Thus, if the taxpayer can meet the Supreme Court test for amortization stated in *Newark Morning Ledger*, show with reasonable accuracy that the deposit in question has an ascertainable value separate and apart from goodwill and going concern value of the acquired bank and has a limited useful life, the taxpayer may amortize that deposit. However, this may be a difficult test to meet if the deposit is sensitive to interest rates.

**EXAMINATION TECHNIQUES FOR CASES BEFORE IRC SECTION 197**

1. The facts bearing on the life and value of an acquired bank's core deposit intangible should be developed by the agent, by IDRs, summons procedures, or interviews. Internal memoranda, corporate minutes, acquisition studies conducted by outside consultants, all documents relating to the price negotiations, the purchase agreement, and applications for regulatory approval and related documents should be obtained and reviewed for evidence relating to the acquired bank's deposits.
2. To assist the valuation engineer, the following specific items should be requested from the taxpayer:
  - a. A copy of the taxpayer's valuation report or, if no formal appraisal was prepared, a written explanation of the methodology used to arrive at the claimed value,
  - b. Copies of the appraiser's work papers and all documents relied on in determining life and value of the intangible,
  - c. CD rates needed to calculate the cost of alternative funds,
  - d. Detailed financial statements,
  - e. Historical account closing data, and
  - f. List of deposit accounts and balances on the valuation date.
3. Obtain and review the appraisal of all of the tangible and intangible assets (Class III assets) of the acquired bank.
4. Review all M-1 adjustments and related work papers. Taxpayers often use different values, amortization periods, and amortization methods for book purposes than for tax purposes.
5. A diskette is available to assist agents in redefining the core deposit base and recalculating the deduction based on the *IT&S of Iowa* and *Peoples Bancorporation* cases. This diskette is available on the ISP bulletin board file under CD.ssf.
6. A computer audit specialist can assist you in examining the core deposits issue. Refer to Chapter 3 for additional information.

**COVENANTS NOT TO COMPETE**

A covenant not to compete (also referred to as a noncompetition agreement) is a contract between the buyer and seller of a business, whereby the seller (or officers or key personnel of the seller) agrees to refrain from operating a competing business within a specified territory for a specified length of time. The covenant not to compete may also require that the seller (also called a "covenanter") not hold employment with a competitor. If the terms of the covenant not to compete are reasonable, and if the covenanter is truly being compensated for giving up his or her right to forego business opportunities in a competitive market, then the buyer is entitled to amortize the lump sum payment or installment payments to the seller over the life of the covenant.

Amounts received by the seller for a covenant not to compete are considered to be given as lost earnings and, consequently, are taxable as ordinary income. Conversely, amounts received by the seller constitute capital gains to the extent they are received as consideration for the goodwill or going concern value of the business, or for the sale of stock.

Prior to 1987, the buyer and seller had competing and conflicting tax interests in the allocation of the purchase price of the business to a covenant not to compete. Due to the differential in tax rates between capital gains and ordinary income, the seller benefited with respect to his or her taxes by allocating as little as possible to the covenant not to compete, and allocating as much as possible to the purchase of the business or its goodwill. Similarly, consideration received in payment for stock was preferable to a seller because such payments represent capital gain to the seller to the extent that the consideration exceeds the seller's basis in the stock. The buyer, on the other hand, preferred to allocate as much as possible to the covenant not to compete because that amount is amortizable, *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959), allowing him or her a deduction against ordinary income, *Sonnleitner v. Commissioner*, 598 F.2d 464, 466 (5th Cir. 1979), whereas an allocation to goodwill or going concern value represents a nondepreciable capital investment.

The Tax Reform Act of 1986, generally, eliminated the preferential tax rate for capital gains. Thus, for transactions occurring after 1986, the tax interests of the buyer and the seller with respect to a covenant not to compete are not adverse. With the elimination of the preferential rate, the seller of a business no longer suffers any significant tax disadvantage if more of the purchase price is allocated to the covenant not to compete. Consequently, the seller will be more inclined to agree to a covenant not to compete and to a greater allocation of the purchase price to the covenant. The buyer benefits because he or she can amortize a greater portion of the total purchase price of the acquired business.

In tax years in which there is rough parity between marginal ordinary income and capital gains tax rates, the Service is concerned that excessive amounts are being allocated to the covenants not to compete. In the case of a stock purchase, an amount paid for a covenant not to compete may actually be disguised stock purchase price. Consequently, we can expect to encounter overstated amortization deductions by buyers. Additionally, buyers may attempt to allocate a portion of the purchase price of the business to covenants not to compete because such assets are amortizable, even though the formal agreements between the buyers and sellers contain no allocation to the covenant. Thus, covenants not to compete must be closely scrutinized in order to ascertain whether the allocation lacks economic reality.

Effective for tax years beginning after 1992, the Revenue Reconciliation Act of 1993 increased the maximum ordinary income tax rate to 39.6 percent, while the net capital gains rate continued at 28 percent. However, the enactment of IRC section 197 causes this difference in rates to be important only to the seller. Under IRC section 197, it does not generally matter to the buyer whether an amount is allocated to goodwill or to a covenant not to compete because the buyer can amortize that amount over 15 years. In fact, it may be beneficial to the buyer to have the purchase contract not state an amount allocable to a covenant not to compete so that the buyer can attempt to allocate that portion of the purchase price to a tangible asset that has a shorter useful life. For years after 1992, it may also be beneficial to the seller to have the purchase contract not state an allocation to a covenant not to compete so that the seller does not flag the transaction for the Service, which would require the seller to report the amount paid for the covenant not to compete as ordinary income rather than as capital gain from the sale of the business or asset.

The focus generally is upon the genuineness and the value of the covenant. To the extent that the value of a covenant not to compete is overstated, this amount represents, in substance, what the buyer paid for the seller's goodwill. The courts have developed several tests for determining the validity and value of covenants not to compete.

### **THE ECONOMIC REALITY TEST**

The economic reality test is primarily concerned with whether a covenant not to compete is genuine, that is, whether it has independent business or economic significance. This test was enunciated in *Schulz v. Commissioner*, 294 F.2d 52, 54 (9th Cir. 1961), in which the court stated that "the covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an

agreement." Where the seller is, objectively, likely to pose a threat of competition, courts will probably sustain some allocation to the covenant. Some of the factors that should be considered include:

1. Did the seller have the ability to compete with the buyer?

This question actually embraces a number of considerations:

- a. Seller's customer network and experience.

Compare *Sonnleitner v. Commissioner, supra* (seller had business contacts and demonstrated selling ability) with *General Insurance Agency, Inc. v. Commissioner*, 401 F.2d 324 (4th Cir. 1968) (seller, widow of agency owner, was not considered serious competition because of her inability to successfully manage the company) and *Schulz v. Commissioner, supra* (seller did not have the business contacts and background necessary to compete, and economic conditions were such that it was unlikely that he could successfully compete).

- b. Seller's financial ability to compete.

Compare *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, *aff'd*, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986) (Seller had economic resources to compete with purchaser.) with *Krug v. Commissioner*, T.C. Memo. 1981-522 (Seller was ill and lacked the financial resources to compete.).

- c. Seller's physical ability to compete, that is, age and state of health.

See, for example, *Major v. Commissioner*, 76 T.C. 239 (1981) (Covenant had minimal value where the seller was of advanced age and had health problems).

- d. Non-contractual restrictions that would have prohibited the seller from competing in absence of the covenant not to compete, such as limited market entry.

This factor may be important where a covenant is granted in conjunction with the transfer of a franchise, license, or operating authority where market entry is limited. See, for example, *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979) (Seller would need an FCC license to compete, which it was unlikely to obtain.); *Major v. Commissioner, supra* (Seller of freight firm would have to acquire interstate operating authorities, which were difficult to obtain from ICC.).

- e. Seller's intention to compete, either by acquiring or by starting a new business in the same market, or by seeking employment with an existing competitor.

A covenant not to compete is not meaningful if the grantor of the covenant has stated his intention to retire or to leave the geographic area covered by the covenant, and thus, poses no real threat of competition. If the grantor has the ability to change plans and re-enter the market, the covenant is more likely to meet the economic reality test. See, for example, *Ansan Tool and Manufacturing Co., Inc. v. Commissioner*, T.C. Memo. 1992-121 (Court agreed that taxpayer's management had reason to be concerned that departing shareholder-manager might accept employment from a rival firm and take clients away, and thus it was of paramount importance that a covenant not to compete be included in the final buy-sell agreement.) *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, *aff'd*, 789 F.2d 1243 (7<sup>th</sup> Cir.), *cert. denied*, 479 U.S. 995 (1986) (Covenant not to compete negotiated in conjunction with taxpayer's purchase of another corporation's cereal binder operations was of considerable value to the taxpayer because other corporation would continue to sell resin-coated sand in the foundry market in competition with cereal binders; Tax Court found that covenant was valid where other corporation possessed the resources to re-enter the cereal binder market.).

2. Was the payment intended as compensation to the seller in lieu of his employment in a competing venture?

This issue goes to whether the amount purportedly paid for the covenant not to compete was actually paid as an inducement for the seller to refrain from competition. It embraces such questions as:

1. Does the payment for the covenant realistically compensate the seller for his loss of earnings by not competing?
2. If the payment for the covenant is to be made in installments, are the payments to the seller conditioned on his or her survival, or is the remaining balance of payments payable to the estate?

In *Ackerman v. Commissioner*, T.C. Memo 1983-469, *aff'd*, 789 F.2d 1243 (7<sup>th</sup> Cir.), *cert. denied*, 479 U.S. 995 (1986), one of the factors which influenced the Tax Court to find that a portion of the purchase price was mutually intended as consideration for the taxpayer's covenant not to compete was the fact that the payments due with respect to the covenant during the term of the covenant terminated in the event of the seller's death.

3. Are there any other factors that reflect the economic reality of the covenant?

Numerous additional factors have been considered by courts in reaching a determination concerning the economic reality of a covenant not to compete. They include:

- a. Formalities of the covenant
- b. Enforceability of the covenant
- c. Scope of the covenant

See, for example, *Dixie Finance Co., Inc. v. United States*, 474 F.2d 501 (5th Cir. 1973) (Court found covenants lacked economic reality where payments to shareholders were based upon percentage of stockholding, including payments to two shareholders who refused to sign the noncompetition agreement, and purchaser did not police the agreement to ensure that sellers abided by its terms.); *Montesi v. Commissioner*, 40 T.C. 511 (1963), *aff'd*, 340 F.2d 97 (6<sup>th</sup> Cir. 1965) (Court found covenants bona fide where noncompetition agreements were entered into with only some shareholders, and each covenant was for the same amount irrespective of the shareholder's stock ownership.); *Howard Construction, Inc. v. Commissioner*, 43 T.C. 343 (1964), *acq.*, 1965-2 C.B. 5 (Court found that purchaser lacked concern about competition where covenant prohibited sellers from managing a similar business, but did not prohibit them from purchasing a similar business.).

### THE MUTUAL INTENT TEST

The mutual intent test looks at whether the parties to the buy-sell agreement mutually agreed that some portion of the total consideration paid for the going concern was intended for the covenant not to compete. This test is applied where the agreement contains a covenant not to compete, but the purchase price is stated as a lump sum for the entire transaction, that is, there is no express allocation of a specific amount to the covenant. While the failure to allocate a portion of the purchase price appears to be good evidence that the parties did not intend one, *Major v. Commissioner, supra*, 76 T.C. at 250, the mere absence of an allocation to the covenant does not give rise to an inference that the parties affirmatively intended to make no allocation (or a zero allocation). *Better Beverages, Inc. v. United States*, 619 F.2d 424 (5th Cir. 1980). Therefore, courts have tended to look at actual contract negotiations to determine whether the parties intended the covenant to have any value. *Patterson v. Commissioner*, 810 F.2d 562 (6th Cir. 1987); *Better Beverages, supra*. Mutual intent

is usually found where the parties bargained over the inclusion of the covenant not to compete, or where it was understood that the covenant was an essential part of the agreement. The "economic reality test" plays a role in this inquiry: The covenant not to compete must also have some independent basis in fact such that the parties might bargain for it. Mutual intent may also be found where:

1. Other language in the agreement evidences the parties' intent that the consideration includes an unspecified amount for the covenant. See *Illinois Cereal Mills, supra; Peterson Machine Tool, Inc. v. Commissioner*, 79 T.C. 72 (1982), *aff'd*, 54 A.F.T.R. 2d 84-5407 (10th Cir. 1984).
2. There is uncontroverted testimony regarding the parties' intent. See *Kreider v. Commissioner*, 762 F.2d 580 (7th Cir. 1985).

Mutual intent will usually be found where the covenant was an essential part of the sales agreement or was separately bargained for. See *Ansan Tool and Manufacturing Co. v. Commissioner, supra; Peterson Machine Tool, Inc. v. Commissioner, supra*. Under such circumstances, the covenant has some value, but an ambiguity exists in the buy-sell agreement -- the ambiguity being just how much of the lump sum consideration was exchanged for the covenant. The court will then proceed to resolve the ambiguity -- that is, it will assess the covenant's independent economic value. *Patterson, supra*. For example, in *Ansan Tool and Manufacturing Co., supra*, the buyer insisted upon a covenant not to compete due to the seller's prominent role in the business. The seller was capable of competing in a new or existing business, and so the economic reality test was met. However, the stock purchase agreement made no allocation of a part of the purchase price to the covenant. The court held that the buyer had met its burden of establishing that the parties required a covenant, and therefore some allocation was called for. Similarly, in *Wilson Athletic Goods Manufacturing Co. v. Commissioner*, 222 F.2d 355 (7th Cir. 1955), the parties did not, in their agreement, allocate a portion of the purchase price to a covenant not to compete which clearly possessed some value. In that case, a major sporting goods manufacturer purchased a shoe factory which produced athletic shoes marketed under the "Wilson" name. The Tax Court found that an unapportioned amount of the purchase price was allocable between goodwill and the seller's covenant. The Seventh Circuit reversed, finding that the taxpayer had demonstrated that all of the unapportioned amount was paid only for the covenant, since Wilson would market the shoes through its own channels and, thus, the seller's goodwill was not of value to it. See also *Kinney v. Commissioner*, 58 T.C. 1038 (1972). (Both parties had attached considerable value to the covenant not to compete, but were unable to agree upon a precise allocation.)



It may be, however, that while the parties engaged in negotiations over a covenant not to compete, no mutual agreement was ever reached concerning the allocation of price to the covenant. For example, if the parties discussed a price for the covenant, but a specific allocation to the covenant was not included in the final agreement, this may be evidence that the parties could not reach an agreement.

See, for example, *Patterson v. Commissioner*, *supra*, 810 F.2d at 573; *Annabelle Candy Co. v. Commissioner*, 314 F.2d 1, 4 (9th Cir. 1963). In *Theophelis v. Commissioner*, 751 F.2d 165 (6th Cir. 1984), *aff'g* 571 F. Supp. 516 (E.D. Mich. 1983), the seller and buyer never discussed a possible allocation to the covenant not to compete until their final meeting, when they agreed in effect not to allocate any specific part of the purchase price to the covenant, but rather, they would allow the Internal Revenue Service to determine its value when the first of the parties to the sale was audited. See also *Forward Communications Corp. v. Commissioner*, *supra* (Covenant not to compete found to have no value or minimal value where parties agreed to pay a sum certain for the assets of the seller and the purchase price was not altered when the covenant was later added.).

In contrast, where the parties never even discussed the covenant, the courts have found mutual intent to allocate nothing to it. The court will not go further to examine the economic reality of the covenant. See, for example, *Lazisky v. Commissioner*, 72 T.C. 495 (1975); *Better Beverages, Inc.*, *supra*. If nothing was paid for the covenant, there is nothing for the buyer to deduct. *Theophelis*, *supra*, 751 F.2d at 167.

### **THE STRONG PROOF DOCTRINE AND THE DANIELSON RULE**

These tests are applied only when one of the parties to the buy-sell agreement seeks to establish a different value for the covenant than the one specifically stated in the contract. Although the Service is not bound by the allocation, the courts are likely to give effect to the agreed allocation where the parties have tax adversity.

Between the parties, the allocation in their written agreement is generally binding. Where the parties clearly and unequivocally allocated a portion of the total consideration to the covenant, some courts have refused to allow one of the parties to subsequently alter the tax consequences of the expressed amount unless he or she can overcome the contract terms by strong proof that the agreement does not reflect the parties' true intentions. This is known as the "strong proof" doctrine. See, for example, *Meredith Corp. v. Commissioner*, 102 T.C. No. 15 (March 14, 1994), as an example of the Tax Court's use of the strong proof doctrine.

The Commissioner prefers the approach of other appellate courts<sup>1</sup> which, relying on *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967), require an even stronger degree of proof before one party will be permitted to alter the allocation for tax purposes. Under the "*Danielson* rule," a party may contradict an unambiguous contractual term, for tax purposes, only by offering proof which would be admissible in an action between the parties to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, or duress. 378 F.2d at 778–779.

### **VALUATION OF A COVENANT NOT TO COMPETE**

The taxpayer has the burden of proving that he is entitled to a deduction. *Welch v. Helvering*, 290 U.S. 111 (1933). Because the amount paid for a covenant not to compete represents compensation to the covenanter, the taxpayer bears the burden of proof for establishing the proper amount attributable to the covenant. The value allocated to the covenant must reflect economic reality. This is a second, separate test from the economic reality test described above. It is possible for a covenant not to compete to possess economic reality, while the amount allocated to its value may not reflect economic reality. The same factors as those listed above have been considered for this purpose.

The purchaser's basis derives from the cost that he or she was actually required to pay to obtain the covenant. Evidence of value is material only if probative of actual cost or as to what portion, if any, of the lump sum price was required to obtain the covenant. In *Better Beverages, supra*, the court recognized that there is not a sufficient correlation between the value of a covenant to the purchaser and its value to the covenanter, such that the purchaser's evidence of value to him or her is inadequate to prove actual cost. The interest relinquished by the seller is not parallel to that sought or received by the purchaser:

The value of such a covenant to a purchaser \* \* \* derives from the projected degree of increased profitability and likelihood of survival of its new enterprise attributable to the insulation of that enterprise, afforded by the covenant, from the deleterious competitive force that the seller could present. Value to the seller, on the other hand, is the measure of his foregoing the opportunity to re-enter a particular market for a given period. Consequently, because they are functions of totally independent sets of considerations, the respective values of the covenant to the buyer and seller are simply unrelated.

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<sup>1</sup> The *Danielson* rule has been adopted by the Third, Fifth, Sixth and Eleventh Circuits. See *Danielson, infra*; *Spector v. Commissioner*, 641 F.2d 376 (5<sup>th</sup> Cir. 1981); *Schatten v. United States*, 746 F.2d 319 (6<sup>th</sup> Cir. 1984); and *Bradley v. United States*, 730 f.2d 718 (11<sup>th</sup> Cir. 1984). The Eighth Circuit, in a case decided prior to *Danielson*, adopted a similar rule. *Sullivan v. United States*, 363 F. 2d 727 (8<sup>th</sup> Cir. 1966). Although the Tax Court has rejected the *Danielson* rule, preferring the less stringent strong proof rule, under the doctrine of *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court will follow a United States Court of Appeals decision which is squarely on point where appeal of Tax Court decision would lie in a particular circuit.

See *Better Beverages, Inc. v. United States*, 619 F.2d at 430.

One reasonable method to value a covenant is the compensation-based approach. Under this method, the covenantor's (seller's) average compensation (including salary, bonuses, and benefits) is calculated, this amount is projected over the life of the covenant, and a discount rate is applied to adjust the figure to present value. This method measures the loss of earnings anticipated by the seller as a result of his forbearance from competing in the specified market.

In some complex buy-sell agreements, however, a court may find the compensation-based approach too simplistic. Valuation texts, in discussing covenants not to compete, refer to a second method which values what the buyer acquired: Protection of the continued profitability of the business from the seller's hostile use of his or her contacts in the market. This method calculates the present value of the economic loss to the buyer on the assumption that the seller re-entered the market. Such an approach was sanctioned by the Tax Court in *Ansan Tool and Manufacturing Co. v. Commissioner*, T.C. Memo. 1992-121, where the compensation-based method was determined inadequate for the unique arrangement between the taxpayer and the seller in a stock buy-out.

Courts will also look to the value claimed for the covenant relative to the values of the other assets acquired. See, for example, *Patterson v. Commissioner, supra*; *Peterson Machine Tool, Inc. v. United States, supra*. For example, in *Dixie Finance Co. v. United States*, 474 F.2d 501 (5th Cir. 1973), where the amount that the taxpayer allocated to the stock purchase was less than its fair market value, the court refused to allocate any of the purchase price to a covenant not to compete. In *Wilson Athletic Goods Manufacturing Co. v. Commissioner, supra*, on the other hand, the court found that the excess purchase price paid for the assets of a shoe manufacturer was allocable to a covenant where the buyer was not interested in acquiring the goodwill of the seller.

Finally, there are situations where the same parties execute both a covenant not to compete and an employment contract. Both agreements need to be evaluated carefully because their provisions may overlap, and thus, so may their values. An employment agreement may convey similar benefits and cover the same time period as a covenant not to compete, and arguably its value is not separate and distinct from the value of the covenant.

### **EFFECT OF IRC SECTION 197**

For transactions occurring after the effective date (including the election-back date) of the Omnibus Budget Reconciliation Act of 1993, a covenant not to compete which is entered into in connection with the direct or indirect acquisition of an interest in a trade or business is an IRC section 197 intangible. Amounts paid or incurred for a covenant not to compete are ratably amortized over 15 years, even if the duration of the covenant is less than 15 years.

An arrangement similar to a covenant not to compete is also treated as an IRC section 197 intangible. For example, excessive compensation or rental paid to former owner of a business for continuing to perform services or to provide the use of property is considered an amount paid for a covenant not to compete. Under the legislative history for IRC section 197, whether compensation is excessive is determined by comparing the compensation under the covenant to the services actually rendered.

An amount paid under a covenant not to compete which actually represents additional consideration paid for stock in a corporation is not an IRC section 197 intangible, and must (as under pre-1993 case law) be added to the basis of the acquired stock. Proposed Treas. Reg. section 1.197-2 was published in the Federal Register on January 16, 1997. See also, Treas. Reg. section 1.197-1T.

### **EXAMINATION TECHNIQUES**

1. Agents are advised to review Form 8594 Asset Acquisition Statement Part II for the allocation of the purchase price to the appropriate asset class. If there are any questions regarding the allocation, your inquiries should be directed to the taxpayer for an explanation.
2. In Part III of Form 8594, special attention should be paid to the column headed "Useful Life." If the amortizable intangible asset is an IRC section 197 intangible, the useful life should be 15 years or more. If it is not, an adjustment should be made to the amortization of the acquired asset.
3. Agents are also advised to request all appraisals relating to tangible assets which were transferred in the acquisition. Under the new law, it will be attractive for taxpayers to allocate more of the purchase to tangible assets than to intangible assets due to the fact that shorter depreciable lives are available under MACRS.

4. The examiner may obtain information relative to the conditions of payment, formalities, enforceability, and scope of the agreement by examining the covenant document itself. However, this usually is inadequate to evaluate the covenant for economic reality and mutual intent. Therefore, the examiner is strongly encouraged to interview both the buyer and the seller to gather facts, rather than rely on opinions. Further, after each interview, the examiner should have the interviewee (especially the buyer) sign an affidavit as part of the factual development since this will improve the chances of the issue being sustained by Appeals.
5. See the sample IDRs in Exhibit 5-1. This may need to be modified depending on whether IRC section 197 applies to the covenant.
6. For covenants not to compete executed in years prior to the enactment date of IRC section 197 (or the election back date available for transactions between July 25, 1991, and August 10, 1993), three tests should generally be applied to determine whether the covenant is amortizable.
  - a. Economic Reality:
    - 1) Is it genuine? Would or could the seller compete if the covenant did not exist?
    - 2) What is the covenantor's ability to compete? Are there restrictions such as age or health, market entry restrictions, financial limitations?
    - 3) Does the covenantor have business contacts in the industry? What is his or her reputation, both in the firm and the industry?
    - 4) What are the covenantor's intentions? Does he or she have plans for present or future endeavors? Has he or she entered into an employment agreement with the buyer or with another firm? Does he or she contemplate a move away from the area?
    - 5) Are there market factors that affect the covenantor's ability to engage in competition, such as type, size, territory of the market; barriers to market entry; market saturation; or general economic conditions?
  - b. Mutual Intent:
    - 1) Is the consideration paid for the covenant not to compete separately stated in the acquisition agreement or in the covenant, or is it included in a lump sum purchase price?

- 2) Did the parties to the agreement bargain over inclusion of the covenant? Did the buyer make the acquisition conditional upon inclusion of a covenant not to compete? Was the covenant a last-minute addition to the acquisition agreement?
  - 3) Is there other language in the agreement that evidences the parties' intent that the consideration includes an unapportioned amount for the covenant?
  - 4) Do both parties agree that the covenant not to compete has value?
- b. Value of the Covenant:
- 1) Does the taxpayer's claimed basis in the covenant match the allocation in the agreement? Does the apportionment of the purchase price claimed by the buyer match the amount reported by the seller?
  - 2) Does the amount allocated to the covenant not to compete reflect economic reality? If the covenant was given in conjunction with the sale of stock, was the consideration paid for the stock reasonable or excessive? If the covenant was given in conjunction with an asset acquisition, does it reflect the value of the covenantor's opportunities foregone?
  - 3) If the seller has an agreement to render post-acquisition services to the buyer or rent property to the buyer, is the consideration for such services or rental excessive?
  - 4) Is there also an employment agreement between the buyer and seller? Do its terms overlap with the covenant not to compete?
  - 5) What is the value of the covenant in relation to the other assets acquired?

### **SUMMARY**

A bank may be amortizing a number of intangible assets for tax purposes. Two of the most common are core deposits and covenants not to compete. If a bank you are examining is amortizing these assets, you may need to request the assistance of an engineer to help determine whether the taxpayer has assigned reasonable values and is using the correct amortization period and method.

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SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564</b> <b>Rev. 6/88</b>	<b>Department of the Treasury</b> <b>Internal Revenue Service</b> <b>INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>           <b>Please return Part 2 with listed documents to requester identified below.</b>		<b>Subject</b> Amortization of Intangibles  <hr/> <b>SAIN No. Submitted to:</b>     <hr/> <b>Dates of Previous Requests</b>

**Description of Documents Requested**

Provide the following documents regarding each acquisition which occurred during this audit cycle:

1. The Quarterly Reports, Annual Financial Statements, SEC filings, etc. for each acquired company for the prior two years.
2. A list of the fixed assets received from each acquired company.
3. A copy of the purchase agreements for each acquired company.
4. A copy of the appraisal of each acquired company.
5. A copy of the lifing studies, valuation studies, etc. for any acquired core deposits, servicing rights, or other intangible.
6. A copy of the schedule showing the amount amortized for core deposits, servicing rights, and other intangibles. This should include the total amount subject to amortization, the method of amortization being used, the period over which it is being amortized, the current years' amortization amount, etc.
7. Is the amount of amortization computed differently for book purposes than for tax purposes? If so, please explain the differences
8. Copies of M-1 adjustments and work papers for core deposits, purchased servicing rights, and all other intangibles that were acquired.

**Information Due By** \_\_\_\_\_ **At Next Appointment**  **Mail In**

<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	



SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564</b> <b>Rev. 6/88</b>	<b>Department of the Treasury</b> <b>Internal Revenue Service</b> <b>INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>          <b>Please return Part 2 with listed documents to requester identified below.</b>		<b>Subject</b> Covenant Not to Compete  <hr/> <b>SAIN No. Submitted to:</b>     <hr/> <b>Dates of Previous Requests</b>

**Description of Documents Requested**

With respect to the acquisition of the covenant not to compete, please provide the following information and documents:

1. A copy of the covenant(s) not to compete entered into by the various individuals or entities involved.
2. Identify who these individuals are and if there are any non-owners among this group.
3. A complete copy of the purchase agreement including all applicable schedules and exhibits.
4. A copy of any appraisals performed as a result of this acquisition including all supporting schedules and exhibits.
5. The current address and phone number of each of the principle sellers of this business.
6. A copy of the financial statements or tax returns for this business for five years before the acquisition.
7. Copies of M-1 adjustments and work papers for covenant not to compete.

**Information Due By** \_\_\_\_\_ **At Next Appointment** [ ] **Mail In** [ ]

<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

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## Chapter 6

### GAIN/LOSS ON FORECLOSED PROPERTY

#### INTRODUCTION<sup>1</sup>

Banks typically refer to foreclosed property as OREO property. This is an acronym for other real estate owned. OREO property typically is property obtained by the bank due to the inability of the debtor to pay off a loan.

OREO property can be acquired by the bank in either of two ways:

1. Voluntary conveyance of the property in settlement of the obligation to the bank. This process is known as deed in lieu of foreclosure. This is accomplished when the mortgagee and the mortgagor agree to convey the property in settlement of the debt to avoid the costs, delays, the unfavorable publicity, and other problems associated with a foreclosure sale.
2. The property can also be acquired through a formal foreclosure of the property by the bank. This method is normally handled through the court system.

In both of the above two situations, the bank will literally take title and possession to the property. The tax consequences to the bank are exactly the same in both a voluntary deed in lieu of foreclosure and in the formal foreclosure proceedings where the deed is transferred under a court order.

A loan renegotiation should not be confused with a foreclosure. A modification of the original loan terms usually results in a continuation of the debtor-creditor relationship. The examiner should consider the effects, if any, of *Cottage Savings* and the final Treas. Reg. section 1.1001-3 and determine whether the modification of the loan document is significant. For a more complete discussion of the *Cottage Savings* case and the regulations, refer to the chapter titled Loan Swaps.

Essentially, there are four potential areas for the examiner to consider when reviewing OREO property:

1. Computation of the gain/loss upon foreclosure or repossession, involving,
  - a. Fair Market Value of the property received, and
  - b. Basis of the loan used for determining gain/loss.

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<sup>1</sup> The tax treatment of foreclosed property acquired by thrifts is governed by IRC section 595 which will not be discussed in this section. IRC section 595 was repealed for property acquired after December 31, 1995, by section 1616(b)(8) of P.L. 104-188, signed August 20, 1996. The discussion which follows concerns only the treatment of foreclosed property acquired by commercial banks.

2. Capitalization of costs during and after foreclosure or repossession.
3. Character of the gain or loss reported by the bank.
4. Covered sales.

Each of these areas are discussed in this section of the guide.

The receipt of foreclosed property by a bank is considered to be a payment for the outstanding obligation. The bank must recognize a gain or loss on transaction for tax purposes. The amount of the gain or loss is the difference between the basis of the loan and the fair market value of the property received. The starting point for determining the gain or loss in both a foreclosure sale and a transfer of the deed in lieu of foreclosure is the debt's adjusted basis.

### **COMPUTING THE BASIS OF THE LOAN FOR TAX PURPOSES**

1. The starting point is the unpaid balance of the loan remaining at the time the collateral is repossessed by the bank. This amount is reduced by any charge-offs taken for tax purposes during the year, or in prior years. For example, if the bank originally provided a loan for \$100,000, received \$10,000 in principal payments, and subsequently wrote off \$20,000 as being uncollectible, the basis of the loan for tax purposes would be \$70,000. This amount does not necessarily tie into the book or legal balance of the obligation remaining for financial reporting purposes.
2. The basis of the loan is increased by any interest income which was accrued by the bank and previously reported as taxable income. This assumes that the interest remains uncollected by the bank at the time the property is transferred to OREO property.
3. The basis of the loan is further increased by other costs, such as back taxes, insurance, legal expenses, and similar items paid by the bank for protecting the value of the property prior to the transfer of ownership to the bank. Legal costs and other similar expenses incurred in connection with the foreclosure proceedings increase the basis of the OREO property.

This chapter on foreclosed property should be read in conjunction with the chapter on bad debt deductions, which is included later in this guide. A loss realized upon foreclosure is normally deducted as part of the bank's overall bad debt deduction, while a gain is recognized as ordinary income. See Revenue Ruling 74-159, 1974-1 C.B. 232.

## EXAMINATION TECHNIQUES

1. One of the most common issues in the foreclosure area involves the valuation of the OREO property when ownership is transferred to the bank. The fair market value of the property must be determined to establish and document the amount of the bank's deductible gain or loss. Generally, the burden of proving the fair market value rests with the bank. Estimates of the value of the OREO property should not be accepted. However, for purposes of determining gain or loss (other than with respect to the bad debt deduction) on the transaction, the FMV of the property is rebuttably presumed to be the amount bid-in by the taxpayer. The burden, of proving that FMV is not the bid-in price, rests with the party rebutting the presumption. See *Community Bank v. Commissioner*, 62 T.C. 50 (1974).

The easiest and most accurate method for determining the fair market value of the OREO property is to request that the bank provide a written appraisal from a professional independent appraiser. This request is not as unreasonable as it may sound. The bank will normally have already secured a complete appraisal for most, if not all, major property acquired through foreclosure. If the bank does not have an appraisal of the property, secondary evidence should be used. This would include property tax valuations, past appraisals, third party purchase offers for the property, and anything else in the loan file which indicates the value of the OREO. Remember, for purposes of computing its bad debt deduction, it is the taxpayer's responsibility to substantiate the fair market value. Failure to properly document the value of the property at the time of foreclosure can result in the disallowance of the bad debt deduction taken for that OREO property.

2. When reviewing the computation of the gain or loss reported for tax purposes, look very closely at the numbers. The full appraisal amount should be used when computing the taxable gain or loss upon foreclosure. It is common practice for the bank to reduce the fair market value of the property by the projected selling expenses, the estimated costs to hold the property until sold, the estimated costs of any improvements, plus other related expenses. If the taxpayer uses this net realizable value, the result will be an overstatement of the loss, or an understatement of the gain on the transaction. While this reduction for other costs is required for book purposes, it is not acceptable for tax purposes.
3. One of the most common issues to consider in this area deals with the expenses which are deducted by the bank during the period of time the repossessed property is held for sale.

In many cases the bank will deduct as current expenses such items as prior year property taxes, selling expenses, substantial repairs and improvements, and the legal expenses of acquiring the property. These expenses are of a capital nature and are not currently deductible. These amounts are considered to be part of the cost of the property until sold.

After the bank takes possession of the property, no portion of the expenses is currently deductible if the bank is holding the property for resale or sale to customers. The OREO property is similar to inventory, and therefore, all expenses are considered to be part of the basis of the property. If, however, the bank is holding the property out for rent, normal maintenance expenses, including depreciation, are deductible by the bank when incurred.

Foreclosure expenses can usually be found on the return under classifications such as ORE expenses, (other real estate expenses), legal expenses, or repossession expenses. These accounts should be thoroughly reviewed for these types of deductions. The bank's policy for these type of expenses should also be reviewed to determine how they are being handled for tax purposes.

4. Another issue which can have significant tax consequences involves the sale of OREO property which is financed by the selling bank. Industry regulators refer to these property sales as covered sales. This consists of foreclosed property which is sold by the bank but financed with over 90 percent of funds provided by the selling bank, or the financing offered by the bank is on terms more favorable than customarily offered to its customers.

These transactions are not considered sales for regulatory purposes unless the purchaser contributes over 10 percent of the purchase price. No gain is recognized by the bank since the majority of the funds used to finance the transaction were bank funds. For tax purposes, the property is generally considered sold when title passes. Therefore, it is subject to the gain/loss procedures. A significant amount of deferred gains could exist if the bank finances its foreclosure sales, especially for community banks.

If the bank offers this type of financing, request a statement of the bank's policy concerning these transactions along with a complete list of OREO property financed by the bank. This list should be reviewed to determine if the sale was properly reported for tax purposes.

Schedule M-1 should reflect any book/tax difference on the recognition of these covered transactions.

5. Once a bank has converted a loan to OREO property, no additional bad debt write-downs or charge-off's are permitted for tax purposes with respect to the old loan or the OREO property. If the bank also finances a new buyer's acquisition of the OREO property, that loan should be reflected on the bank's books for tax purposes.

Review the expense accounts for any write-downs the bank may have deducted. In some cases, the bank will have an account titled "OREO write-downs," which will allow you to easily identify any deductions claimed.

It should be noted that the above positions in connection with mortgage foreclosures assume that the bank does not actively sell foreclosed property within the ordinary course of the bank's business. A bank that actively and regularly sells foreclosed property may be classified as a dealer in real estate, in which case the tax implications may be different.

All of the above issues are timing adjustments. Before a lot of time is spent in this area, consideration should be given to the period of time it takes the bank to sell or otherwise dispose of the foreclosed property. This is the turnover rate. If it is the bank's policy to dispose of the property almost immediately, any disagreements over an appraisal or costs to be capitalized are of no consequence. The bank would be entitled to these deductions at the time the property is sold.

### **COORDINATED ISSUE PAPER**

The coordinated issue paper dealing with foreclosed property (which involved the character of the gain or loss reportable by a bank on the sale of foreclosed property or securities received as part of a debt restructuring) relied on the "***Corn Products***" doctrine which was substantially modified by the Supreme Court in the ***Arkansas Best*** case. Therefore, the issue paper as originally written is no longer technically correct. If you have this issue, please contact the Industry Specialist for Commercial Banking for an update of the current IRS position.

It is presumed for both regulatory and financial accounting purposes that OREO property is property held for sale to customers. Although this presumption is not controlling for tax purposes, if such property is held for sale to customers in the ordinary course of the bank's trade or business, then under IRC section 1221(1) gains or losses are ordinary deductions.

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## Chapter 7

### GROSS-UP NET LOANS

#### INTRODUCTION

The fourth and final coordinated issue in the commercial banking area deals with banks involved in foreign or international operations. Normally, the smaller community banks, and even most of the mid-size banks, do not have any international operations and seldom get involved in foreign transactions. Accordingly, this coordinated issue will have no effect on those cases. However, most of the larger banks have significant international operations. These cases will have "international issue" stamped on the front of the tax return and will include various international forms within the return. The revenue agent usually will not examine the international issues. Rather, they will rely on the expertise of a trained international agent. Chapter 3 of this guide includes a section on the involvement of specialists. If your case has any potential international issues, refer to that section for information on requesting the assistance of an international agent.

#### COORDINATED ISSUE PAPER

The coordinated issue involves the gross-up of net loans.<sup>1</sup> Specifically, whether an amount equal to the foreign withholding taxes due to be paid by borrowers pursuant to "net" loan agreements must be included in the gross income of the lender in the taxable year in which the obligation of the borrower to pay such taxes arose.

If the foreign withholding tax is creditable and included in the income of the lender, whether such taxes recognized for purposes of inclusion in the lender's gross income are also considered documented for purposes of the foreign tax credit, in accordance with IRC section 905.

This issue is not as important as it was in the late 70's and early 80's. The banking industry has attempted to comply for the most part with the coordinated issue paper. The real issue is that many banks have grossed-up taxable loans only where they obtain tax receipts.

Part of the problem lies with the substantiation of the foreign tax credits. Taxpayers insist that because they do not have a tax receipt, they can use secondary evidence to verify their foreign tax credits. The secondary evidence provision of Treas. Reg. section 1.905-2(b)(1) has limited application. This section specifically cites when secondary evidence can be used, and also what type of evidence is acceptable.

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<sup>1</sup> This issue has also been referred to as the "Foreign Withholding Tax" Issue.

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As part of the audit process, examiners should strictly enforce the requirements of IRC section 905 and the applicable regulations. The work papers should clearly document the tax receipts along with any secondary evidence that the tax was actually paid. It is important to identify all evidence provided by the taxpayer into separate categories such as tax letters from borrowers, missing or no exchange rates, etc. Such detail summarized by categories assists in the settlement of the issue at a later date.

The opinion in *Continental Illinois Corp. v. Commissioner*, 998 F.2d 513 (7th Cir. 1993) held that borrower letters are not deemed secondary evidence within the provisions of Treas. Reg. section 1.905-2(a)(2) and 2(b)(1). This opinion also rejected the concept of a net loan gross-up without a corresponding tax credit.

See Exhibit 7-1 for a sample IDR detailing information to be requested for the net loan issue.

## **INTERNATIONAL TAX ISSUES**

Other foreign issues which have potential tax implications are as follows:

1. Computation and verification of all foreign tax credits claimed on the return.
2. Level of substantiation required for a foreign tax credit to be allowed for tax purposes, and can the taxpayer use borrower letters as proof of payment to support the tax credit.
3. Is the Brazilian tax credit a creditable foreign tax credit for U.S. tax purposes, and if it is, is the Brazilian Central Bank exempt from tax? (See item on Brazilian tax credits, discussed below.)
4. The existence of subsidies, refunds, or rebates, which signifies that the foreign tax was not paid for foreign tax credit purposes.
5. Tax implications of foreign transactions, such as sales of foreign debt to third parties, debt-for-debt loan swaps, etc.
6. Non-accrual of interest income on foreign debt.
7. Foreign loan charge-offs, some of which are guaranteed by the foreign country. This is an area which can easily be abused by the taxpayer.
8. Foreign hedging transactions and other financial product transactions.
9. Proper application of the Allocated Transfer Risk Reserves (ATRR) charge-offs.

10. Proper application of the Source and Withholding rules.
11. The above list should be used by the international examiner to determine the scope of the examination. The list is not all inclusive, and is simply a starting point. The agent should also contact the Industry Specialist for Commercial Banking for a copy of the Coordinated Issue Paper and any updates on the issue.

### **BRAZILIAN FOREIGN TAX CREDITS**

One of the issues that continues to come up in the larger cases involves the Brazilian Foreign Tax credit. The IRS has taken the position that the Brazilian tax is not a creditable foreign tax. See Rev. Rul. 89-119, 1989-2 C.B. 132, as modified by Announcement 89-152, 1989-48 I.R.B. 21. A complete breakdown of the foreign tax credits should be secured from the taxpayer as soon as possible to determine whether any Brazilian credits were claimed. This information should be included in the international referral to assist the reviewing agent.

In *Continental Illinois*, the Seventh Circuit affirmed the Tax Court and ruled that the Brazilian tax is potentially creditable, but second or third party rebates must be reduced from the total credit claimed. In *Continental Illinois*, the Court held that these rebates constituted indirect subsidies to the taxpayer, and disallowed foreign tax credits to the extent of the subsidy. See also, *Norwest v. Commissioner*, 69 F.3d 1404 (8th Cir. 1995). This information should be included in the international referral to assist the reviewing agent.

Regarding the Brazilian Central Bank, the Tax Court held that the Central Bank was not required to pay taxes on its net loan interest remittances on restructured debt because the Central Bank had tax immunity. The Tax Court disallowed the lender's foreign tax credits even though the lender had tax receipts. *Riggs National Corporation v. Commissioner*, 107 T.C. No. 18 (Dec, 10, 1996).

### **MEXICAN FOREIGN TAX CREDITS**

The major issue involving Mexican Foreign Tax Credits centers around the substantiation of the credit. One of the main problems that we have come across involves the receipts, and other documentation from the Mexican oil company Petroleos Mexicanos, more commonly known as PEMEX. It is the position of the IRS that as PEMEX is a government agency that has never paid any tax, it is, in effect, tax exempt. This would make any credit being claimed by taxpayers with respect to PEMEX loans, highly questionable. The IRS position was adopted by the Tax Court in *Continental Illinois v. Commissioner*, T.C. Memo. 1991-66. The same is true for receipts from Commission Federal de Electricidad.

Because PEMEX is the largest single Mexican borrower of U.S. source loans, there is a strong possibility that a large number of taxpayers, (banks in particular), may be using incorrect and inaccurate documents to substantiate the foreign tax credits which arise from loans to PEMEX.

**ARTICLES**

Fuller & Kornblatt, "Foreign Tax Credit and Net Loans: A Creditable Attack," 5 J. Bank Taxation, No. 1, 5 (1991).

SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564 Rev. 6/88</b>	<b>Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>		<b>Subject</b> <b>Net Loan Issue</b> <hr/> <b>SAIN No.   Submitted to:</b>     <hr/> <b>Dates of Previous Requests</b>
<b>Please return Part 2 with listed documents to requester identified below.</b>		

**Description of Documents Requested**

This information request relates to interest income reported from all foreign loans as detailed in the bank's annual report and as reported on the tax return.

1. Provide a complete copy of all foreign loan files. The loan file should contain at least the following information:
  1. Complete loan agreement
  2. Name and address of the borrower
  3. Amount of the loan and interest rate being charged
  4. Due dates and actual dates of amount of payments of principal and interest
  5. Whether the loan agreement required the borrower to pay foreign taxes due on the interest payments.
  
2. With respect to each foreign loan, provide the following information for each year under examination:
  1. The amount of interest received for each year
  2. The foreign tax due on the interest received for each year
  3. The amount of foreign tax paid with respect to the interest reported.
  
3. Produce all tax receipts issued by foreign governments for tax payments during the examination years which were attributable to the foreign loan interest.

<b>Information Due By _____ At Next Appointment [ ] Mail In [ ]</b>		
<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

SAMPLE INFORMATION DOCUMENT

<b>Form 4564</b> <b>Rev. 6/88</b>	<b>Department of the Treasury</b> <b>Internal Revenue Service</b> <b>INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>  <b>Please return Part 2 with listed documents to requester identified below.</b>		<b>Subject</b> <b>Net Loan Issue</b>  <b>SAIN No. Submitted to:</b>  <b>Dates of Previous Requests</b>

**Description of Documents Requested**

4. Provide all worksheets and other documentation utilizing any foreign exchange rates along with verification of that rate.
5. Produce all tax returns filed by or on behalf of the bank with respect to foreign taxes due or paid during the examination years and attributable to the foreign loan interest.
6. Produce transcripts, statements of account, or other documents and records maintained by foreign governments with respect to taxes due or paid on the foreign loan interest.
7. With respect to each foreign loan, produce all correspondence with the borrower and all books and records of the borrower reflecting payments of foreign taxes on behalf of the bank during the examination years.
8. With respect to each foreign tax payment, foreign tax claimed as a credit on the bank's tax return and for which a foreign tax receipt is not produced, explain why a tax receipt is not available and describe all efforts to obtain the receipt.
9. Identify any foreign loans which are exempt from foreign taxation and state the reason for the exemption, and produce all documents and records identifying such loan as exempt from foreign tax.

The documents produced in response to this request should be the original documents. If the original documents are unavailable, copies should be produced and your response to this request should include an explanation of why original documents are unavailable and a description of all taxpayer's efforts to obtain these documents.

In the event any of the documents are in a foreign language, a translation of the information contained in the documents should be provided. In addition, a source person should be made available if and when any other translation questions or problems arise.

<b>Information Due By _____ At Next Appointment [ ] Mail In [ ]</b>		
<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

## Chapter 8

### MORTGAGE SERVICING RIGHTS

#### INTRODUCTION

The mortgage servicing area has received a lot of attention in the media over the last couple of years. It involves an issue which has significant tax implications for banks, savings and loan associations, and mortgage bankers. Specifically, the issue deals with the coupon stripping rules of IRC section 1286 which require the allocation of a basis to the servicing rights retained by the bank when the corresponding mortgage is sold in the marketplace.

When a bank sells a mortgage, it simultaneously enters into a contract to service the mortgage for a fee which is based on a percentage of the outstanding principal balance of the loan. This contract is called the servicing right.

Servicing a mortgage involves collecting the homeowner's monthly payment, remitting the principal and interest to the investor, accumulating an escrow account for payment of insurance and taxes, disbursing the escrow funds as payments come due, maintaining all records relating to the loan, and handling all delinquency problems. The loan servicer is paid amounts from interest for performing these services.

These amounts are the heart of the issue. If the financial institution receives amounts from interest which are in excess of reasonable compensation, basis must be allocated to the servicing right in accordance with the coupon stripping rules of IRC section 1286. The allocation of a portion of the basis to the servicing right will reduce the tax basis of the mortgage instrument and effectively increase the gain or reduce the loss reportable for tax purposes in the year the mortgage is sold.

This issue can be compared to the situation in which interest coupons are stripped from a bond. The real value of the coupons is equivalent to the present value of the income stream of the future payments to be received. This valuation is the basis allocated to the coupons and will proportionally reduce the cost basis of the bond. This allocation directly affects the gain or loss reportable for tax purposes.

The additional amount of income that the taxpayer reports due to the basis allocated to the servicing right is approximately equal to the present value of the excess servicing income that the taxpayer will receive in future years.



The value of the excess portion of the servicing right retained by the taxpayer is based on the facts and circumstances of each case. The taxpayer can elect to use the safe harbor provisions of Revenue Procedure 91-50, 1991-2 C.B. 778. This revenue procedure provides guidelines for determining what constitutes "reasonable compensation" for mortgage servicing contracts. The election available to the taxpayer is discussed in detail later in this section of the guide.

### **EXAMINATION AREAS**

Consider several different examination areas when reviewing mortgage servicing.

1. Determine if the taxpayer is properly following all of the requirements of Rev. Rul. 91-46, 1991-2 C.B. 358, and has made the appropriate election under Rev. Proc. 91-50, 1991-2 C.B. 778.
2. Many variables are used when computing the value of the servicing right, all of which can significantly affect the amount reported for tax purposes. The computation of the value of the excess portion of the servicing right must be reviewed and verified.

### **BACKGROUND INFORMATION**

To obtain a better overall understanding of the issue, it is best to provide some basic information on the subject of mortgage servicing.

The general steps in a typical mortgage process are as follows:

1. A consumer will secure a mortgage loan at a commercial bank, mortgage banker, or savings and loan. The financial institution then has a loan in the place of the cash which it used to pay the seller.
2. The lender then packages the mortgage loans into groups with similar interest rates and terms. The lender then sells the loans. This sale by the lender is a taxable event and is often completed within a few months of the time the loan was originated.
3. Instead of selling the mortgage loans, the lender may choose to exchange them for mortgage backed securities (MBS). The bank may retain the MBS in their own investment portfolio. Alternatively, the bank may sell or exchange the MBS in a taxable event.

4. The purchaser of the mortgages will bundle the loans together and use them as the basis for issuing a mortgage backed security. Security firms on Wall Street will then sell the MBS to investors. This investment carries a low risk because it generally is guaranteed by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC), or some other government guarantor. With the profits from the sale of the mortgage backed security, the purchaser will then buy additional mortgage loans from a lender and continue the cycle.

Servicing rights are extremely valuable assets. They provide the owner with a predictable cash flow. The mortgage department of a bank, savings and loan, or mortgage company, derives its income almost exclusively from servicing fees, origination fees, and interest income earned on money held in escrow accounts. The servicing portion of the mortgage banking business can be extremely profitable when done in volume.

Some financial institutions purchase individual mortgage loans from other lenders to secure the underlying servicing rights. Then the mortgage will usually be sold along with the mortgages the bank originated. The financial institution which decides to sell the servicing right with the mortgage will do so for various reasons. The bank may not specialize in mortgage servicing or it may not service mortgages for a certain area of the country. When mortgage loans are sold, the seller will always receive more for a mortgage with the servicing right included than for a similar mortgage without the servicing right. For accounting purposes, the difference is called a servicing release premium.

The primary reason for the sale of the mortgage is to eliminate the risk of fluctuations in interest rates. Years ago, many institutions retained the mortgages they originated in the banks' own portfolios. However, when interest rates rose significantly in the early 1980's, the banks were holding fixed rate mortgages paying relatively low interest rates, while they were forced to pay higher rates on funds deposited with the banks. To eliminate this risk, banks sell the mortgages to outside investors. Mortgages are also sold to secure additional funds to lend to future customers. Since the bank has a limited amount of money to lend, it sells the loans and turns the money over indefinitely.

### **SALE OF MORTGAGE LOANS & MORTGAGE BACKED SECURITIES**

The majority of the loans originated by the taxpayers we examined were guaranteed by GNMA and FNMA. These entities along with FHLMC also known as Freddie Mac, dominate the secondary mortgage market. They buy loans from lenders and package them into mortgage backed securities for sale to investors. Their basic purpose is to create a secondary home loan market by buying home loans from

financial institutions and selling securities backed by the mortgages to investors. GNMA is a federal agency and FNMA and FHLMC are government sponsored, publicly traded companies.

When the mortgage loans are sold, the servicing of the mortgages is normally required to be retained by the seller. All of the governmental agencies which purchase mortgage loans such as FNMA, GNMA, and FHLMC, will not accept the mortgages with the servicing included. A comparison of pass-through mortgage-backed securities can be obtained from Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., Washington, D.C.

### **EXCESS SERVICING FEE**

The fee actually earned by the servicer of the loans will vary depending on the sales price of the loan package. For accounting purposes, servicing fees can be subdivided into two types, normal servicing and excess servicing. Revenue Ruling 91-46 requires a basis allocation for amounts which exceed reasonable compensation for services to be performed. In Rev. Proc. 91-46, basis was required to be allocated to a portion of normal servicing as well as to excess servicing. Revenue procedure 91-50 provides safe harbor rates that the taxpayer can elect to compute reasonable compensation for servicing one to four family mortgages.

If a taxpayer so elects, the amounts considered to be reasonable compensation in Rev. Rul. 91-46 for purposes of the safe harbor provisions of Rev. Proc. 91-50 are as follow:

1. 25 basis points for conventional fixed rate mortgages with an original principal balance greater than \$50,000,
2. 44 basis points for loans sold to GNMA and mortgages with an original principal balance of \$50,000 or less, or
3. 37.5 basis points for all other types of residential mortgages, such as adjustable rate mortgages, sold to parties other than GNMA.

Those amounts are in addition to the guarantee fees charged by GNMA, FNMA, or FHLMC. Thus, it is not uncommon for the spread between mortgage rates and the related MBS to be 50 basis points and result in no basis allocation under IRC section 1286.

The servicer of the loan will remit the homeowner's interest and principal payment, less the servicing fee, to the holder of the mortgage. The fee paid to the servicer is a percentage of the principal balance of the loan remaining at the time of the payment. As the principal balance of the loan is reduced, the fee earned by the servicer of the loan is reduced accordingly.

It should be pointed out that these safe harbor rates apply only to one to four unit residential mortgages. There is no guidance on commercial or other mortgage type loans.

### **COMPUTATION OF THE EXCESS SERVICING FEE**

The servicing amounts received are determined by multiplying the remaining principal balance of the mortgage by the difference between the rate collected from the homeowner and the rate that is to be sent to the purchaser of the mortgage. Since these amounts are annual percentage rates, the amount computed is divided by 12 to get the monthly amount. The monthly amounts are used since as each payment is made, the remaining principal balance of the mortgage will be reduced. It is this remaining balance that is used to compute the corresponding amount or fee earned by the servicer of the mortgage.

The total servicing amount, both normal and excess, will be reported by the financial institution as it receives the fees. The taxpayer, however, also is entitled to recover basis allocated to stripped coupons under the OID rules.

Currently, there is a computer program created by IRS personnel which takes into consideration all of the requirements of the new Revenue Procedures and the OID rules. This disk will value the various mortgage pools and compute the correct amount of the excess servicing fee that should be reported as taxable income by the taxpayer. It will also compute the annual deductions allowed to the taxpayer based on variables existing in your case.

Many taxpayers also have programs which compute the present value of excess servicing. The accuracy of their computations can be verified by using the IRS program.

### **PREPAYMENT OF MORTGAGES**

If the mortgage is paid off due to a refinancing or a sale of the residence, then the servicing fee being earned by the servicer of the loan will end. The servicer will no longer be collecting any payments and therefore that individual servicing right will be worthless. The rate of prepayment varies depending on interest rates.

Prepayments, payoffs, and refinancing were fully considered in determining the average life of a mortgage. For every mortgage that is paid off early, there are other mortgages that will go beyond the mortgages average life. In fact, some of the mortgages will not be paid off until the entire 30 years has elapsed. The financial institution will continue to collect the servicing fee on these mortgages to maturity. As anyone with a mortgage knows, the principal balance does not go down very much until the last several years. Therefore, even though the servicing fee may be reduced, it does not go down very much until the very end of the mortgage, which is far beyond the average mortgage life.

The life expectancy of a mortgage is very important. The computation of the value of the excess servicing right uses the present value of the future income stream the bank will receive. This future income stream takes into consideration the length of time the taxpayer will be receiving this income. Secondly, the amount reported as excess servicing fee income is allowed as an amortization deduction in later years. The amortization rate is based on the life expectancy of the servicing right. A reasonable prepayment model, such as the PSA model, should be used to determine the value of retained servicing rights.

## **LAW**

IRC section 1286 discusses the tax treatment of stripped bonds and allocates a tax basis to the coupons when they are stripped from the related coupons. Basis is allocated between the portion of the bond sold and the portion retained.

IRC section 1286 treats the purchaser of a stripped bond as having acquired an original issue discount (OID) instrument with the OID equal to any excess of the stated redemption price at maturity over the bond's purchase price. The seller of the stripped bond is treated as having retained a portion of the bond for an amount equal to the allocated basis under the stripping provisions.

The IRS issued Rev. Rul. 91-46, which ruled that the coupon stripping rules in IRC section 1286 apply to the sale of mortgage loans if the seller retains the right to receive amounts from interest other than as reasonable compensation.

Taking into consideration IRC section 1286, some gain or a reduced amount of loss may be recognized for tax purposes at the date of sale. The basis is allocated between the mortgage instrument and the servicing right based on the fair market value of the items at the date of sale.

## **SFAS 65**

The Financial Accounting Standards Board published SFAS 65 which requires the sales price of mortgages to be adjusted whenever there is excess servicing involved. It attempts to correct the inequities in the recording of the sale of mortgages which involve excess servicing. SFAS 65 requires that the amount of the present value of the excess servicing fees to be received versus the normal servicing fee, is to be included into income for financial reporting. The inclusion of the value of the servicing fees has the effect of increasing the selling price and makes the sale comparable to a normal servicing fee sale in a regular market. If the mortgage had been sold without the retention of the right to future mortgage service income, the mortgage would have been sold at a greater selling price. The increase would approximate the value of the servicing rights. The amount includible into income at the time of the sale of the mortgage is the present value of total fees receivable in excess of normal servicing fees.

SFAS 65 was modified by SFAS 122.

## **EXAMINATION LIMITS AND RESTRICTIONS**

Mortgage servicing involves one of the rare instances where the IRS has moved very quickly to formalize a position on a new issue being developed in the field. The National Office released one Revenue Ruling and three Revenue Procedures dealing directly with mortgage servicing rights on August 8, 1991. These rulings are discussed in detail later in this section of the guide.

It is important to note that the opportunity to pursue this issue is somewhat limited for taxable years ending before August 8, 1991. Revenue Procedure 91-51 provides that the examining agent cannot make adjustments for the value of servicing rights to taxable years prior to publication of the ruling if:

1. The taxpayer was not under examination at the time the ruling was issued or
2. The taxpayer was under examination and the servicing rights issue was not yet raised by the agent.
3. For these exemptions to apply, the taxpayer must have timely filed Form 3115 to change their method of accounting for servicing rights in accordance with Revenue Procedure 91-51 and actually implemented the method change. This method change is subject to verification upon examination.

If the taxpayer elects to change its method of accounting, they do not have to report taxable income for the value of the servicing rights until years ending after August 8, 1991. For calendar year taxpayers, the Revenue Ruling would first apply to the 1991 year. The provisions apply to mortgages which are sold on or after the first day of the taxable year of change.

Subject to the rules applicable to changes in accounting methods, the examining agent can adjust all open years for the full value of the servicing rights retained if the issue was raised during the examination before the taxpayer filed Form 3115.

It should be emphasized that even if you are examining a taxable year ending after August 8, 1991, and the taxpayer has changed its accounting method, potential still exists for an adjustment in this area. Adjustments in the taxpayer's computations valuing the servicing rights may be possible in several areas, including the discount rate used in the present value computations and the retirement rate of the loans for projecting future receipts. Each of these variables can have a significant impact on the computation of the gain reportable for tax purposes and can result in considerable adjustments. These variables are discussed later in this section of the guide.

### **EXAMINATION TECHNIQUES**

1. Review the tax return for elections made by the taxpayer involving a change in the method of accounting for servicing rights, an election for the safe harbor provisions per Revenue Procedure 91-50, or changes in the computation of the gain on the sale of the mortgage. These elections will affect how you proceed on this issue.
2. Review the Schedule M-1 for book to tax differences and analyze the computations by the taxpayer. Most taxpayers have excess servicing for financial reporting purposes. This amount will not necessarily be the same for tax purposes. It should be remembered that the Schedule M-1 adjustment is not indicative of the amount of excess servicing in any one year. Most taxpayers will net the excess servicing with the amortization deduction allowable from past year's servicing. These computations should be reviewed by the examining agent and understood in order to know what the taxpayer did and why.
3. Determine the proper amount of gain or loss on the sale of mortgages to be reported for tax purposes. This examination technique is probably the most important suggestion in this chapter. It involves an area where most of the adjustments will exist in future years, assuming the taxpayer has elected the safe harbor rates of Revenue Procedure 91-50.

This computation includes the following areas:

- a. If the taxpayer elected the safe harbor provisions of Revenue Procedure 91-50, make sure that the taxpayer used the correct safe harbor rates and applied them properly.

- b. The present value of the servicing rights and the OID valuations can vary significantly depending upon the assumptions and other factors used in the computation. These variables can significantly change the amount of gain or loss reportable for tax purposes.

The variables include:

- 1) Coupon rate of the mortgage
- 2) Pass-thru rate
- 3) Normal servicing rate
- 4) Discount rate
- 5) Prepayment speed
- 6) Method of determining the prepayment:
  - a) Constant
  - b) Accelerated

The age and remaining term of the mortgages can have an effect on all of the above variables.

- c. Changes in the above variables can significantly alter the amount of income to be reported by the taxpayer. They should be reviewed thoroughly and verified as to their accuracy. But most importantly, determine whether the assumptions are reasonable. Be alert to differences between assumptions made for book purposes and those made for tax. Consider using the computer program discussed under the caption "Excess Servicing Fee" to determine the amount of servicing that should be included into income for tax purposes based on IRS assumptions.
- 4. If the taxpayer did not elect the safe harbor provisions, the fair market value of the stripped coupons is determined based on all the relevant facts and circumstances in your particular case. Due to the technical aspects of the issue, consider requesting the assistance of an engineer or in some districts, a financial products specialist, to properly value the servicing rights in this situation.

Also, keep in mind that if your taxpayer did not elect to change their method of accounting or include the value of the rights in its return, then an adjustment can be made to all years open under the statute of limitations. Proper consideration must be given to the rules governing changes in accounting method.



**ANALYSIS OF RULINGS**

The National Office has issued guidelines on the servicing rights issue. One Revenue Ruling, plus three Revenue Procedures were issued. A brief summary of these rulings are as follows:

**1. Revenue Ruling 91-46 (1991-2 C.B. 358)**

IRC section 1286 is applied to certain sales of mortgages where the owner simultaneously enters into an agreement with the purchaser to service those mortgages. Revenue Ruling 66-314 was determined to be obsolete.

**2. Revenue Procedure 91-49 (1991-2 C.B. 777)**

Provides simplified OID procedures for certain mortgage loans that are determined to be stripped bonds under IRC section 1286. Provides guidance on de minimis rule contained in the OID provisions.

**3. Revenue Procedure 91-50 (1991-2 C.B. 778)**

Provides a "safe harbor" that taxpayers may elect for purposes of determining what constitutes reasonable compensation in applying IRC section 1286 to certain mortgage servicing contracts.

The elective safe harbor rules of Revenue Procedure 91-50 are applicable to:

- a. One to four unit residential mortgages,
- b. Where the servicer provides substantially all of the following services:
  - 1) Collects periodic mortgage payments from the mortgagor and remits those payments to the owner of the mortgage,
  - 2) Accumulates escrows, if any, for the payment of insurance and taxes and disburses these funds as payments come due,
  - 3) Maintains records relating to the mortgage,
  - 4) Handles delinquency problems.

If the safe harbor provisions are elected, reasonable compensation will be computed as follows:

- a. Safe harbor rate, not to exceed contract, plus
- b. Income, other than servicing fees, received in the normal course of servicing mortgages.

Safe harbor rates are as follows:

- a. 25 basis points for conventional fixed rate mortgages with original mortgage balances exceeding \$50,000.
- b. 44 basis points for mortgages which are less than one year old and insured or guaranteed by the FHA, VA, or FMHA.
- c. 37.5 basis points for any other one to four unit residential mortgage with an original mortgage balance exceeding \$50,000.
- d. 44 basis points for all mortgages with an original principal balance of \$50,000 or less.

These rates are in addition to the amounts paid to GNMA, FNMA, or FHLMC as guarantee fees.

The use of the safe harbor provisions in Rev. Proc. 91-50 is revocable by the taxpayer at any time by filing a statement with the tax return.

**4. Revenue Procedure 91-51 (1991-2 C.B. 779)**

This Revenue Procedure provides guidance to the taxpayer by explaining how to obtain a consent to change their method of accounting for certain sales of mortgage loans from a method that does not comply with IRC section 1286.

- a. Provides for automatic change procedures for taxpayers not currently under examination.
- b. Provides special procedures for taxpayers under examination, in appeals, or currently before a court.

**ARTICLES**

Conlon, Butch & Mac Donald, "IRS's New Position on Excess Mortgage Servicing Affects Both Lenders and Investors," 76 J. Taxation 38 (1992).

## Chapter 9

### LOAN ORIGINATION COSTS

#### INTRODUCTION

One of the primary business activities of every bank is the origination of loans. A loan is originated when a bank lends money to a customer. The bank incurs substantial costs which are directly related to making the loan. Some of these costs are: Employee wages, commissions, office supplies, telephone expenses, and postage. Typically, the bank will capitalize some of the expenditures for book purposes, but expense them for tax purposes. Analyze the bank's loan origination costs to determine whether they should be treated as capital expenditures or currently deducted for tax purposes.

#### BOOK REPORTING OF LOAN ORIGINATION COSTS

It is important to understand how loan origination costs are treated for financial reporting to determine how they should be treated for tax purposes. Most large financial institutions changed their method of reporting loan fee income and expenses in 1988 as a result of the issuance of Statement of Financial Accounting Standards No. 91. SFAS 91 establishes the rules for accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or a group of loans.

SFAS 91 applies to loans that are purchased from a third party and to loans that are originated by the financial institution. It also applies to leasing transactions. The statement generally relates to transactions entered into in fiscal years beginning after December 15, 1987.

SFAS 91 requires lenders to capitalize fee income and costs from loan originations. Fee income and loan costs are netted. The net amount is amortized using the interest method, which is explained in Statement 91. The net amount is considered to be an adjustment to the amount of interest paid by the borrower.

Statement 91 states direct loan origination costs of a completed loan shall include only:

1. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and

2. Certain costs directly related to specified activities performed by the lender for that loan. Those activities are: Evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms, preparing and processing loan documents, and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

The Statement requires the lender's indirect costs to be expensed, rather than capitalized. These expenditures include costs for advertising, solicitation, servicing, administrative overhead, rent, and equipment. Costs related to unsuccessful loan origination attempts are also expensed.

When adopting Statement 91, many financial institutions established new accounts on their books to record the fee income they received for various loans such as FHA or VA mortgages, adjustable rate mortgages, conventional fixed mortgages, etc.

The institutions also may have established new expense accounts such as, loan origination compensation expense contra, loan origination office supplies expense contra, loan origination telephone expense contra, etc. This reflects amounts that were capitalized for book purposes.

Often, a bank will compute an average cost per loan origination for a given time period, such as a month. That cost figure is multiplied by the number of loans closed during the period to determine the total amount to be allocated to the previously mentioned accounts.

Typically, the loan fees and costs are tracked on a loan-by-loan basis. If the loan is sold or paid-off, the unamortized portion is included in income or expensed at that time. The net fee income or expense for refinanced loans may also be recognized when the new loan is granted.

### **TAX REPORTING OF LOAN ORIGINATION COSTS**

Historically taxpayers have expensed the costs related to the origination of loans for tax reporting. Banks included these costs in the regular expense accounts for wages, office expenses, etc. Since the release of SFAS 91, most banks make M-1 adjustments to reverse the amount of expenses that were capitalized for books. This results in all costs associated with loan originations continuing to be expensed for tax purposes.

Most agents examining banks are taking the position that these costs should be capitalized for tax purposes, as well as for book reporting, because they result in the creation of an asset with a life extending beyond the tax year. This issue has been designated a "significant issue" by the IRS Banking Industry Specialist. The Savings and Loan Industry Specialist is also recommending that agents pursue this issue.

The Service issued Announcement 93-60, 1993-16 I.R.B. 9, to suspend all ruling requests for method changes with respect to this issue while it is under study. This announcement is discussed later in this chapter.

Generally, IRC section 263(a) and case laws provide support for the capitalization of loan origination costs. However, there are a number of unresolved issues presented upon a determination that loan origination costs should be properly capitalized, including issues involving the proper treatment of specific types of costs and the proper computation of basis and the applicable amortization period.

This area is under active consideration in the National Office.

Discussed below are some of the approaches which have been taken by revenue agents:

1. Capitalize all costs that are directly related to originating all loans. SFAS 91 costs are used as a starting point, but there may be costs that should be treated differently for tax than for book purposes. Some examples of direct loan origination costs are: Credit report costs, filing and recording fees, and attorney fees.
2. Capitalize the same items for tax that were capitalized for books. Under this approach, however, anomalies may result because of the netting approach permitted by SFAS 91 and the immateriality standard available for book purposes.
3. Net specific fee income against the related costs with the excess of the loan origination costs over certain related fee income being capitalized.

Note, certain amounts received from borrowers that are paid to third parties for specific charges or services have, generally, been excluded from income or netted against the related costs.

Examiners raising this issue will also need to determine what amortization methods and periods are allowable. The burden is on the taxpayer to establish the life of the loans. Theoretically, if a useful life cannot be established, no amortization would be allowable. (The taxpayer would receive a deduction for the costs in the year the loan is terminated.) Practically speaking, there are usually industry standards for the average lives of the various types of loans. For example, historically 30 year mortgages have lasted 12 years and 15 year mortgages have lasted 8 years. However,

these averages have been affected in recent years by lower interest rates, refinancings, etc. The taxpayer may have studies showing how long other types of loans, such as car loans or commercial loans, last. It should also be noted that some home equity loans have an indefinite life since they are open-ended.

For book purposes, the bank may track the net of the fee income and the loan costs on a loan-by-loan basis. Some banks have set up their computer systems to separate the fee income and the loan costs. They can then determine whether the loans have been paid off prematurely, the amount being amortized for books, etc. Book amortization figures may be used as a starting point for tax amortization.

## LAW

The law supporting the IRS' position that loan origination costs should be capitalized is found in part in IRC section 263(a), Treas. Reg. section 1.461-1(a), IRC section 446(a), IRS rulings, and several court cases, including *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992). These are discussed below.

IRC section 263(a) states that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate and any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Treas. Reg. section 1.461-1(a) provides the general rule for the taxable year of deduction. Any expenditure, that results in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year, may not be deductible, or may be deductible only in part, for the taxable year in which incurred.

IRC section 446(a) states that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Treas. Reg. section 1.446-1 further provides that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. It further states that a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Rules and regulations prescribed by state and federal regulatory authorities may require taxpayers to record transactions in a manner inconsistent with the Internal Revenue Code specifications. In the event of such a conflict, the Commissioner is not bound by the regulatory authorities' methods and may require the taxpayer to

recompute its taxable income under different methods as required by the Code. See *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932) and Revenue Ruling 68-220, 1968-1 C.B. 194.<sup>1</sup>

In *Commissioner v. Lincoln Savings & Loan Assoc.*, 403 U.S. 345 (1971), the court held that an expenditure should be capitalized if it creates or enhances a separate and distinct asset for which a value can be ascertained.

Consider, for example, home equity lines of credit ("HELOCs"). These credit lines often generate fees for credit reports, filing and recording fees, attorney fees, and related closing costs. As with credit cards and revolving credit lines, the bank typically does not pass these costs to the customer (unlike in a purchase money mortgage loan situation). The Service has treated HELOCs as separate assets having useful lives beyond the present tax year. As such, the costs incurred to create or acquire them are subject to the capitalization principles discussed above. Further, the question of capitalization does not turn on whether such costs are paid to employees ("in-house" expenses) or third parties ("out-house" expenses). See Rev. Rul. 57-400, 1957-2 C.B. 520; Rev. Rul. 69-331, 1969-1 C.B. 87. Rather, the principle focus should be on whether the incurred cost directly and significantly contributed to the creation or acquisition of the loan.

Rev. Rul. 57-400, 1957-2 C.B. 520, held that "'Finders fees' (buying commissions) paid by mutual savings banks, building and loan associations, cooperative banks and other classes of banks, to brokers, title companies, and other third parties for their introduction of acceptable applicants for mortgage loans, constitute a part of the acquisition cost of the loans which must be capitalized and amortized over the lives of the mortgage loans made to such applicants."

Rev. Rul. 69-331, 1969-1 C.B. 87, held that where a taxpayer has paid commissions to its own employees, and the commissions played a direct and significant part in the acquisition of capital assets, the commissions must be capitalized.

In *Indopco, Inc. v. Commissioner*, 112 S.Ct. 1039 (1992), *aff'g National Starch and Chemical Corp. v. Commissioner*, 918 F.2d 426 (1990), *aff'g* 93 T.C. 67 (1989), the Supreme Court discussed the deductibility of expenses incurred during a friendly takeover. It held that the expenses were not deductible because they created benefits that extended beyond the current year. The creation or enhancement of a separate asset was not a necessary condition to require expenses to be capitalized. The court stated, "Deductions are exceptions to the norm of capitalization and are allowed only if there is clear provision for them in the Code and the taxpayer has met the burden of showing a right to the deduction."

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<sup>1</sup> The argument for book-tax conformity per IRC section 446 for loan origination costs supports the capitalization theory only if the bank is following SFAS 91. Some banks did not adopt the statement. In those cases other code sections, regulations, rulings, and court cases should be cited as authority.



*Indopco* was significant because it held that the creation of a separate asset was not necessary for capitalization of the related expenditures. *Indopco* strengthens the Government's position that loan origination costs must be capitalized, because it clarifies that expenditures are capitalized when future benefits are created. Some of the future benefits created by originating a loan are the right to receive interest, the right to service the loans, the opportunity to solicit the borrowers for additional business, etc.

The uniform capitalization rules of IRC section 263A were enacted by the Tax Reform Act of 1986. UNICAP requires the capitalization of certain expenditures incurred (1) for real or tangible personal property produced by a taxpayer and (2) for real or personal property (tangible or intangible) acquired for resale. Treas. Reg. section 1.263A-1(b)(13) states:

**EXTRACT**

Treas. Reg. section 1.263A-1(b)(13)

\* \* \* the origination of loans is not considered the acquisition of intangible property for resale. (But IRC section 263A(b)(2)(A) does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

Therefore, per the regulation, IRC section 263A does not apply to originated loans, but does apply to loans purchased for resale. Thus, IRC section 263A requires capitalization of certain costs allocable to loans purchased for resale. The regulation applies to costs incurred in taxable years beginning after December 31, 1993. IRS Notice 88-86, 1988-2 C.B. 401, was applicable for years beginning before January 1, 1994. The Notice said that the origination of a loan is considered the production of intangible property, rather than the acquisition of intangible property for resale. Therefore, IRC section 263A does not apply to originated loans. However, IRC section 263A may apply to the purchase of pre-existing loans from other parties for resale. The applicable portion of Notice 88-86 is reprinted below:

Commentators have inquired as to whether a taxpayer that originates loans (that is, loans money to other persons in return for promissory notes or other documents evidencing a promise to repay) would be treated as acquiring intangible property for resale under IRC section 263A.

In response to these inquiries, forthcoming regulations shall provide that the origination of a loan shall be treated under IRC section 263A as the production of intangible property for resale. Thus, the capitalization rules of IRC section 263A shall not apply to such activity, because IRC section 263A only applies to the production of tangible personal property. IRC section 263A, however, applies to taxpayers purchasing pre-existing loans from other parties for resale. Such taxpayers are treated as acquiring intangible property for resale, and hence are subject to the uniform capitalization rules. The provisions of this paragraph apply only for purposes of IRC section 263A and no inference relating to the treatment of such property for other purposes of the Code is intended (see for example, Rev. Rul. 72-523, 1972-2 C.B. 242).

Therefore, under both the regulations and the Notice, IRC section 263A applies only to loans purchased for resale, not to loans originated by the taxpayer.

IRC section 263A requires the capitalization of indirect costs that would otherwise be deductible. Since IRC section 263A does not apply to originated loans, IRC section 263 should instead be referenced to determine which expenditures are capital in nature. The applicability of IRC section 263 was discussed above. Fewer expenses are capitalizable under IRC section 263 than would be capitalized under IRC section 263A.

IRC section 263A, however, applies only to IRC section 1221(1) property. See IRS section 263A(b)(2)(A). For loans subject to IRC section 475, IRC section 263A will generally not apply. See IRC section 475(d)(1). Thus, IRC section 263A will rarely have application even with respect to purchased loans in tax years after the effective date of IRC section 475.

### **CHANGE IN ACCOUNTING METHOD**

The taxpayer's method of accounting must be changed when it is determined that loan origination costs should be capitalized. Announcement 93-60, 1993-16 I.R.B. 9, was released in March 1993 to temporarily suspend the filing of accounting method change requests for loan origination costs. Any Forms 3115 that had been filed were returned to the taxpayers, unless they involved a pending issue before examination or appeals. The following excerpt from the ruling is particularly relevant for revenue agents:

If a taxpayer is currently under examination or subsequently comes under examination, the taxpayer may give the examining agent a copy of the returned Form 3115 and cover letter, or request a change in accounting method (with respect to loan origination costs) by filing a Form 3115 with the examining agent during the first 90 days of the examination or during any of the window periods available under Rev. Proc. 92-20. For taxpayers who file their Form 3115 with the examining agent, any change in method of accounting for loan origination costs will be made under terms no less favorable than those available to taxpayers not under examination. Thus, taxpayers will not be adversely affected by this proscription on filing a method change request regarding this matter with National Office.

Therefore, first determine whether your taxpayer has previously filed Form 3115 or is still within one of the window periods provided by Rev. Proc. 92-20, 1992-1 C.B. 685. If so, the year of change would be later than the year you are examining and you would not want to spend time developing the issue. However, if the bank did not file a request for a change and is no longer within one of the window periods, the issue can be raised.

**EXAMINATION TECHNIQUES**

1. Review the tax return. Taxpayers sometimes attach disclosure statements which discuss their treatment of loan origination costs. Often there will be a line item on the Other Deduction schedule for loan origination costs.
2. Review the Schedule M-1 to determine if there is an adjustment to expense costs that were capitalized for book purposes. (This adjustment is often identical to the amount on the Other Deduction schedule.) Also, see whether there is an item adjusting fee income that was amortized for book purposes. Taxpayers may have two separate M-1 adjustments for these items, one to decrease book income for the expenses and another to increase book income for the fees. However, they may net these two items and have only one M-1 adjustment. Since the fee income is usually larger than the related expenses, the net M-1 often will increase book income. Therefore, you may have an issue even if book income is not being decreased. Look at the M-1 work papers to determine how loan origination costs have been handled.
3. Determine whether the bank has filed a Form 3115 regarding the tax treatment of loan origination costs. As mentioned earlier, refer to Announcement 93-60 if the taxpayer previously filed a Form 3115 or files one within 90 days of the start of the examination. You would not want to pursue this issue if the taxpayer is still within one of the window periods for filing a Form 3115.
4. Interview the tax manager extensively regarding the bank's book and tax treatment of loan origination costs. He or she should be able to explain the method of capitalizing costs, whether M-1 adjustments were made, the types of costs that may have been capitalized, etc. If not, interview another bank employee who is knowledgeable in this area.
5. Determine early in the examination the types of loans the bank makes and which of these they retain. If the bank sells a particular type of loan shortly after it is originated, you will need to decide whether the related costs are significant enough to warrant capitalization. For example, if the bank sells all of its mortgages within one month of origination they would get a deduction for the costs one month after they were capitalized. Your time may be better spent reviewing the expenditures for loans that the bank retains.
6. Some banks prepare a report for their executive boards to provide them with information regarding loan closings and costs. The report generally will list the number of loans closed during the month, the number of loans in the process of being closed (in the "pipeline"), the fees received on the loans, the per loan costs, the types of loans closed, etc. Inquire whether the bank you are examining prepares this type of report and request copies of them.

7. Request that the bank provide a listing of sample journal entries used to record SFAS 91 transactions. This should include entries that are made from the time the borrower applies for the loan through the time fee income and loan expenses are amortized. This will help you develop a better understanding of the bank's practices and may assist in developing the issue. See Exhibit 9-1 for a sample IDR.
8. Review the general ledger to see whether particular accounts have been set up to record SFAS 91 expenses. Also, use the account stratification that was prepared by the CAS to identify balance sheet accounts which relate to SFAS 91 costs. Once the accounts are identified, review account selections and identify specific entries for further analysis. The detail will probably consist of a number of journal entries. Request the back up documents for a sample of the entries.
9. Determine whether the bank pays handling fees or commissions to automobile dealerships for processing loans for customers who purchase vehicles. The dealerships' employees prepare the loan documents on behalf of the bank. The bank pays the dealer a fee, usually a percentage of the loan amount, for performing this service. Banks will normally capitalize this cost for books, but expense it for tax purposes. This fee is no different from other loan origination costs and should be capitalized for tax reporting also.
10. Read the applicable portions of the taxpayer's accounting manual which provide explanations for the types of transactions that are recorded in the accounts.
11. The costs that have been included for SFAS 91 purposes may not be the same as those that should be capitalized for tax purposes. Analyze the taxpayer's expenses to determine if additional costs should be capitalized.
12. If the bank did not capitalize any loan origination costs under SFAS 91, you will need to reconstruct the amounts. Determine which bank personnel are directly involved in the origination of loans and allocate a portion of their salaries. Also, take into consideration office supplies, telephone costs, travel expenditures, and other directly related costs. If the bank used SFAS 91 in subsequent years, you may be able to use those cost figures as a guideline. The bank should have records regarding the number of loans closed each year. If you calculate the average costs per loan, this amount can be multiplied by the number of loans that were closed to estimate the amount that should be capitalized.
13. Since this issue involves the change of an accounting method, an IRC section 481 adjustment may need to be computed. This can be very difficult since the taxpayer is unlikely to have computed its SFAS 91 costs for years prior to 1988. You may want to use costs from the years you are examining and project them backwards, allowing for inflation. The taxpayer may be able to assist you in determining what the prior years' costs would be.

The taxpayer may request that you make adjustments in the current years only and allow the bank to continue to report prior year loans under the old method. The taxpayer has the burden of proof as to the proper IRC section 481(a) adjustment. *Hitachi Sales Corporation of America v. Commissioner*, T.C. Memo. 1994-159. The use of the cut-off method has not been approved for loan origination costs.

14. If the useful life of the loans can be determined with reasonable accuracy, calculate the allowable amortization. The amount capitalized is usually amortized on a straight line basis over the life of the related loans. If the bank tracks its loan origination costs on a loan by loan basis, you may consider doing the same for tax purposes.
15. Several articles have been written on this topic. Keep in mind that these articles express the point of view of the banking industry, not the IRS. However, you can review these for further information on this issue:
  - a. Alexander and Conjura, "IRS haunts banks by applying FAS 91 at tax audits," *ABA Bankers Weekly*, August 18, 1992.
  - b. Goeller, "Will Accounting Rules Bar Deductibility of Loan Origination Costs?," *Journal of Bank Taxation*, Vol 6/No 2, Winter 1993, p.3.
  - c. Andaloro and Alexander, "IRS Fails to Consider Loan Origination Costs in Overall Business Context," *Journal of Bank Taxation*, Vol 6/No 2, Winter 1993, p.7.
  - d. Ruempler and Salfi, "Tax Treatment of Loan Origination Costs and Fees," September 27, 1993, Tax Notes 1745.

## **SUMMARY**

The capitalization of loan origination costs should be reviewed during the examination of every financial institution. This issue has been identified as a significant issue by the banking industry specialist and the National Office is working on the topic. Determine whether a position has been announced and whether the taxpayer has filed Form 3115 prior to spending a lot of time in this area.

You must use a considerable amount of judgment in developing this issue. You need to determine which costs to capitalize, their amounts, which loans to consider, their amortization periods, etc. SFAS 91 costs can be used as a starting point, but additional costs may be capitalizable for tax purposes.

SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564 Rev. 6/88</b>	<b>Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>		<b>Subject Loan Origination Costs</b> <hr/> <b>SAIN No. Submitted to:</b>   <hr/> <b>Dates of Previous Requests</b>
<b>Please return Part 2 with listed documents to requester identified below.</b>		

**Description of Documents Requested**

Please provide the following information regarding costs associated with the origination of loans by the bank.

1. Has the bank filed any Forms 3115 regarding the treatment of loan origination costs? If so, please provide copies of the requests for the change in accounting method. Also, provide copies of any correspondence to or from the IRS regarding the forms 3115.
2. Schedule M-1 shows an adjustment for SFAS 91 of \$XXX,XXX. Please furnish copies of the work papers computing and explaining all of the book and tax differences. If the M-1 adjustment is a net amount, provide a complete breakdown between the income and the expenses that are being deferred. This should include a breakdown by accounts.
3. Please provide a list of all accounts and their amounts that are used in the SFAS 91 computation, for both fee income and the related expenses.
4. Please furnish a statement as to the specific directly related loan expenses that were capitalized for book purposes, such as wages, supplies, commissions, etc.
5. How was the amount to be capitalized determined? For example, were particular items identified or was a percentage taken of an entire expense account?
6. Are the expenses that are capitalized separated by the type of loan to which they relate, such as construction loans, car loans, etc.? If so, please provide a breakdown of the expenses for each category of loan.

Continued on the next page

<b>Information Due By _____ At Next Appointment [ ] Mail In [ ]</b>		
<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564</b> <b>Rev. 6/88</b>	<p align="center"><b>Department of the Treasury</b>  <b>Internal Revenue Service</b>  <b>INFORMATION DOCUMENT REQUEST</b></p>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>        <b>Please return Part 2 with listed documents to requester identified below.</b>		<b>Subject</b> <b>Loan Origination Costs</b>  <hr/> <b>SAIN No. Submitted to:</b>  <hr/> <b>Dates of Previous Requests</b>

**Description of Documents Requested**

7. Please provide a list of the sample journal entries that are used to record SFAS 91 transactions. Include entries beginning with the time the borrower applies for the loan through the time fee income and expenses are amortized.

8. Does the bank prepare any reports on a periodic basis for the Board of Directors, the Executive Committee, the Chief Financial Officer, or for anyone else which discuss the number of loans originated, the fee income, the loan origination costs, etc.? Please provide copies of all of these reports for the year.

9. In what accounts are the loan fees and costs being amortized? Are the expenses netted against fees and the net amount amortized or are the income and expenses being amortized separately?

10. How are these amounts being amortized for book purposes? What method and lives are being used?

11. How were the lives of the loans determined? Please provide any studies or industry standards you used to determine the useful lives.

<b>Information Due By _____ At Next Appointment [ ] Mail In [ ]</b>		
<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

## Chapter 10

### BAD DEBTS

#### INTRODUCTION

The primary business of a bank is to lend money to its customers. A bank will claim a bad debt deduction for losses resulting from loans that are not fully repaid, therefore, the amount deducted for bad debts can be significant. The bad debt deduction is an area for potential adjustments since the determination of worthlessness requires a facts and circumstances analysis. Therefore, a fair amount of time should be spent ascertaining the allowable tax deduction.

Prior to the Tax Reform Act of 1986, all banks could elect to deduct their bad debts using either of two methods:

1. Reserve Method

Under the reserve method a bank is allowed to take a deduction for debts that are expected to become worthless in the future. This method permits the bank to establish a reserve for these future worthless debts. The amount deducted is normally based on a 6 year moving average of prior experience. IRC section 585 is the authority for banks to use the reserve method for deducting loan losses. The reserve method authorized by IRC section 593 is available only to thrifts. Note that the reserve method of IRC section 593 was repealed for tax years beginning after December 31, 1995, by section 1616(a) of P.L. 104-188 signed August 20, 1996.

2. Specific Charge-Off Method

Under this method, a bad debt deduction is allowed only in the year a loan is determined to be wholly or partially worthless. IRC section 166 allows the deduction for the portion of the debt that becomes worthless during the year.

The Tax Reform Act of 1986 repealed the use of the reserve method for all taxpayers except for commercial banks with \$500 million or less in assets and thrift institutions.<sup>1</sup> Large banks are allowed to use only the specific charge-off method for computing their bad debt deductions for years beginning after 1986. In addition, these large banks must recapture their entire loan loss reserve balance for tax purposes beginning with the 1987 year. The specific requirements of the reserve recapture are discussed later in this chapter.

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<sup>1</sup> Insurance reserves are governed by subchapter L of the Code and were not directly affected by the repeal of former IRC section 166(c).



**DEFINITION OF A "LARGE" BANK**

A bank is considered to be a large bank if for any taxable year beginning after December 31, 1986, the sum of the average adjusted tax basis of all assets of such bank exceeds \$500 million. If the bank is a member of a controlled group, the test is met if the sum of the average adjusted basis of all assets of such group, including bank and nonbank members exceeds \$500 million. If you are examining a case which has an asset base close to the \$500 million amount, refer to Treas. Reg. section 1.585-5(c) which provides additional guidance to assist you in determining whether this threshold has been exceeded. Final regulations were issued December 29, 1993, covering section 1.585-5 through 1.585-8. See 58 Fed. Reg. 68753 as corrected by 59 Fed. Reg. 4583 (Feb. 1, 1994).

Once a bank is formally classified as a large bank, it will always be considered to be a large bank, even if the asset base drops below \$500 million in a later year.

**RESERVE METHOD**

For banks which are still permitted to use the reserve method, the issue is more computational than technical. The reserve method permits a bad debt deduction for the amount which is determined to be a reasonable addition to the reserve. IRC section 585(b)(1) provides that the reasonable addition to the reserve for bad debts of a financial institution is determined by the experience method.

IRC section 585(b)(2) provides that the amount determined under the experience method shall be the amount necessary to increase the balance of the reserve for losses on loans to the greater of:

**EXTRACT**

IRC section 585(b)(2)(A)

(A) the amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the five preceding taxable years \* \* \* adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such six or fewer taxable years, or

(B) the lower of --

(i) the balance of the reserve at the close of the base year, or

(ii) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year.

\* \* \* \* \*

To put it very simply, the experience method permits a deduction in the amount necessary to increase the reserve for loan losses to the level determined using a 6-year moving average, or the amount required to increase the loan loss reserve to the balance existing in the base year. The base year is the last taxable year before the most recent adoption of the experience method except that for taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. While this may seem confusing, these computations are usually included with the tax return and simply must be reviewed for accuracy by the examining agent.

If the reserve method is being used, verify that the taxpayer includes only permissible loans in computing the addition to the reserve for bad debts. Permissible loans refers to those loans acquired (including originated) in the normal course of business. Additional information on the reserve method for bad debts can be found by referring to one of the publications listed in the Resource and Reference Materials chapter in this guide.

### **SPECIFIC CHARGE-OFF METHOD**

Under the specific charge-off method, a bad debt deduction is allowed only in the year in which the loan is determined to be wholly or partially worthless. Treas. Reg. section 1.166-2(a) provides that in determining whether a debt is worthless, all pertinent evidence including the value of the collateral and the financial condition of the debtor will be considered.

An examiner should consider the following factors in determining the deductibility of a bad debt:

1. A true debtor-creditor relationship must exist:
  - a. There must be a valid and enforceable obligation to pay a fixed and determinable sum of money.
  - b. If a creditor has a disputed claim for which the amount due cannot be accurately determined, the disputed amount is not allowable as a bad debt deduction since the existence of a bona-fide debt has not been established.
2. Debt's worthlessness must be considered:
  - a. The determination of whether a particular loan is worthless, either in whole or in part, is primarily a question of fact. The value of the underlying collateral, the financial condition of the debtor, along with any other factors affecting the possibility of collection must be considered. The burden of proof as to the worthlessness of the debt is on the taxpayer, not the IRS.

- b. Bankruptcy of a debtor is not in and of itself a valid indication as to the worthlessness of a debt. Take into consideration other factors such as the value of the collateral supporting the debt and the reason the debtor filed for bankruptcy.
- c. The taxpayer must exhaust all reasonable means of collection before worthlessness can be established. The taxpayer must retain documentation showing the attempts made to collect the debt. The mere fact that a debt is difficult to collect does not make it worthless for tax purposes. However, a creditor does not have to pursue legal action if in all probability this action will not result in the collection of the debt.
- d. Taxpayer must have a charge-off, that is, the taxpayer must take some action to remove the worthless portion of the asset from its books. See *Brandtjen & Kluge, Inc. v. Commissioner*, 34 T.C. 416 (1960), *acq.*, 1960-2 C.B. 4. This issue is also illustrated in PLR 9338044.
- e. The interaction between debt modification under IRC section 1001 and partially worthless debt is addressed by temporary regulation 1.166-3T, T.D. 8676, 1996-30 IRB 4 (July 22, 1996) and FI-59-94 1996-30 IRB 24 (July 22, 1996).

### **CHARGE-OFF MANDATED BY REGULATORS**

Special provisions in Treas. Reg. section 1.166-2(d) apply to a bank which is subject to Federal or State supervision and which charges off a debt in whole or in part. In these cases, the debt is conclusively presumed to be worthless in whole or in part if the charge-off is made:

1. In obedience to the specific orders of such authorities or
2. In accordance with established policies of such authorities, and upon their first audit of the bank after the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off.

Simply stated, a debt charged off by the bank per written instructions of a regulatory agency is conclusively presumed to be worthless. The charge-off must be in the loss category described below. Loans designated as substandard or doubtful are not deductible for tax purposes.

Practically speaking, we do not see charge-off letters very often because we are reviewing loan files which were written off by the bank prior to supervisory examination. The regulators take a conservative approach and usually will not review loans already determined to be uncollectible by the bank. The bank examiner is much more concerned with loans remaining on the books. Therefore, no written opinion by the regulators on charged-off loans will exist. As to the second item listed above, it is unusual to have the banking examiners give a charge-off letter to the bank after the fact.

For an example in which a bank was not entitled to a presumption of worthlessness on a participation loan which it charged off prior to receiving the Shared National Credit Review, refer to PLR 9253003.

### **BREAKDOWN OF LOAN CLASSIFICATIONS USED BY BANKING REGULATORS**

Regulatory examiners categorize a loan (or some portion of a loan) according to the degree of risk associated with a particular loan and its potential for future losses. The banks use similar criteria in their internal loan review process.

The various loan loss classifications are as follows:

#### **Loss Loans**

Loans classified as loss are considered to be uncollectible. This classification does not mean that the loan has no recovery or salvage value. However, the amount of any potential recovery would be small. The amount of the loan classified as "loss" should be completely charged off for both book and tax purposes. This is the only loan classification which permits a deduction for tax purposes.

#### **Doubtful Loans**

Doubtful loans have all the weaknesses of substandard loans but are one step closer to being uncollectible. Based on all the facts existing at the time and considering the valuation of the assets involved, the possibility of full collection of the loan is highly unlikely. Even though the probability of a portion of the loan being uncollected is very high, the classification of this loan to the "loss" category is deferred due to a reasonable expectation of a full recovery. Potential factors which may influence the classification are a potential merger, additional collateral, an injection of new capital, or a new financing source.

**Substandard Loans**

The substandard category is applied to those loans which are inadequately protected from future losses. This may be due to a lack of security pledged as collateral for the loan, due to the current financial condition of the obligor, or other reasons. These loans have the potential for a portion of the loan to be uncollectible if additional collateral is not secured or the financial condition of the obligor does not improve.

**Special Mention Loans**

This category involves potentially weak loans but which are currently fully protected by the value of the collateral pledged, or the paying capacity of the obligor. The loans are mentioned by the banking examiner since they constitute a credit risk due to the deteriorating financial condition of the obligor, but would not justify any further downgrade in the rating of the loan at this time.

**Unclassified Loans**

Unclassified loans do not have any greater than normal risk. The obligation is expected to be fully repaid and no loss is anticipated.

The following table lists the various classifications of loans used by the regulators and the applicable deduction of the amount of the loan so designated for book and tax purposes. The amount written off for book purposes for both substandard and doubtful loans are based upon each bank's history of loan losses as determined by the regulators. The percentages used below for these classifications are the normal amounts by an average bank.

<b><u>Loan Classification</u></b>	<b><u>Book Purposes</u></b>	<b><u>Tax Purposes</u></b>
Loss	100% deduction required	100% deduction allowed
Doubtful	50% deduction required	0% deduction allowed
Substandard	30% deduction required	0% deduction allowed
Special Mention	0% deduction required	0% deduction allowed
Unclassified	0% deduction required	0% deduction allowed

**CONFORMITY ELECTION FOR BAD DEBT CHARGE-OFFS**

New regulations finalized in February 1992 allow banks to elect to account for bad debts in a manner corresponding more closely to bank regulatory classifications. These regulations allow a regulated financial institution a conclusive presumption that debts which are properly charged-off for regulatory purposes are also worthless for tax purposes, if certain conditions are met. This presumption applies to loans classified under regulatory standards as "loss" assets. These provisions provide conformity with the regulatory standards on loan review and loss classification.

Treasury Decision 8492, 1993-2 C.B. 73, states that:

Treas. Reg. section 1.166-2(d)(3) permits supervised banks to elect a method of accounting under which their debts generally are conclusively presumed to be worthless for Federal income tax purposes when the debts are charged off for regulatory purposes. One of the requirements for this "conformity presumption" is that the bank obtain an express determination letter from its [Federal] supervisory authority in connection with the most recent examination involving the bank's loan review process.

\* \* \* \* \*

\* \* \* The final regulations in this document amend Treas. Reg. [section] 1.166-2(d)(3) to require that a bank's supervisory authority expressly determine that the bank maintains and applies "loan loss classification standards"\* \* \* that are consistent with regulatory standards. \* \* \* In addition, the transition rules in Treas. Reg. [section] 1.166-2(d)(3) allow a bank to make the conformity election without an express determination letter until its first examination (involving the loan review process) that is after October 1, 1992, \* \* \*

Certain important facts to consider in this area are:

1. The conformity presumption is limited to debts that are classified "loss".
2. The conformity presumption applies only to tax years ending on or after December 31, 1991.
3. A bank need not obtain an express determination letter until the completion of its first Federal examination that is after October 1, 1992. The key here is the date the examination report was issued, not the period being examined.
4. Under Notice 93-50, 1993-2 C.B. 336, a bank can, under certain circumstances, elect this accounting method via an amended return for tax years ending on or after December 31, 1991.
5. Rev. Proc. 92-84, 1992-2 C.B. 489 (modifying and superseding Rev. Proc. 92-18, 1992-1 C.B. 684), discusses requirements for obtaining an express determination letter and describes the contents of the letter.

6. The Comptroller of the Currency Examining Circular 216 Supplement 1 issued October 2, 1992 discusses the process for National Banks.

### **BAD DEBT RECOVERIES**

The tax treatment for recoveries of debts which were previously deducted for tax purposes depends upon the method used by the bank to deduct its bad debts.

#### Specific charge-off method:

Recoveries are included in income and fully taxable to the extent a tax benefit was derived by the bank at the time of the deduction.

#### Reserve Method:

Recovery of a debt which was previously charged against the reserve is credited to the reserve, rather than included in income. This affects the computation of the reserve deduction in future years. No deduction is allowed for the amount of the recovery credited to the reserve.

### **BAD DEBT RESERVE RECAPTURE**

The Tax Reform Act of 1986 required that large banks recapture their entire loan loss reserve balance beginning in 1987. If the bank does not meet the criteria for being a large bank at that time, then the loan loss reserve balance will be recaptured beginning in the first taxable year in which the total assets of the bank exceeds the \$500 million limit.

The switch to the specific charge-off method by the bank is considered to be a change in a method of accounting. This change in method of accounting is treated as being made with the Commissioner's consent.

The 1986 Tax Reform Act stipulated that the loan loss reserve balance is to be recaptured by using one of the following elective methods:

1. Fixed Percentage Recapture - General Method

This method requires the reserve balance to be recaptured over a 4-year period using the following percentages:

- a. 10 percent of the reserve balance starting in the disqualification year, 1987, or the year the bank becomes a large bank, whichever is later
- b. 20 percent in the second succeeding year

- c. 30 percent in the third year
- d. 40 percent in the fourth year.

2. Variable Percentage Recapture - Alternative Method

The bank can recapture any amount of the reserve up to 100 percent, in the disqualification year, with a minimum recapture of 10 percent. The balance of the reserve is recaptured in the subsequent 3 years using the following ratios:

-- 2/9s, 3/9s, and 4/9s.

3. Cut-Off Method Recapture

Under this method, all charge-offs and other losses and recoveries on loans in the bank's portfolio as of the end of the taxable year preceding the disqualification year would be accounted for as adjustments to the reserve account, and not as separate items of income and expense.

4. Troubled Bank Exception

The loan loss reserve recapture is not required during any year in which the bank is formally classified as being "financially troubled." However, a troubled bank may elect to report the recapture amount for the first year of the recapture period. This is usually done by a bank with expiring NOLs or tax credits that might otherwise not be used.

A financially troubled bank is defined in IRC section 585(c)(3)(B) as any bank in which the nonperforming loan percentage exceeds 75 percent. This percentage is computed as follows:

The sum of the outstanding balance of nonperforming loans as of the close of each quarter.  
The sum of the equity capital balance of the bank as of the close of each quarter.

See Example 3 in Treas. Reg. section 1.585-6(d)(5).

The amount of nonperforming loans and equity capital are determined by the banking regulators in accordance with federal regulatory guidelines.

Recently, finalized regulations under IRC section 585(c) provide that large banks may not use the reserve method of IRC section 585 for taxable years beginning after December 31, 1986. Treas. Reg. section 1.585-8 provides rules for making and revoking elections regarding the recapture of the reserve and the use of the cut-off method. These rules do not authorize the opening of closed years to make or revoke elections or to file amended returns.



**EXAMINATION TECHNIQUES**

1. Review the tax return to determine whether the taxpayer has elected the new regulatory/tax conformity presumption of worthlessness accounting method which is effective for taxable years ending on or after December 31, 1991. If so, the following procedures should be followed:
  - a. The examiner should request a copy of the "Express Determination Letter" which confirms that the taxpayer maintains classification standards in conformity with the regulators. Refer to Rev. Proc. 92-84, 1992-2 C.B. 489.
  - b. Review the bad debts claimed for book purposes to verify that the bank deducts only amounts actually categorized under the loss classification. Whatever is claimed on the books automatically becomes a bad debt deduction for tax purposes, but only for the loss classification. The taxpayer must have total book/tax conformity in this classification.
  - c. This election does not provide relief for taxable years prior to 1991. Make sure that the taxpayer does not attempt to apply these rules retroactively. The burden is on the taxpayer to support all deductions claimed.
2. If the taxpayer is using the reserve method, which is available only for banks with \$500 million or less in assets, verify the computation of the deduction claimed for tax purposes. Ask the taxpayer to adequately explain any large or unusual items included in the computation.
3. If the reserve method is being used for tax purposes, make sure that the taxpayer does not deduct loan loss amounts elsewhere on the return. It is possible that bad debt deductions could be buried in Schedule D, Form 4797, or in Other Deductions. All bad debt losses should be run through the reserve account, including charge-off's of previously accrued interest income.

A loan restructure should be deemed a sale or exchange of property within the meaning of IRC section 1001 and the loss, if any, should be deductible under IRC section 165 rather than a bad debt deduction.

4. If the taxpayer is on the specific charge-off method, request a complete listing of all loans deducted for tax purposes. This amount should tie exactly into the amount claimed on the tax return. Any discrepancies in these amounts should be explained by the taxpayer.

Usually, we do not request specific verification for loan charge-offs under a certain dollar amount. This amount would depend on the size of the bank being examined and upon the discretion of the examiner.

5. Request a meeting with someone from the bank who handles loans currently in default.

Discuss with him or her the procedures used by the bank to determine when a loan should be charged off, and the bank's loan classification policies. In most of our cases, the tax department was unaware of these procedures and simply deducted for tax purposes whatever the loan control department instructed them to deduct for book purposes. Book accounting and tax requirements are different. That is why it is important to talk to someone familiar with the bank's policies and procedures in this area.

6. Check for any book to tax differences on schedule M-1 dealing with the bad debt deductions. Is the bank taking a deduction for tax purposes but not for book? Analyze any differences. It should be emphasized that the taxpayer cannot deduct a bad debt for tax purposes unless and until there is a book charge off. For partially worthless debts, a book deduction should always be taken before a tax deduction.
7. From the listing of loans charged-off for tax purposes, selectively request the complete loan files for all large, unusual, or interesting loans. In multiple year examinations, emphasis should be placed on the most recent charge-offs since subsequent collections on earlier loans will have already been reported as a recovery.
8. When reviewing the loan file, make sure the taxpayer has provided you with the entire file. Look for recent notes indicating that the file is up-to-date and complete. An outdated loan file is of no value. In order to make a proper determination, you must have the most current information available for each and every loan file requested.
9. Review the loan files for comments and notes by the loan officer on the possibility of subsequent events that could affect the collectibility or recoveries in future years.
10. Request the current status reports for several of the larger loans. Analyze the bad debt recoveries in subsequent years. A large recovery and consistent future payments on a particular loan may indicate that the loan should not have been written off during the examination year.

An analysis of the loan file can help put the bad debt issue in perspective. However, it should be noted that the taxpayer is not bound by subsequent events, such as recoveries or future events to determine a charge-off. Also, the IRS does not have to accept subsequent events to determine if a debt is bad in the current year.

11. An aggressive position can be taken on the charge-offs. It is the bank's responsibility to establish the worthlessness of the debt. Failure to properly document the reduced value of the debt precludes the taxpayer from taking a deduction.
  - a. The taxpayer must document the worthlessness of each loan. The documentation for one loan does not permit the deduction for any other loan. Each loan stands on its own merits and substantiation, or lack thereof.
  - b. Failure by the taxpayer to provide a loan file can give rise to a complete disallowance of any deduction taken for that particular loan. Unusual facts and circumstances should be considered that would affect the availability of the loan file.
  - c. It should be remembered that a loan officer's determination as to the collection potential for a particular loan is self serving. In fact, in some cases the loan officer is probably arguing that the loan will be collected in as much as the loan officer was responsible for making the loan in the first place. His or her comments should not automatically be accepted without other substantiating evidence supporting their opinion. The facts contained in the loan file should speak for themselves.
  - d. In our cases, many of the adjustments we made were based on the taxpayer's failure to provide sufficient proof of worthlessness. The taxpayer was also unable to show that sufficient attempts were made to collect the debt at the point in time of the charge-off.

## **MISCELLANEOUS ITEMS/TERMS**

### **PARTICIPATION LOAN**

A loan made by a bank or financial institution to a borrower, if the lender thereafter sells, assigns, or otherwise transfers a portion of the loan to one or more institutions.

### **SYNDICATION LOAN**

A multi-financial institution loan in which all of the lenders are named as parties to the loan and have privity of contract with the borrower.

### **SHARED NATIONAL CREDIT EXAM**

An examination of a large participation loan shared by more than one federally insured bank.

**SHARED NATIONAL CREDIT REVIEW**

A list of ratings of large participation loans. The list is compiled annually.

**SUMMARY**

With the elimination of the reserve method for large banks, the timing and substantiation requirements for charge-offs take on even greater significance. Large banks have less flexibility in managing their tax position with respect to their bad debt deduction. Therefore, the examining agent should take the time to closely scrutinize all bad debt deductions claimed by the taxpayer.

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## Chapter 11

### FSLIC ASSISTANCE

#### **BACKGROUND**

To encourage investors to acquire troubled savings and loan or thrift institutions, the now defunct Federal Savings and Loan Insurance Corporation (FSLIC) often provided various forms of financial assistance or incentives to acquiring institutions. These acquisitions normally included some or all of the following types of assistance:

1. Issuance of a note receivable to the purchaser

The purpose of a note receivable is to compensate the acquiring institution for the insolvency of the thrift. The amount of the note usually equaled the negative net worth of the thrift. In other words, the amount by which the S&L's liabilities exceeded the value of the underlying assets.

2. Yield maintenance subsidies on loans or other assets

This type of assistance involved the guarantee of additional interest, or provided for a minimum amount of interest, to be received by the purchaser on certain specified interest bearing assets.

3. Reimbursement of losses on disposition of certain assets

These payments reimbursed the acquiring institution for all assets specifically covered in the agreement which were sold for amounts less than a specified amount or became worthless.

4. Indemnification against undisclosed liabilities and litigation resulting from the acquisition

5. Various tax attributes

Under the terms of the agreement, the acquiring institution may be entitled to use various tax benefits of the thrift, such as net operating loss or credit carryovers. However, the agreement may stipulate that FSLIC is entitled to share in the utilization of these tax benefits.

The majority of the assistance payments from the Government were made to cover losses incurred from the sale of the assets of the troubled institution. That's because for the most part, the thrifts which were taken over were insolvent. Prior to the revision of IRC section 597, these assistance payments were excluded from income.

The issue which is discussed in this chapter of the guide involves those cases in which a bank has acquired an insolvent thrift from the FSLIC and receives assistance payments to reimburse losses from the sale of the thrift's assets or their subsequent worthlessness.

For tax purposes, our concern centers around these non-taxable reimbursements. The taxpayer will claim a deduction for the loss on the sale of the assets acquired from the thrift, even though the amount of the loss is fully reimbursed. Since these reimbursed losses account for the majority of the tax benefits, the emphasis is on those acquisitions structured during the period of time when assistance payments were excluded from income and a corresponding loss deduction was taken for tax purposes.

### **ENACTMENT OF FIRREA**

IRC section 597 was amended by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to rectify the above situation and eliminate this preferential treatment for subsequent acquisitions of troubled thrifts. This act was signed by the President on August 9, 1989, and is part of Public Law No. 10-73.

The purpose of FIRREA was to restore the public's confidence in the savings and loan industry. The Act grew out of the massive financial crisis in the thrift industry caused by a regional economic collapse, fraud, and insider abuse that ultimately cost the taxpayers hundreds of millions of dollars.

The Act abolished the Federal Home Loan Bank Board (FHLBB) and created the Office of Thrift Supervision (OTS) which is part of the Department of the Treasury. OTS assumed the role of thrift regulator, and is responsible for the examination and supervision of all savings institutions. FIRREA also abolished the Federal Savings and Loan Insurance Corporation (FSLIC) and gave the Federal Deposit Insurance Corporation (FDIC) the duty of insuring the deposits of savings associations as well as banks. The insurance funds are kept separate with thrift funds in the Savings Association Insurance Fund (SAIF) and the bank funds in the Bank Insurance Fund (BIF). Both SAIF and BIF are administered by the FDIC.

FIRREA also established the Resolution Trust Corporation (RTC), whose purpose was to resolve failed thrifts. The RTC went out of existence on December 31, 1995. IRC section 501(b)(11)(B)(i) of FIRREA, which added new IRC section 21A to the Federal Home Loan Bank Act (12 U.S.C. section 1421, et seq.), provided that one of the RTC's responsibilities was to:

Review and analyze all insolvent institution cases resolved by the Federal Savings and Loan Insurance Corporation between January 1, 1988, and the date of enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, and actively review all means by which it can reduce costs under existing Federal Savings and Loan Insurance Corporation agreements relating to such cases, including restructuring such agreements \* \* \*

Taxpayers who acquired a thrift institution may have renegotiated the original purchase agreements with the RTC or FDIC.

This chapter does not deal directly with those cases in which the Resolution Trust Corporation or the Federal Deposit Insurance Corporation has taken over the institution and continues to operate the business under their control. However, these types of cases are discussed in the next chapter to provide a better overall understanding of the issue.

### **S&L's ACQUIRED PRIOR TO FIRREA**

Prior to the revision of IRC section 597 by FIRREA, all money or property contributed by the Federal Savings and Loan Insurance Corporation under the FSLIC's financial assistance program was generally excluded from the institution's income. In addition, the receipt of this assistance did not require a reduction in the basis of the thrift's assets. Approximately 100 thrift institutions were acquired during the years 1988 and 1989 which involved federal assistance prior to the revisions to IRC section 597.

The Tax Reform Act of 1986 had scheduled for repeal old IRC section 597 along with the special treatment for FSLIC payments for amounts received after December 31, 1988, unless these payments were made pursuant to an acquisition or merger occurring before that date. The Technical and Miscellaneous Revenue Act of 1988, also known as TAMRA, initially extended these provisions through December 31, 1989, with certain modifications and reductions in tax attributes. However, the enactment of FIRREA subsequently changed IRC section 597 for those amounts received or accrued on or after May 10, 1989.

Specifically, the new law provided that financial assistance from federal insurers to troubled financial institutions generally is taxable income to the institutions. The changes to the Code effectively eliminated the generous tax break that initially lured other banks and investors into buying sick thrifts from the Government prior to 1989.

### **ANALYSIS OF THE ISSUE**

The major tax issue involves pre-FIRREA assisted transactions. Specifically, it involves those acquisitions of troubled institutions which were entered into prior to the changes in the law. During this period of time, the law permitted the acquiring corporation to exclude from income the payments received from the Government to cover losses or expenses on the sale or disposition of covered assets. The problem is that the bank then claims a deduction for the losses or expenses associated with the sale of the assets, even though fully reimbursed.



This practice, commonly called double dipping, also gave the bank an incentive to sell the thrift's assets at the lowest price. The lower the price, the larger the tax deduction. Keep in mind that the entire amount of the loss is reimbursed by the Government, so the acquiring entity simply received a larger tax benefit.

For example, if the acquired thrift sells a covered asset for \$70 which was originally carried on the books at \$100, the Government would reimburse the acquiring institution for the total amount of the loss, or in this case \$30. The thrift then deducted that \$30 from its taxable income while receiving a tax free reimbursement of the loss from the Government.

The March 1991 Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions concluded that "assisted institutions should not be allowed to deduct losses and expenses that are reimbursed by the FDIC."

On January 20, 1992, the Office of Chief Counsel issued Notice N (35)000-98 which stated that they will consider litigating the deductibility of covered asset losses in appropriate cases. More recently, as part of the Omnibus Budget Reconciliation Act of 1993, Congress provided that taxpayers could not obtain tax deductions under IRC sections 165, 166, 585, or 593 for losses reimbursed by tax exempt assistance. The provision is effective for tax years ending on or after March 4, 1991. With respect to losses or reimbursements that occurred prior to March 4, 1991, contact the ISP (S&L) Industry Specialist.

#### **YEARS ENDING ON OR AFTER MARCH 4, 1991**

IRC section 13224 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66) provides a legislative solution to the FSLIC double dip issue for tax years ending on or after March 4, 1991. FSLIC Assistance with respect to any loss of principal, capital, or similar amount upon the disposition of any asset shall be taken into account as compensation for such loss for purposes of IRC section 165. See Act section 13224(a)(1).

Any FSLIC Assistance with respect to any debt shall be taken into account for purposes of IRC sections 166, 585, or 593 in determining whether such debt is worthless or the extent to which such debt is worthless and in determining the amount of any addition to a reserve for bad debts arising from the worthlessness or partial worthlessness of such debts. See Act section 13224(a)(2).

As a result of this new legislation, agents should carefully examine any losses or bad debts being claimed in years ending after March 4, 1991, which were the subject of FSLIC assistance.

## **EXAMINATION TECHNIQUES**

1. Prior to devoting any significant audit time to this issue, make sure that the position in this guide is current. At a minimum, contact the S&L Industry Specialist for an update on how the issue should be handled and find out what your options are as an examiner in the field.
2. Transactions involving these types of acquisitions are extremely complex and usually involve agreements of several hundred pages. If your institution is involved in the acquisition of a thrift institution, ask them to provide any letter rulings or other agreements with the IRS concerning the transaction. This will allow you to determine exactly what the primary provisions and stipulations of the acquisition are before you begin to read the multitude of pages in the agreement.
3. There is a considerable emphasis to renegotiate agreements issued by the FSLIC prior to 1989, specifically, those agreements in which the acquiring institution received an overly generous tax break. In the event that your taxpayer was involved in a pre-1989 acquisition, request any renegotiated agreement or closing agreements signed by the taxpayer.
4. Review the schedule M-1 adjustments for any book to tax differences in this area. Normally the taxpayer will handle the acquisition differently for book purposes and a review of the accounts and computations which make up the book numbers may give you a better understanding of the transaction and lead you to other potential areas.
5. Keep in mind that even though this issue primarily affects earlier year acquisitions, restrictions in the acquisition agreement may limit the use of the losses on the disposition of the assets to future years. Therefore, the issue can also come up when examining a bank with an NOL carryforward.

## **POST FIRREA FEDERAL ASSISTANCE PAYMENTS**

Thrift and bank acquisitions which occur after May 9, 1989, fall under IRC section 597 as amended by FIRREA. In these cases, assistance payments paid to troubled financial institutions generally are taxable income to the institution.

The final regulations under IRC section 597 were published in the Internal Revenue Bulletin (1996-6 IRB 4 (February 5, 1996)) and outline the tax treatment of post-FIRREA Federal assistance. The following is a summary of the major provisions of the regulations:

1. Federal Financial Assistance (FFA) is ordinary income.

2. The financial institution receiving assistance for its losses must recognize income. The income generally should match the institution's losses less any acquisition premium paid by the acquirer. Provisions permit the institution to defer recognition of FFA income to the extent that the use of current expenses and NOLs have not completely exhausted shareholders' equity.
3. The IRS will not collect tax due to Federal assistance if a government agency would bear the burden of tax.
4. All tax attributes of the failed institution are eliminated.
5. The Agency making the assistance payments can not use IRC section 7507 except in direct payout situations.
6. The final regulations allow a retroactive election to deconsolidate upon computation of a "toll charge." We don't expect an actual "toll charge" to be paid unless there is a negative capital account for the subsidiary. The potential therefore exists that some audit adjustments could be nullified by this election.

The Service issued Notice 89-102, 1989-2 C.B. 436, on September 7, 1989, which provides preliminary guidance when dealing with taxable acquisitions of troubled financial institutions and which involve the receipt of assistance payments. This notice covers post FIRREA acquisitions prior to the effective date of the proposed IRC section 597. It does not deal with FSLIC assisted "tax-free" reimbursements.

Post FIRREA acquisitions by banking institutions should not involve the covered asset loss issue discussed earlier in this chapter. However, these acquisitions could involve audit issues in other areas, such as claims for refund, tentative allowances, consolidated return restrictions, etc.

## Chapter 12

### FAILED THRIFT INSTITUTIONS OPERATED BY THE RTC

#### INTRODUCTION

Savings and loan institutions which failed between May 10, 1989, and December 31, 1995, were placed under the control of the Resolution Trust Corporation (RTC) until an acquirer could be found or the deposits could be transferred to another institution. The RTC went out of existence on December 31, 1995, and institutions still under RTC control on that date were transferred to a special unit of the Federal Deposit Insurance Corporation (FDIC) in Dallas, Texas.

The examination of a failed savings and loan (thrift) under the control of the RTC provided an unusual dilemma for the IRS in light of the Congressionally funded clean-up effort. Questions arose as to whether to pursue audits or collection of taxes if the amounts would ultimately be paid by the U.S. Treasury.

After more than 2 years of intense study and negotiation, the Internal Revenue Service and Resolution Trust Corporation Inter-Agency Agreement was signed on December 10, 1992. This Agreement was entered into in order to facilitate the disposition of cases involving failed thrifts under the control of the RTC in an orderly and cost efficient manner. Without this Agreement, both Agencies were destined to spend substantial resources challenging and defending tax issues which would only produce a circular flow of cash from one Treasury pocket (RTC through increased Treasury funding) to another Treasury pocket (IRS). A summary of the major provisions of the Agreement and examination processing procedures follows.

For those institutions previously under RTC control, the FDIC has ratified the Inter-Agency Agreement. As a result, the provisions of the agreement continue to apply to those former RTC cases. The Agreement does not, however, apply to institutions which were always under FDIC control. To avoid confusion and make it clear that the special procedures discussed in this chapter apply only to institutions previously under RTC control, these cases will continue to be referred to as RTC cases even though the RTC no longer exists.

#### WHO IS COVERED BY THE AGREEMENT

Not all failed financial institutions are covered by the Agreement. Covered institutions, (referred to in the Agreement as thrifts), include any federal or state chartered savings institution for which the RTC was appointed conservator or receiver, regardless of whether or not the institution meets the requirements of IRC section 7701(A)(19).

**The Agreement does not cover commercial banks or institutions always under the control of the FDIC**

This is an important distinction since savings institutions which failed in 1988 or early 1989 (often called '88 deal cases) were placed under the control of the Federal Savings & Loan Insurance Corporation (FSLIC). When FSLIC was abolished by FIRREA in 1989, these institutions were transferred to the control of the FDIC. While it may appear on the surface that these cases also involve Treasury funds, the situation is not the same and they are not covered by this Agreement since they are not under the control of the RTC. The Bank Insurance Fund (BIF) which insures commercial banks is funded by the industry, not by Treasury.

In examinations involving a parent corporation not controlled by the RTC, the Inter-Agency Agreement does not apply, and it is business as usual although the RTC-controlled subsidiary may be protected by the noncollection provision of the Inter-Agency Agreement.

Please refer to Exhibit 12-1, a flow chart, to assist you in determining whether the IRS/RTC Inter-Agency Agreement applies to your case.

A video user guide entitled "Failed S&L's" (Document 9073 (3-93)) was mailed to each District and outlines the procedures to be followed by examination personnel in the processing of these cases.

**FAILED THRIFT RECEIVERSHIPS**

It may be helpful at this point to briefly explain the typical life cycle of a failed thrift. In dealing with an insolvent savings and loan, the RTC typically used two receiverships. When a savings and loan institution was determined to be insolvent (or otherwise in jeopardy due to unsafe and unsound business practices by prior management or liquidity problems encountered by the thrift) the RTC was appointed its receiver. This first receivership is often referred to as a pass-through receivership because substantially all the deposits and assets are transferred to an interim or "bridge" savings and loan under the RTC's control in conservatorship.

The RTC conservatorship continued to operate the historic business of the old savings and loan by accepting deposits and making or purchasing loans. To the public there may have been little indication that the institution was under RTC control. If the institution was originally known as ABC Savings and Loan, it may now be known as ABC Federal Savings and Loan. For tax purposes, we treat the bridge institution and the original institution as the same taxpayer. The tax year should not end and the EIN should remain the same. It is, however, important to use both names when preparing

statute extensions, closing agreements, or audit reports. The bridge institution will remain in operation for as long as necessary to find an acquirer or, in rare instances, to fully liquidate the institution. This can span several tax years.

At the time of the second receivership, the RTC generally stops the operation of the bridge institution. In many instances, the second receiver transfers substantially all the deposits and assets to an acquirer. In some cases a substantial amount of assets (usually "bad" assets) may remain in the receivership for ultimate liquidation. The RTC often referred to this receivership as a liquidating receivership or final receivership.

The RTC may contribute federal financial assistance to the original insolvent institution, the bridge institution or the acquirer. The tax consequences of this assistance are governed by IRC section 597, Notice 89-102 (1989-2 C.B. 436) and final regulations under IRC section 597 (T.D. 8641, 1996-6 I.R.B. 4 (February 5, 1996)).

### **RTC CERTIFICATION**

Once you have determined that the RTC controlled your thrift, request the required written certification from the FDIC. Previously, this certification was provided by the RTC. FDIC has delegated signature authority for these certifications to several people. The FDIC names you will see most often are Jonnie Wells, David Jones, Richard Cywinski, Sharon Kelley, and Sharon Shroder. If you see other names, contact your local FDIC office and obtain a copy of the delegation order authorizing that person to sign. This written certification provides information specific to the thrift and will state that:

1. The assets of such thrift are insufficient to satisfy the claims of the thrift's depositors;
2. If the IRS were to collect taxes before all depositors were paid in full, additional Treasury funds would be used to satisfy depositor claims;
3. The Federal Income Tax Liability will not be borne by the thrift on account of a tax sharing agreement.

The FDIC is required to provide the certification for each thrift that meets the certification criteria, they cannot selectively certify. The certification will follow one of two formats:

1. Federal Deposit Insurance Corporation  
FDIC AS SUCCESSOR RECEIVER TO RESOLUTION TRUST CORPORATION  
CERTIFICATION OF TREASURY FUNDS USAGE

This certification, also known as FDIC 4360/88, indicates that the RTC controlled a thrift that was either a stand-alone corporation or was the parent of a consolidated group. These are institutions to which all the provisions of the Agreement apply since these are the situations which would produce a circular flow of cash from one Treasury pocket to another.

2. Federal Deposit Insurance Corporation  
FDIC AS SUCCESSOR RECEIVER TO RESOLUTION TRUST CORPORATION  
NON-COLLECTION STATEMENT

This certification, also known as FDIC 4360/89, indicates that the RTC controlled a thrift which was itself a part of a consolidated group for which the RTC did not control the parent. For these institutions only the special non-collection provisions of the Agreement apply. Those provisions only protect the RTC from collection of the tax liability. Collection of the liability from the non-controlled parent of the group will occur under normal procedures.

If the certification criteria cannot be met, the Agreement does not apply and the case will be processed in the normal manner. Although we know of no case to date for which the certification cannot be made, it is possible that in the future, as the new regulatory capital requirements take effect, marginally solvent institutions will be placed in receivership. In those cases, federal taxes may be assessed and collected without affecting the payment of depositors. If you believe you have such a case, immediately contact either the Industry Specialist for Savings and Loans in Los Angeles, or the Industry Counsel for Savings and Loans in Denver.

### **TAXES COVERED BY THE AGREEMENT**

The Agreement covers federal income tax matters. The essence of the Agreement is that the Service will continue to assess all taxes, interest, and penalties against insolvent institutions in RTC receiverships.

The "assess but not collect" rule does not apply to:

1. Employment or trust fund taxes
2. Refunds pursuant to IRC section 6402(i)
3. Certain separate income tax liabilities of a subsidiary of an insolvent institution
4. Cases in which the certification of the use of Treasury funds is erroneous
5. Liabilities arising from tax-sharing agreements.

### **CASE PROCESSING**

Once you have determined that the Agreement applies in its entirety (that is, the RTC controlled thrift is either a stand alone entity or the parent of a group) to your case, special handling rules apply. To avoid transferring money between Treasury pockets, the IRS has agreed not to collect income tax from the RTC on behalf of failed thrifts if Treasury funds are needed to pay depositors. In exchange for our agreement not to collect income taxes, the RTC has agreed not to challenge the amount of tax determined by the IRS. This means the RTC will not be exercising their normal appeal rights.

### **EXAMINATION CONSIDERATIONS**

In determining whether to conduct an examination, or how involved the examination should be, consideration should be given to the spirit of the Inter-Agency Agreement which is to reduce the burden and administrative cost to both the IRS and the RTC while still determining the proper tax. It was decided, nonetheless, that resources should continue to be used for limited audits to ensure that an insolvent institution's tax liabilities are properly determined and assessed. These assessments can reduce potential refunds or eliminate the carry-forward of beneficial tax attributes. Moreover, these assessments will permit an accounting of foregone tax revenue that can be used by the Treasury Department to determine the aggregate cost of federal assistance to insolvent financial institutions. Resource expenditures should be carefully weighed both in light of this Agreement and in light of the emphasis the Service is placing upon collectibility in general.

### **REPORT PREPARATION**

Upon completion of the examination, prepare a Revenue Agent Report (RAR) and a closing agreement. After coordinating the proposed closing agreement with Industry Counsel in Denver, solicit agreement from the RTC. Meritorious issues should be included on the RAR. Include all years examined in the report, particularly where there are adjustments which would offset other adjustments or would eliminate net operating losses or claims already filed. Include both the deficiency years and the overassessment years. If the net result is an overassessment, RTC will waive its right to the refund. If the net result is a deficiency, IRS will not collect this amount under the Agreement.



In CEP cases, prepare Forms 4549-A, 870, and a closing agreement. For non-CEP cases, prepare Form 4549 and a closing agreement. Closing agreement examples for both consolidated and non-consolidated returns are available. Authority to sign these closing agreements is covered by Delegation Order 245.

### **JOINT COMMITTEE CONSIDERATIONS**

The normal Joint Committee jurisdictional rules (IRC section 6405) apply to tax returns for insolvent thrifts under RTC control. Therefore, if refunds or tentative allowances have already been paid in excess of the \$1 million threshold, a report to the Joint Committee on Taxation must be prepared. The closing agreement should not be countersigned on behalf of the IRS until Joint Committee approval has been received. Since under the agreement the IRS will no longer be paying refunds and the RTC will no longer be filing claims for refunds or tentative allowances for cases governed by the Agreement, it is anticipated that Joint Committee volume will decrease significantly.

### **CASE CLOSING**

Attach a copy of Form 3198 "Special Handling Notice" to the case file. Check the "other" box and insert the following instructions:

This taxpayer is covered by the Internal Revenue Service and Resolution Trust Corporation Inter-Agency Agreement. Please assess the tax, additions to tax, penalties, and interest. In processing the assessment input TC 530, closing code 15.

This closing code will alert other Service personnel that Collection efforts beyond the initial notice and filing of the proofs of claim are not warranted. In addition, this code causes notices to be frozen and separates these cases in the Accounts Receivable Dollar Inventory (ARDI). It provides information on the tax costs of the savings and loan bailout.

### **UNAGREED CASES**

The Agreement curtails litigation activity (with some limited exceptions concerning appellate litigation) and provides that all tax disputes be resolved administratively between the IRS and the RTC at whatever stage the case may be when the S&L comes under RTC control. This means that the RTC will agree to IRS assessments without litigation or challenge. Cases in Examination will be settled at the Examination level and cases docketed in Tax Court will be settled without trial by District Counsel. The expeditious resolution of issues at the lowest possible level conserves resources and promotes consistency of position and result.

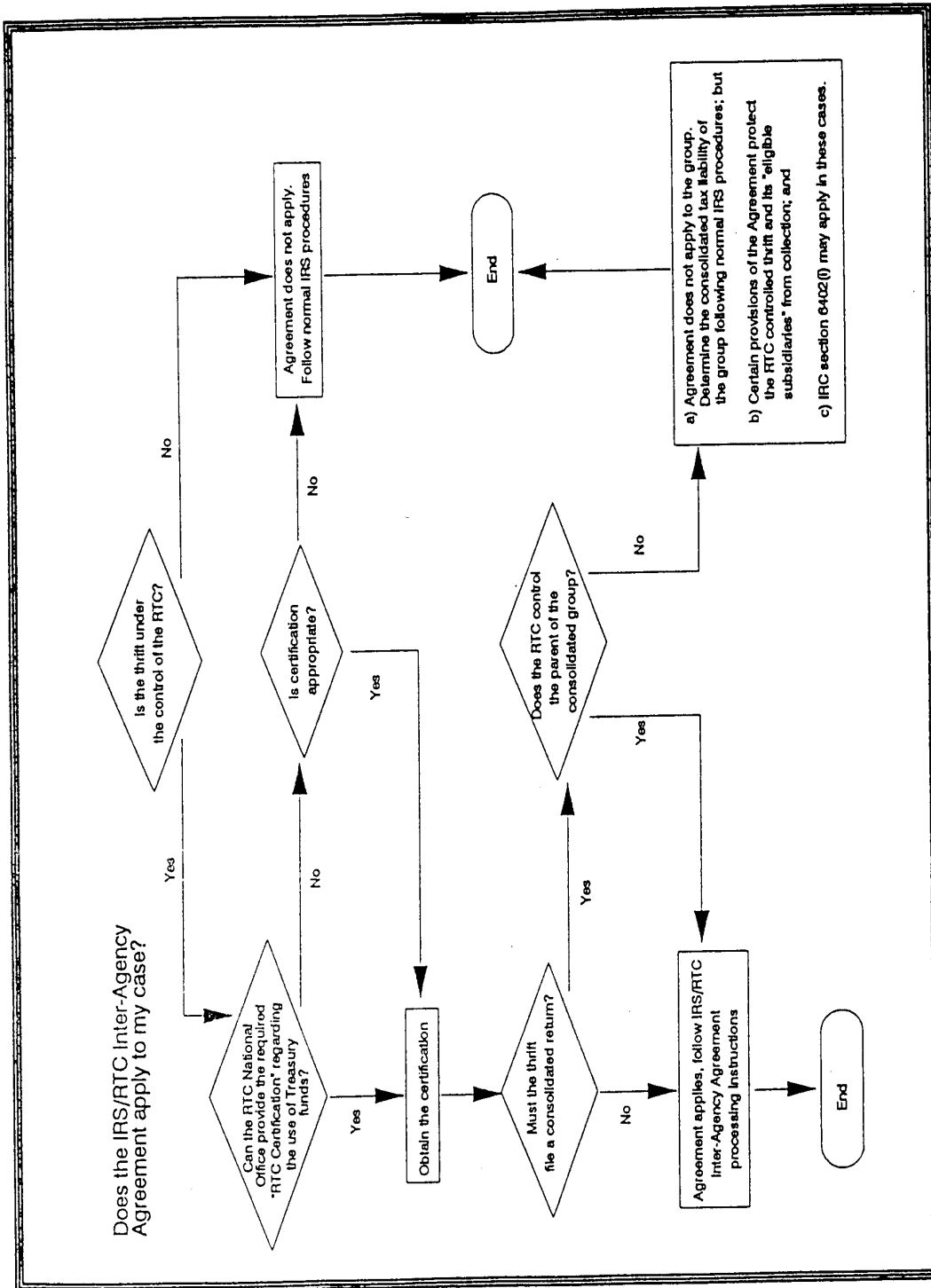
For those situations in which the RTC does not agree with the revenue agent's determination of tax, interest, penalties, and additions to tax, normal appeal procedures will not apply. Do not issue either a 30-day letter or a statutory notice of deficiency. Contact the S&L ISP Industry Specialist or Industry Counsel to review your adjustments. If an agreement cannot be reached, the RTC National Office representative will be afforded an opportunity to either instruct their field personnel to agree with the proposed adjustments or present the unagreed issues to the IRS National Office for a final determination. This procedure will function primarily to resolve questions of tax policy and to ensure consistent treatment of tax issues. The National Office should sustain the agent's reasonable adjustments.

## **REFUNDS**

For those cases to which the entire Agreement applies, the IRS will no longer make any payments to an insolvent thrift or to the RTC as a result of income tax claims for refund, tentative allowances, or refund suits. This prohibition on payment of refunds includes income tax returns filed which show an overpayment of estimated taxes and cases already approved by the Joint Committee where the refund has not yet been issued. Before any payment is authorized to such an insolvent thrift or the RTC, please contact the S&L ISP Industry Specialist, or Industry Counsel. For any claims which have not yet been paid by IRS, RTC will agree in writing to withdraw the claim. The RTC will not file or pursue any further income tax related refund claims for thrifts under its jurisdiction except as specifically provided in the separate IRS/RTC 6402(i) agreement dated September 27, 1991.

## **SERVICE CENTER OVERVIEW**

Special return screening procedures are in place to identify returns to which the Agreement may apply. A classification specialist in each Service Center reviews these returns to determine whether the Agreement applies and whether additional information is necessary to process the return. If you have questions on how these returns are processed at the Service Center, contact the Program Analyst, Coordinated Examination Program, in the National Office.



Reprinted from IRS document 9073 (3-93), Failed S & L's Video User Guide.

## Chapter 13

### ACQUISITION COSTS AND OTHER CAPITAL EXPENSES

#### INTRODUCTION

If you are examining a bank that merged with another bank, acquired a bank, or was acquired by another entity, consider the appropriate tax treatment of the expenses which were incurred. Generally, merger and acquisition expenditures should be capitalized, rather than deducted currently. They usually are not amortizable. The applicable law for this treatment is discussed later in this chapter.

In recent years there have been numerous mergers and acquisitions of large national banks as well as smaller local banks. Banks may decide to merge to reduce operating expenses through elimination of extra personnel and branches, to expand geographically, cheaply, and quickly, or to discourage an acquisition by an undesirable bank.

Acquisitions of banks are also common. A bank may seek a buyer, such as when the owners of a closely held bank wish to retire and receive cash for their investments. Bank acquisitions are "unfriendly" or "hostile" when they are opposed by the target bank. Publicly held banks, whose stocks are undervalued in relationship the value of their assets, are potential takeover targets. Also, troubled institutions may be taken over by the Federal Deposit Insurance Corporation or the Resolution Trust Corporation. These organizations may then sell the assets to healthy financial institutions.

There are various types of expenses that a bank can incur when it undergoes a change in structure. A number of these expenses are discussed below:

1. Legal Expenses - A substantial amount is paid to attorneys for drafting agreements, negotiating prices, resolving Community Reinvestment Act protests, fighting lawsuits, etc. Normally the bank will hire a particular law firm which specializes in mergers and acquisitions. Ask the taxpayer which firm they used and review those specific invoices. Allocation of the bank's in-house attorneys' salaries should also be considered.
2. Investment Banker Expenses - Investment bankers perform several services in relation to merger and acquisition activities. They often render a fairness opinion as to whether the consideration offered is reasonable. They also may market a company that is interested in being purchased.

3. Appraisal Costs - Accountants and engineers may be hired to value certain tangible and intangible assets. As discussed in an earlier chapter, a bank may pay a premium for an existing deposit base. There are companies that specialize in the valuation of these core deposits. In a tax free stock merger, appraisers may still be hired to value assets for book purposes.
4. Regulatory Fees - Banks are required to receive regulatory approval before a merger or acquisition can be finalized. The regulatory agencies may charge a fee for the work that they do in processing and approving the merger or acquisition. For example, the fee charged by the Financial Institutions Bureau in Michigan as of June 1992 was \$10,000. Fees are also paid to the Security and Exchange Commission.
5. Accounting Fees - Accountants may be hired to perform various functions. They may provide tax advice to the different parties. An analysis of the banks' different computer and accounting systems may be made in order to efficiently combine them. Also, they may do studies to determine the value of assets. The banks may also incur in-house costs for this type of work, which may be subject to capitalization.
6. Payment for Due Diligence Study - The Board of Directors will often hire an accounting or investment firm to study all aspects of the proposed transaction. They will render an opinion as to whether the merger or acquisition is in the best interests of the company. This protects the directors from shareholders who may not be pleased with the change.
7. Shareholder Costs - The bank is required to receive shareholder approval for any changes in business structure. The bank will incur costs for notices in newspapers, printing of prospectuses, mailings to shareholders, etc.
8. Salaries and Wages - As mentioned above, bank employees, such as attorneys and accountants may spend considerable time working on the merger or acquisition. The key officers of the bank will also be involved in negotiations, decision making, traveling, etc. A portion of their salaries should also be considered for capitalization.

There are a number of issues related to merger and acquisition activity. Some of them, such as core deposits, recapture of bad debt reserves, and FSLIC assistance payments are discussed elsewhere in this guide. Other merger and acquisition issues such as the type of reorganization, the gain/loss that should be recognized, recapture provisions, etc. are complex and are beyond the scope of this guide. In this chapter, we will limit our discussion to the examination techniques and tax treatment for acquisition and merger expenses. Several other types of capital expenditures by financial institutions will also be discussed.

**EXAMINATION TECHNIQUES**

1. First review the tax return. Since many of these expenses are capitalized for book purposes, the taxpayer may have made an M-1 adjustment to expense them for tax purposes. Sometimes the taxpayer will attach a disclosure statement to the tax return to disclose that merger or acquisition costs were expensed. Also, the detail schedule for "other deductions" may include these expenses as a separate line item.
2. Read the portion of the bank's annual report that discusses past, present, and pending business combinations. It will provide general information as to your bank's merger and acquisition activity.
3. The corporate minute book should be reviewed to obtain more detailed information. It may disclose activity that was considered, but never consummated. The minute book may also discuss some of the costs associated with mergers and acquisitions.
4. Once you have determined that a bank incurred expenses related to merger or acquisition activity, an IDR should be issued requesting specific cost information. A sample IDR is included (See Exhibit 13-1.) which shows the type of information that can be requested. Most banks keep detailed records of their costs because they need to report this information to their regulatory authorities. Also, they use the information for internal planning purposes. However, the tax department often is not aware that merger and acquisition cost information is readily available. They may need to check with the legal department to find out what records were maintained.
5. Request a copy of the Notification and Report Form for Certain Mergers and Acquisitions that the bank files under the Hart-Scott-Rodino Antitrust Improvement Act of 1976. This form is provided to the Federal Trade Commission and the Antitrust Division of the Department of Justice to allow them to consider the anti-competitive effects of the proposed merger or acquisition.
6. If the bank has not kept detailed records, you may need to review the specific transactions which were recorded in accounts titled "Legal Expenses," "Accounting Fees," "Consulting Fees," etc. A computer audit specialist can perform stratifications and account selections to assist you in selecting a sample.
7. Interview employees that were involved with the mergers or acquisitions to determine what types of expenses were incurred, especially if in-house legal or other work was performed. An allocation can be made for the salaries of bank employees who assisted in the merger or acquisition.

## LAW AND DISCUSSION

The tax treatment of merger and acquisition expenses may vary depending on whether the expenses are paid to defend against a takeover attempt, whether the proposed merger or acquisition is abandoned, or whether the institution you are examining is the acquiring or the target bank. Each of these items is discussed below.

### General Information

The most important court opinion in this area is *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), *aff'g National Starch and Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990), *aff'g* 93 T.C. 67 (1989). The Supreme Court held that the investment banking fees and expenses incurred during a friendly takeover were not deductible under IRC section 162. The Court stated in *Indopco* at p. 1040:

Petitioner's expenses do not qualify for deduction under IRC section 162(a). Deductions are exceptions to the norm of capitalization and are allowed only if there is clear provision for them in the Code and the taxpayer has met the burden of showing a right to the deduction. *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354, holds simply that the creation of a separate and distinct asset may be a sufficient condition for classification as a capital expenditure, not that it is a prerequisite to such classification. Nor does *Lincoln Savings* prohibit reliance on future benefit as means of distinguishing an ordinary business expense from a capital expenditure. Although the presence of an incidental future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is important in determining whether the appropriate tax treatment is immediate deduction or capitalization. The record in the instant case amply supports the lower courts' findings that the transaction produced significant benefits to petitioner extending beyond the tax year in question.

This case was significant because the Supreme Court said that the creation or enhancement of a separate asset was not a necessary condition for capitalization. Instead, the creation of a long term benefit was sufficient to require the expenses to be capitalized. Some of the benefits that resulted from this merger were (1) additional technological resources, (2) synergy, (3) a reduction in shareholder expenses, and (4) administrative advantages from the reduction in shares. The court determined that the taxpayer, National Starch, believed that the shift in ownership was in its best interest and would benefit the company for many future years.

IRC section 197 was added by the Revenue Reconciliation Act of 1993. The new law provides for the amortization of certain purchased intangible assets. However, there are a number of intangible assets which are specifically excluded from the application of IRC section 197. IRC section 197(e)(8) provides that any fees for professional services or other transaction costs with respect to transactions in which gain or loss is not recognized under IRC sections 351-368 cannot be amortized under IRC section 197. Therefore, most merger and acquisition costs are specifically excluded.

The Conference Committee's report indicates that it was not Congress' intent to overturn *Indopco* by enacting IRC section 197. Since these transaction costs are specifically excluded from IRC section 197, they should be treated as they were prior to the section's enactment. Therefore, continue to look to *Indopco* to determine the nature of these expenditures. If merger or acquisition costs create a long term benefit, they should be capitalized and not amortized.

Revenue Ruling 73-580, 1973-2 C.B. 86, states "compensation paid for services performed by employees relating to the acquisition of other corporations is not distinguishable from fees paid for similar services performed by outsiders." Thus, a corporation must capitalize the portion of the compensation paid to its employees that is reasonably attributable to services performed in connection with corporate mergers and acquisitions.

### **Takeover Attempts**

Whether a proposed corporate takeover is friendly or hostile is not determinative of the proper tax treatment with respect to professional fees. *A.E. Staley Mfg. Co. v. Commissioner*, 105 T.C. 166 (1995). But see *United States v. Federated Department Stores*, 171 Bankr. 603 (S.D. Ohio 1994), *appeal pending* (6th Cir. No. 94-4676). The focus should be on whether the target corporation obtained a long-term benefit as a result of making the expenditures. The taxpayer must demonstrate that it did not obtain a long-term benefit. Expenditures for professional fees incurred in a takeover attempt, labeled hostile or friendly, may be classified as either currently deductible under IRC section 162 or capitalizable under IRC section 263, depending on the specific facts and circumstances of each case.

Costs incurred by the target company in repurchasing its stock from the corporate raider should also be considered. Assume that a target company makes a lump sum payment to the corporate raider for reimbursement of the raider's fees and for expenses which were incurred as a result of the unsuccessful takeover attempt. Both of these expenses are treated as nondeductible capital expenditures since they relate to the repurchase of stock where the repurchase was not essential to the corporation's continued existence.

In summary, some of the expenses incurred in defending a takeover may be deductible. The primary factor in determining deductibility is whether the expenditure resulted in a long term benefit. If so, the expense should be capitalized. If not, the cost can be expensed. For a more detailed discussion of loan fees in connection with a redemption of stock, see the Mergers & Acquisitions ISP Coordinated Position Paper on this issue. [The "Loan Commitment Fee In a Stock Redemption" paper was originally issued as a LBO Industry Coordinated Issue Paper; however, the LBO ISP has been redesignated as the Mergers & Acquisitions ISP.]



### **Abandoned Mergers**

Merger and acquisition costs, otherwise capitalizable, are generally deductible losses under IRC section 165 when the transaction is abandoned. See Rev. Rul. 73-580, 1973-2 C.B. 86. However, if an expense is incurred for an item used subsequently, the costs would generally not be deductible. Each cost should be analyzed to determine whether it created a long term benefit. For example, a target company may reject several takeover bids prior to accepting a final offer. If the taxpayer can establish through careful documentation that particular expenses relate only to the abandoned proposals, those expenses may be deductible. However, any expenses that relate to both the abandoned and the adopted merger should be capitalized. For example, valuations of stock or appraisals of property could be used to evaluate more than one offer.

There have been several court cases and revenue rulings which discuss the deductibility of expenses related to abandoned projects. In *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950), the court held that the taxpayer was entitled to deduct as ordinary and necessary expenses the costs attributable to an abandoned merger. The merger was one of three proposals that were not alternatives and the taxpayer could have accepted any or all of them. It cited *Doernbecher Manufacturing Co. v. Commissioner*, 30 BTA 973 (1934), which determined that the amount paid by the taxpayer as its share of expenses of investigating the possibilities of forming a merger were deductible in the year in which the plan to form the merger was abandoned. *Doernbecher* was also mentioned in Rev. Rul. 67-125, 1967-1 C.B. 31. This revenue ruling discusses the treatment of legal expenses for securing advice on the tax consequences prior to the consummation of a merger, stock split, and partial redemption. The ruling states that these expenditures are capital in nature, but could be deducted in the year of abandonment if the proposed redemption of stock is subsequently abandoned.

Rev. Rul. 73-580, which was discussed above, held that amounts paid to employees with respect to abandoned plans for mergers or acquisitions are deductible as losses under IRC section 165(a) in the year of the abandonment.

However, if the proposed transactions are alternatives, only one of which can be accepted, no abandonment loss is proper unless the entire transaction is abandoned. See *Staley*, 105 T.C. at 200.

### **Target vs. Acquiring Company**

The general rule that merger and acquisition expenses are nondeductible and capital may be clearer for the acquiring company than for the target company. It is readily apparent that the acquiring company would not incur these expenses unless it

anticipated that they would benefit the company for a period of time. However, a target company may incur expenses in defending a hostile takeover or in evaluating friendly takeover proposals which were later abandoned. The general theory from *Indopco* should be applied, namely that costs should be capitalized if they create a future benefit.

## **OTHER CAPITAL EXPENDITURES**

There are a number of other situations in which a bank incurs expenses that may be subject to capitalization. The general philosophy as to whether a separate asset or a future benefit is present should be considered to determine whether an expenditure should be capitalized or expensed. Some of the areas where potential issues exist are discussed below:

### **Branch Costs**

When a bank opens new branch offices, it incurs numerous expenses such as attorney fees, studies of various site locations, application fees to obtain regulatory approval, etc. The bank may form a new corporate subsidiary for the new branches. Regulatory approval generally must be obtained prior to opening a new branch. This creates an intangible right the bank did not previously have. The general position of the Service has been that branch expansion costs are capitalized since a separate and distinct asset is created. The *Indopco* case discussed above provides additional support for the Government's position since the opening of a branch office would create a future benefit. However, the banking industry takes the position that these costs should be currently deductible under IRC section 162. The banks feel that they are merely extending their current business activity by opening new branches. The Fourth Circuit has allowed banks to deduct their expansion costs, while the Fifth Circuit and Eleventh Circuits have denied the deduction.<sup>1</sup> Some taxpayers have elected to amortize these costs over 60 months per IRC section 195 for Start-Up Expenditures.

Each cost should be independently analyzed to determine whether it creates a future benefit. If so, that expenditure should be capitalized, even though other business expansion costs may be currently deductible. See *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992).

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<sup>1</sup> *North Carolina National Bank v. United States*, 78-2 U.S.T.C. ¶ 9661 (D. N.C. 1978), *rev'd*, 651 F.2d 942 (4th Cir. 1981), *aff'd upon reh. en banc*, 684 F.2d 285 (4th Cir. 1982); *Central Texas S&L Association v. United States*, 84-1 U.S.T.C. ¶ 9471 (5th Cir. 1984); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), *cert denied*, 103 S. Ct. 3537.

### Credit Card Start-Up Costs

The theory behind whether or not a bank can deduct the costs it incurs for credit card start-up costs is very similar to whether or not new branch costs can be expensed. The taxpayers maintain that these costs are an extension of their current business. However, the IRS can argue that some of the expenditures result in the creation of a future benefit or a separate asset. In general the courts have held that when payment was made to allow a bank to join a particular credit card system, it was capital in nature since it had value to the bank for its duration. However, expenses for credit reports, advertising, etc. were allowed as current deductions.<sup>2</sup>

### Automatic Teller Machine Fees

Banks pay one time fees to join some of the automatic teller machine (ATM) systems. However, some ATM systems do not require any initial fee to be paid. NYCE, CIRRUS, and MAC are a few of the systems which do charge upfront fees. The bank acquires the future right to use the ATM system indefinitely. Therefore, this cost would be a capital expenditure.

### Advertising

There was considerable discussion after the opinion in *Indopco* on whether advertising expenses created a future benefit that should be capitalized. The IRS issued Revenue Ruling 92-80, 199-2 C.B. 57, to clarify its position. The ruling provides that the *Indopco* decision does not affect the treatment of advertising costs under IRC section 162(a). These costs are generally deductible under that section even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. \* \* \* Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized.

### SUMMARY

Because of the proliferation of mergers and acquisitions in the last decade, it is very likely that the bank that you are examining may have been considered as a takeover target or may have considered acquiring another institution. If so, the bank would have incurred considerable expenses that should be capitalized.

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<sup>2</sup> See the discussion of this issue in Charles W. Wheeler, JD and Jack B. Wilson, Jr., CPA, *The Bank Income Tax Return Manual-1992*, p. 5-89 to 5-90.

Prior to the *Indopco* opinion, many taxpayers were expensing merger and acquisition related costs. Some continue to do so. Determine early in the examination whether the bank has any of these types of expenses. If so, each expenditure should be analyzed carefully to determine whether it should be capitalized.

Even if the bank did not have any merger or acquisition related expenses, you may need to evaluate whether other types of costs were improperly expensed. Consideration should be given to whether these expenditures contributed to the creation of a separate asset or a future benefit. If so, they should be capitalized.

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SAMPLE INFORMATION DOCUMENT REQUEST

<b>Form 4564</b> <b>Rev. 6/88</b>	<b>Department of the Treasury</b> <b>Internal Revenue Service</b> <b>INFORMATION DOCUMENT REQUEST</b>	<b>Request Number</b>
<b>TO: Name of Taxpayer and Co. Div. or Branch</b>       <b>Please return Part 2 with listed documents to requester identified below.</b>		<b>Subject</b> <b>Acquisition Costs</b>  <hr/> <b>SAIN No. Submitted to:</b>  <hr/> <b>Dates of Previous Requests</b>

**Description of Documents Requested**

During 19XX and 19XX the bank made a number of acquisitions of other banks and of banking assets. When making such acquisitions it is common to incur costs for related expenses, such as: Outside legal fees, consulting fees, valuation studies, lifing studies, accounting fees, salaries for key employees, investment banking expenditures, etc.

1. Please provide a detailed list of the expenditures that were incurred for each of the acquisitions during these years.
2. Were any reports provided to the FDIC, RTC, SEC, or any other agency regarding acquisition costs? If so, please provide copies.
3. In what account(s) were acquisition costs recorded?
4. How were these expenses treated for tax purposes? Were they expensed or capitalized? Were any of them depreciated or amortized?
5. In 19XX there is an M-1 adjustment for the bank to decrease book income by \$XXX,XXX for acquisition fees. Please provide the work papers to explain this adjustment. Were any other M-1 adjustments made in 19XX or 19XX for acquisition related fees? If so, please provide those work papers.

**Information Due By \_\_\_\_\_ At Next Appointment [ ] Mail In [ ]**

<b>FROM:</b>	<b>Name and Title of Requester</b>	<b>Date</b>
	<b>Office Location</b>	

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## LEVERAGED BUYOUT LOANS

### INTRODUCTION

A leveraged buyout (LBO) involves the purchase of a company in which a substantial portion of the purchase price is paid by borrowed funds which are secured by the assets of the company. The debt is repaid from the future earnings of the company, sale of company assets, issuance of public stock, additional capital contributions, or any combination of the above.

Since the early 1980's, the stock market has seen an explosion of leveraged buyouts. Mergers and acquisitions became common in almost every industry. The banking industry participated in the leveraged buyout boom in that a significant portion of the financing for these transactions was provided by the banks. A change in the Federal Reserve regulations allowed investment bankers to arrange financing for the acquisition of stock in public companies.

As discovered within the last couple of years, a lot of the leveraged buyout loans made by financial institutions did not come without substantial risk. The collapse of several institutions can be directly related to the financing or participation in highly leveraged LBO loans along with so called "junk bonds." However, if successful, these LBO loans could be very lucrative to the banks in the form of higher interest rates, substantial fees paid up-front for participating in the loan, and possibly even a financial interest in the company itself.

### INVESTMENT BANKERS

Investment bankers, in most cases, are the primary people involved in the leveraged buyout field. They are often referred to as LBO "specialists." Investment bankers find companies for sale, structure the deal, and negotiate with both the selling and buying groups. They also arrange debt financing and equity investments. After a buyout, the investment banker will continue to monitor the company in the event additional assistance is needed, such as a public offering of the stock. The vast majority of the LBO activity is conducted by big investment firms and companies specializing in this area.

### EXAMINATION TECHNIQUES -- NON-CASH COMPENSATION

If your case involves a bank that was only a participant in the financing of an LBO loan, as opposed to being the investment banker, the issue is fairly simple. The Securities and Exchange Commission (SEC) requires that a bank disclose the extent of their LBO activity in their annual reports.



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1. Review this report to determine the extent the bank is involved in this type of investment. If no formal annual report is prepared by the bank, this information can usually be found in the regulatory or SEC filings.
  2. If you determine that the financial institution participated in LBO transactions, secure a complete list of the individual LBO loans from the taxpayer. These loans should tie into the amounts reflected in the annual report.
  3. Specifically, inquire as to whether there were any "perks" given to the bank as an incentive to participate in the leveraged buyout.

These perks, also known as "sweeteners," consist of stock warrants or other noncash consideration which allows the bank to earn additional profits based on the success of the company. Stock warrants are simply a right to purchase the stock of the company for a specified price for a certain period of time. The bank does not pay any money or give up any other consideration that may be due in exchange for these warrants. The warrants are an additional payment to the bank for providing the funding necessary for the LBO.

4. Also request a signed statement from someone with personal knowledge of these transactions to explain the extent of the bank's involvement in these types of transactions. This is the easiest way to determine if any issues exist and whether the bank received any compensation in return for its participation.
5. A random check should also be made of selected loan files to verify the taxpayer's statement.

In most of our examinations, we have found that it was the bank's policy not to request this additional consideration. However, if warrants or other incentives were given to the bank and accepted without any restrictions or further requirements of the bank, these rights are considered to be additional compensation. The fair market value of the warrants is fully taxable to the bank as ordinary income at the point in time the warrants are issued as part of an investment unit under IRC section 1273.

The fair market value of the warrants which was previously included in income will become the basis for the warrants. If the warrants are exercised instead of sold, the basis in the warrants becomes part of the bank's basis in the stock.

The primary reason these warrants are offered to the lender is to give the bank a reason for wanting the company to be successful. If times became tough, the bank would be reluctant to foreclose on the property because the value of the company would be diminished. By receiving these warrants, the bank has received a partial ownership in the success of the company.

The most difficult part of this issue involves the valuation of the rights.

Treasury Reg. section 1.83-7(b)(3) provides the following insight in determining the value of an option.  
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### **EXTRACT**

Treas. Reg. section 1.83-7(b)(3)

\* \* \* the fair market value of an option to buy includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise price), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. \* \* \*

This last sentence is very important because it allows a value to be placed on the future prospects of a company, not just the value of the company at the point in time the option was granted. The value of a warrant or other similar option cannot easily be determined and must be based on the facts and circumstances of your case. If an issue is found in this area, a specialist may be required to determine the fair market value and the amount of the adjustment.

### **EXAMINATION TECHNIQUES – FEES PAID TO THE BANK**

Another issue in the leverage buyout area involves the fees paid to the bank, other than fees paid for the loan, to participate in the LBO transaction, or for other services rendered. These fees are all taxable when the cash is received by the bank. These amounts cannot be deferred for tax purposes, such as over the life of the loan, or any other method of deferral.

1. A sample LBO loan file should be reviewed to determine the amount of fees received by the bank. Verify that these amounts are properly reported on the tax return. Most banks will have a separate account for these types of fees, and therefore tracing the fees to the tax return should not be that difficult.
2. Request also that the bank provide its current policy as to how these amounts are reported for tax purposes.
3. Review the schedule M-1 adjustments for any differences in the timing of income or deduction for financial and tax purposes relating to LBO fees or expenses. All of these areas can lead to potential adjustments.

## SUMMARY

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Currently, there is an LBO specialist in the Industry Specialization Program. Several Coordinated Issue Papers have been proposed in the leveraged buyout area. The majority of the issues involve the tax implications to the LBO target entity. However, there are also issues involving investment banking activities. The ISP has a data base on LBO transactions. This data base can help to identify potential leads on your case.

If you are examining a large entity which is involved in investment banking services, the LBO coordinated issues should be reviewed. Since these issues involve only a limited number of banks, they are beyond the scope of this guide.

## AMORTIZATION

### INTRODUCTION

Amortization is the method of allocating the cost of an intangible asset over its useful life. When a deduction for amortization is claimed, Part VI of Form 4562, Depreciation and Amortization, should be completed by the taxpayer. The amount deducted for amortization should be included as part of line 26 of the tax return, other deductions.

Amortization issues are usually seen in cases where an entire business or a group of assets is purchased. In these cases, a portion of the purchase price is normally allocated to an intangible asset. In the past, it was common for the taxpayer to allocate as much of the purchase price as possible to intangible assets which are amortizable for tax purposes. This reduced the remaining value allocated to goodwill or going concern value. The larger the allocation of the purchase price to an amortizable intangible, the bigger the deduction for tax purposes. Treas. Reg. section 1.167(a)-3 provides: "no deduction for depreciation is allowable with respect to goodwill." The historical position of the IRS has been that an amortization deduction was not allowed for amounts allocable to intangible assets such as work force in place and going concern value. However, recent changes in the law have significantly affected this issue.

### LAW CHANGES

Congress passed the Revenue Reconciliation Act of 1993 which provides that the capitalized cost of specified intangible assets referred to as "IRC section 197 intangibles" are to be ratably amortized over a 15-year period. This provision of the law provides that the 15-year amortization period is applicable regardless of the actual useful life of the intangible property. The new law was intended to eliminate controversies between the Service and taxpayers over allocations of purchase price between amortizable intangibles and nonamortizable goodwill. It carries some loss deferral rules but taxes gains on early dispositions of IRC section 197 intangibles.

The enactment of this law will significantly affect how we examine the amortization and intangible areas for tax purposes. See discussion of the Intangibles Settlement Initiative in Chapter 5. Proposed Treas. Reg. section 1.197-2 was published in the Federal Register on January 16, 1997. See also Treas. Reg. section 1.197-1T.

## AMORTIZATION ITEMS

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Amortization is normally applicable to intangible assets. Some of the most common banking assets which are subject to the amortization provisions are as follows:

- \* 1. Core deposit intangibles
  - \* 2. Covenant not to compete
  - \* 3. Merger and acquisition costs
  - \* 4. Loan origination costs - SFAS 91
  - \* 5. Originated servicing rights
  - \* 6. Credit card start-up costs
  - \* 7. Entrance and exit fees for bank insurance funds
  - 8. Purchased servicing rights
  - 9. Organizational and business start-up costs
  - 10. Work force in place.
- \* Items 1-7 are discussed in detail elsewhere in this guide. The remaining items are discussed below. Suggested examination techniques and potential issues are provided.

## LAW

Internal Revenue Code section 167(a) states:

### EXTRACT

IRC section 167(a)

\* \* \* There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) --

- (1) of property used in the trade or business,
- or
- (2) of property held for the production of income.

**EXTRACT**

Treas. Reg. section 1.167(a)-3

\* \* \* If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to \* \* \* depreciation. \* \* \*

**GENERAL EXAMINATION TECHNIQUES**

1. It is important to keep in mind that just because the taxpayer does not include an amortization amount on Form 4562, does not mean that an amortization deduction was not claimed by the taxpayer. It has been our experience that it is common for the taxpayer to include the amortization expense elsewhere on the return, even if it is not specifically listed on Form 4562. Since the amount deducted for amortization is included as part of line 26, other deductions, the amount can easily be combined with another account, netted against income, mislabeled, or just included as part of miscellaneous expenses.

Therefore, the taxpayer should be specifically asked whether any amortization deductions were claimed on the return. If any exist, then request a complete list of the assets being amortized along with the worksheets computing the amount of the deduction taken on the return. All of these items should be reconciled and tied into the amount on the return. On one of our cases, the taxpayer acquired another bank with a core deposit. The amortization deduction was buried in a subsidiary bank which was not being examined. Obtaining a detailed listing of the assets being amortized for all entities in the consolidated return group from the taxpayer is helpful for identifying these issues.

2. The taxpayer is not required to include on its tax return a detailed listing of the items being amortized from prior years. For example, if the taxpayer were to acquire and amortize a Core Deposit in a year preceding the examination year, this fact would not be apparent from reviewing the tax return. The taxpayer is required to provide only the amount of the amortization deduction being claimed for assets acquired in prior years. A description of the property, the cost of the property, and the method of amortization is only required for intangible assets acquired during the current year. Therefore, always review prior year amortization deductions and request adequate documentation.
3. Review the annual report or SEC filings for any indication as to whether or not assets are being amortized. Usually, there is a section in the annual report dealing with income taxes and accounting policies which may mention intangible assets and give you clues as to potential areas to examine. This latter section may also discuss the method of amortization being utilized for financial reporting purposes.

4. Review Schedule M-1 for any book to tax differences in the amount of amortization being claimed by the taxpayer. There should always be an M-1 adjustment if the taxpayer is amortizing goodwill or similar assets for book purposes since these deductions are not allowed for tax purposes. Amortization deductions in excess of the amount taken for book purposes should be closely scrutinized.
5. The life of the asset and the method of computing the amortization are also areas which should be thoroughly reviewed. A shorter useful life, or the use of an accelerated method will produce a larger deduction for the taxpayer. These computations should always be reviewed to determine if they are technically correct and reasonable.
6. Normally, the straight-line method of amortization is used for tax purposes. Any accelerated method claimed on the return should be closely scrutinized. However, under certain circumstances, taxpayers are permitted to take additional amortization if they can show that it properly reflects the actual decline in value of the asset.

For example, if all or a portion of the mortgage servicing rights were sold or unanticipated prepayments were made (such as might occur if interest rates declined), the value of the remaining asset may decrease more rapidly than provided for by the original straight-line amortization. Based on the facts and circumstances, the taxpayer may be able to support an additional amortization deduction to match the anticipated servicing income stream on the remaining principle balances of the associated mortgages.

7. One of the biggest problems encountered with an amortization issue deals with the valuation of the intangible assets. This is especially true where the purchase price is not allocated to the individual assets in the purchase contract. These valuations are dependent on the facts and circumstances of each particular case and normally require the assistance of an engineer. Even if the taxpayer has secured a sophisticated appraisal or paid for an expert valuation report, the reasonableness of the conclusions must be evaluated by an IRS engineer.

### **PURCHASED SERVICING RIGHTS**

Mortgage servicing can be very profitable to a bank if done in volume. A bank that decides to operate a mortgage servicing department will occasionally purchase servicing rights from other banking entities. The bank may also purchase servicing rights from another servicer in bulk. The primary reason for purchasing these additional servicing rights is that the bank cannot originate enough servicing rights fast enough to become profitable.

While purchased servicing rights are similar to originated servicing rights, the issue should not be confused. The purchased servicing rights issue deals solely with the computation of the amortization deduction claimed by the taxpayer on servicing rights which it has purchased. Originated servicing rights are obtained when a bank lends money for a mortgage and retains the right to service the loan after it is sold.

As discussed in detail under the originated servicing issue, the servicing rights have significant underlying value. A bank will pay a premium for these rights. It is this premium which is being amortized by the purchasing bank.

As also discussed in detail under the originated servicing issues, rights to receive mortgage servicing fees are stripped coupons within the meaning of IRC section 1286(e)(3) to the extent, if any, that they exceed reasonable compensation for the services to be performed under the servicing contract. This is true not only for originated servicing rights, but also for purchased servicing rights. Rev. Proc. 91-50, 1991-2 C.B. 778, provides guidance on determining the extent to which mortgage servicing fees constitute reasonable compensation.

IRC section 1286(a) provides that stripped coupons are treated as having original issue discount (OID). Therefore, the basis attributable to any portion of mortgage servicing fees that exceeds reasonable compensation is recovered in accordance with the OID rules. In contrast, any basis attributable to the portion of purchased servicing that constitutes reasonable compensation is subject to IRC section 197. The legislative history of this section makes it clear that IRC section 197 does not apply to amounts that exceed reasonable compensation.

Under IRC section 197, purchased mortgage servicing rights will be amortizable over 9 years provided they relate to indebtedness secured by residential real property and they were not acquired as part of the acquisition of a trade or business. Other purchased mortgage servicing rights will be amortizable over 15 years. The new provisions are effective for property acquired after August 10, 1993. The taxpayer may elect, subject to some stringent rules, to apply the new rules to all property acquired after July 25, 1991. Questions remain about the possible interplay between IRC sections 197 and 475 for purchased mortgage servicing rights.

## **EXAMINATION TECHNIQUES**

1. As mentioned earlier in this guide, one of the first questions to ask the taxpayer is whether the bank operates a mortgage servicing department. If they do, request the taxpayer to provide the purchase contract and verify the amortization deductions for all servicing rights acquired from outside parties, along with any related work papers.
2. Review the taxpayer's computations to determine whether the amount of the deduction is accurate. This issue normally does not involve a valuation problem.



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Rather, the issue involves the method and life over which the rights are amortized by the purchasing bank. The amount of premium paid for the servicing rights is usually evidenced by a purchase agreement. However, when servicing rights are purchased along with other assets, such as in an acquisition, an allocation of the cost must be made. The amount allocated to the rights should be amortized over its useful life as discussed below.

3. The correct method or life for amortization purposes must be determined based on the facts of your particular case. Usually, a 12-year life for a 30-year fixed rate mortgage is the norm, with an 8-year life for a 15-year mortgage. The determination of the life is complicated if the mortgages are aged, if there is a combination of 15-year and 30-year mortgages, or if there are both conventional and adjustable rate mortgages. Salomon Brothers publishes a table showing the estimated useful lives of mortgages depending on the age of the mortgage and also takes into consideration the interest rate of the mortgage. This book, or a similar type book is usually available from the mortgage department of the bank.
4. The straight line method of amortization is required unless the taxpayer can substantiate otherwise. Because of the large number of mortgages that were refinanced in the early 90's, the taxpayer may argue that the useful lives of earlier mortgages are shorter than the 8 and 12 years mentioned normally allowed for amortization. Normally, we will allow the taxpayer to deduct the actual run-off of the mortgage repayments if the amounts can be adequately substantiated. However, in those cases the life of the mortgage servicing may extend beyond 12 years. Theoretically, lower interest rate mortgages have longer lives, especially if interest rates have increased, because there would be fewer people refinancing.

## **ORGANIZATIONAL AND BUSINESS START-UP COSTS**

Organizational expenditures are those costs directly related to the creation of a corporation. All costs associated with starting up the business are not allowed as a current deduction and must be capitalized. However, an election to amortize the expenses can be made.

IRC section 195 deals with start-up expenditures. It provides in part that:

### **EXTRACT**

IRC section 195

(a) CAPITALIZATION OF EXPENDITURES.—

Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

(1) IN GENERAL.--Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer \* \* \*

\* \* \* \* \*

(c) DEFINITIONS.--For purposes of this section--

(1) START-UP EXPENDITURES.--The term "start-up expenditures" means any amount--

(A) paid or incurred in connection with -

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, \* \* \*

\* \* \* \* \*

IRC section 195 provides that start-up expenses be deferred and amortized at the election of the taxpayer over a period of not less than 60 months. The election to amortize organizational expenditures must be made in a statement attached to the return for the taxable year in which the business begins.

Both IRC section 195 and IRC section 248 allow these costs to be capitalized and then amortized over 60 months. It thus might not seem important to distinguish between the two types of costs; after all, both receive the same treatment. This might well be the case for the regular income tax.

But it is important for the Alternative Minimum Tax. IRC section 56(g)(4)(D)(ii) requires an Adjusted Current Earnings (ACE) adjustment for IRC section 248 organizational costs. There is, however, no corresponding adjustment for IRC section 195 start-up costs. Thus, the distinction between IRC section 248 organizational costs and IRC section 195 start-up costs is important for the AMT.

Taxpayers might want to take IRC section 248 organizational costs and recharacterize them as IRC section 195 start-up costs to reduce their alternative minimum taxable income (AMTI).

1. Review Form 851, Affiliations Schedule, which is attached to the return to determine if the taxpayer started any new businesses or subsidiaries during the examination years. The issue is most common in those entities which are expanding their asset bases through new businesses.
2. Analyze all of the cost areas associated with the creation of the new company, such as legal expenses, salaries, and fees paid. It has been our experience that the taxpayer will actually capitalize many of the direct costs clearly associated with a new business. However, many of the indirect costs such as officers' salaries and in-house legal costs are overlooked by the taxpayer and should be capitalized.

Some examples of the costs which must be capitalized are as follows:

- a. Legal services related to the creation of the corporation such as drafting the corporate charter, bylaws, minutes of organizational meetings, and similar expenditures,
- b. Accounting services,
- c. Expenses of organizational meetings of the board of directors or shareholders, and
- d. Fees paid to the state of incorporation.

The chapter on acquisition costs provides additional examples of the type of expenses you may encounter.

3. Review the minute book and annual report for clues as to any plans the corporation may have to expand into new areas. Research the bank in a local library, and secure any other public information concerning your bank to assist in this examination area.

If the corporation fails to make the proper election to amortize the organizational expenses, they must be capitalized and will remain on the books until the year of dissolution or liquidation. At that time they will be deductible as a loss from the sale or exchange of a capital asset.

**WORK FORCE IN PLACE**

When a bank acquires another institution, it may allocate a portion of the purchase price to an intangible asset which they call "work force in place." This is the name given to the employees of the acquired company which are retained by the new entity.

Historically, the IRS position has been that an amortization deduction for this type of intangible asset is not allowable. However, this issue may be affected by the Supreme Court's decision in *Newark Morning Ledger* and by the enactment of IRC section 197. See *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. 253 (1991), *aff'd*, 17 F.3d 684 (4th Cir. 1994). A complete discussion of this issue is beyond the scope of this guide. This issue usually involves a rather large deduction and we recommend the assistance of an engineer be requested.

## **GENERIC POSITION PAPERS**

The following Coordinated Issue Papers deal with various amortization issues. They were issued in generic form which means that they can apply to industries across the board as opposed to any specialized industry. Copies of the complete Issue Papers are available from your ISP/MSSP District coordinator. However, in view of the enactment of IRC section 197, a revision of the Issue Papers may be required. Contact your District ISP Coordinator for an update.

### **Amortization of Assembled Workforce**

Whether in the context of an acquisition of a business, the benefit inherent in acquiring a trained staff of employees already in place is an amortizable asset.

### **Covenants Not to Compete**

Whether covenants not to compete entered into during acquisition negotiations are amortizable.

### **Customer Based Intangibles**

In the acquisition of a going business, whether customer based intangible assets, in which a cost basis has been allocated, are amortizable under IRC section 167. In other words, whether the particular customer based intangible is an asset separate and distinct from the goodwill of the acquired business.

### **Employment Contracts**

Whether employment contracts entered into by a target company during acquisition negotiations are an asset of the target company where there is no substantial business purpose for the target company independent of the proposed sale of the company.

### **Amortization of Market Based Intangibles**

Whether a benefit derived from a competitive market position is an amortizable asset under IRC section 167(a).

**Amortization of Order Backlog**

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Whether a benefit derived from acquiring unfilled customer orders at the acquisition date is an amortizable asset under IRC section 167(a).

## FEE INCOME

### INTRODUCTION

Although interest income is the primary source of a bank's revenue, fee income can also be a significant income source. There are many types of fee income; however, labels are not determinative of their treatment. This chapter will discuss commitment fees, service fees, and points (also called loan origination fees).

### COMMITMENT FEES

A commitment fee is generally a nonrefundable charge for making funds available for a specific period of time at a fixed rate of interest. This fee is not considered interest income since the fee is not paid for the use or forbearance of money. For example, someone building a home may pay a commitment fee to the bank to guarantee that it will lend \$100,000 within 90 days at 8 percent.

For cash basis banks, the commitment fee is income in the year it is received. For accrual basis banks, the fee is included in income in the year it becomes due or when received, whichever is earlier.<sup>1</sup>

Keep in mind that many banks are required to use the accrual method of accounting after 1986. Banks with gross receipts of more than \$5 million are prohibited from using the cash method of accounting, except for certain specified transactions.

### SERVICE FEES

Banks charge fees for services rendered in connection with loaning money such as: escrow fees, recording fees, credit inspection fees, appraisal fees, etc. The tax treatment of these fees depends on whether the taxpayer reports its income on the cash or accrual method and when payment for the fees was received.

Taxpayers using the accrual method report their fee income when it is earned or received, whichever is earlier. Therefore, accrual basis taxpayers will report service fees in the year the loan is made regardless of whether cash was received or whether the fees were added to the loan balance.

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<sup>1</sup>

Rev. Rul. 70-540, 1970-2 C.B. 102.

Cash basis taxpayers report service fees as income when received. Therefore, if the service fees are paid at closing they are reportable at that time. However, if the amount of the fees is added to the loan balance instead of paid at closing, a cash basis taxpayer includes the fee in taxable income ratably, as payments are made on the loan.<sup>2</sup>

## **POINTS**

Revenue Ruling 70-540, 1970-2 C.B. 101, defines points as a charge made by the lender to the borrower, which is in addition to the stated annual interest rate, and is paid by the borrower to the lender as an adjustment of the stated interest to reflect the actual cost of borrowing money. The number of points charged by the lender is determined based on the factors that dictate an acceptable rate of interest. Points are paid for the use or forbearance of money and are considered to be interest.

For example, if the market rate of interest for a zero point mortgage is 8 percent, a borrower might pay one point to lower the interest rate to 7.75 percent. One point is 1 percent of the loan balance, for example, \$1500 for a \$150,000 loan.

Rev. Rul. 70-540, amplified by Rev. Rul. 74-607, 1974-2 C.B. 149, provided guidance concerning when points charged by a lender were to be included in the lender's income. In general, Rev. Rul. 70-540 held that points were includable in a lender's income upon receipt. The final original issue discount (OID) regulations, however, change the lender's treatment of points.<sup>3</sup>

Treas. Reg. section 1.1273-1 defines OID as the excess of a loan's stated redemption price at maturity over its issue price. Under Treas. Reg. section 1.1273-2(g), points paid when a loan is originated reduce the issue price of the loan, thereby creating or increasing the amount of discount on the loan.<sup>4</sup> If the points are financed by the lender, the loan's stated redemption price at maturity is increased by the amount of the points. Thus, all points charged on a loan create or increase the amount of discount on the loan.<sup>5</sup>

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<sup>2</sup> Ibid.

<sup>3</sup> Rev. Rul. 70-540 (to the extent of any holdings concerning the lender's treatment of points) and Rev. Rul. 74-607 were made obsolete by Rev. Proc. 94-29, 1994-1 C.B. 616.

<sup>4</sup> For example, if a borrower pays at closing \$2,000 in points on a loan with a stated principal amount of \$100,000, the loan's issue price is \$98,000, the loan's stated redemption price at maturity is \$100,000, and, therefore, the loan has discount of \$2,000.

<sup>5</sup> The rule in Treas. Reg. section 1.1273-2(g) does not apply to the borrower's treatment of the points if the points are deductible under section 461(g)(2) of the Code.

If the amount of the discount on a loan is more than a de minimis amount (as determined under Treas. Reg. section 1.1273-1(d)), the lender includes the discount (OID) in income over the term of the loan. See Treas. Reg. section 1.1272-1. If the amount of the discount on the loan is a de minimis amount, the lender includes the discount (de minimis OID) in income as stated principal payments are made on the loan. See Treas. Reg. section 1.1273-1(d)(5).

On April 4, 1994, the Service released three revenue procedures dealing with accounting method changes for OID and de minimis OID (including discount attributable to points): (1) Rev. Proc. 94-28, 1994-1 C.B. 614, (2) Rev. Proc. 94-29, 1994-1 C.B. 616 and (3) Rev. Proc. 94-30, 1994-1 C.B. 621. The revenue procedures are discussed in more detail later in this chapter.

A distinction should be made between points that are paid for the use or forbearance of money and points that are paid as reimbursement for closing costs. Points that are charged for specific services by the lender are not interest and can not be deferred. Examples of fees for services not considered to be interest are the appraisal fee, preparation costs, settlement fees, and notary fees. The final OID regulations do not change the treatment of service fees.<sup>6</sup>

Both cash and accrual banks must report service fees as income when the loan closes if they are paid at closing. Accrual basis banks must report financed service fees as income when earned at closing.

## **EXAMINATION TECHNIQUES**

1. The taxpayer should be questioned extensively regarding all the types of fee income the bank earns. Fee income may be properly reported for one type of loan, but improperly deferred for another type of loan. For example the bank may report cash fees for adjustable rate mortgages, but amortize the cash fees for 30 year conventional mortgages.
2. Review the general ledger for deferred income accounts. There are likely to be different accounts for each type of loan, such as: 30-year fixed conventional, 15-year adjustable rate mortgages, 30-year FHA, etc. The accounts in the general ledger should be compared to the M-1 work papers to determine which accounts have not been adjusted for tax purposes.

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Under Treas. Reg. section 1.1273-2(g), a payment by the borrower for services provided by the lender in a lending transaction, such as commitment fees or loan processing costs, does not reduce the issue price of the loan.



3. Review the M-1 schedule to ensure that the bank's fee income was reported differently for tax than for books. For book purposes, banks are required to report most of their fee income as an adjustment to yield over the life of the related loans, regardless of whether the borrower paid or financed the fees. Therefore, many fees are required to be reported earlier for tax than for book, especially if they were not financed by the borrower. The M-1 adjustment for this item is often titled "Deferred Fee Income."

The M-1 adjustment may either increase or decrease book income depending primarily on whether lending activity has increased or decreased during the year. Analyze the taxpayer's M-1 work papers to obtain a complete understanding of what adjustments are being made. The following computation is a very simple example of what the work papers might show:

Fee income reported for books	\$400,000
Deferred fee income balance 1/1	(300,000)
Deferred fee income balance 12/31	<u>500,000</u>
Taxable fee income	<u>\$600,000</u>

The M-1 adjustment is \$200,000. This represents the change in deferred fees for the year. The deferred fee account is increased by any cash fees that were not reported as income on the books and is decreased as the fees are subsequently recognized for books.

4. Determine whether the taxpayer filed a Form 3115 to change its method of accounting for fee income. Even if the IRS has approved the change, you still need to verify that the facts are the same as they were represented in the ruling.
5. If the taxpayer is deferring fee income (other than points) for tax purposes, a complete analysis of the loan documents must be made. Consider the following items:
  - a. Did the borrower bring cash to closing? If so, deferral of fees (other than points) may not be allowable. This may be true even if the taxpayer contends these funds were for reimbursement of the bank's costs, such as for filing fees.
  - c. Evaluate the loan documents to determine the terms of the agreement between the bank and the customer. Unless there is a clear understanding between the lender and the borrower that the fees are being financed and this is confirmed by the loan documents, the fees (other than points) should not be deferred.

6. If the bank earns fees which can be deferred, you will need to determine whether they are being amortized into income properly. Some of the amortization methods that you may encounter are discussed below:
- a. Sum of the month's digits and straight line have been allowed as amortization methods for both cash and accrual basis taxpayers.
  - b. The composite straight line method has been allowed for use by accrual basis taxpayers for tax years prior to the OID regulations. Under this method fees are recognized ratably over the life of the loans. See Rev. Rul. 54-367, 1954-2 C.B. 109.
  - c. For years prior to the application of the OID regulations, the liquidation method has been approved for use by cash basis taxpayers. Under this method, the percentage of the fees recognized each month is equal to the percentage of principal liquidated during the month. See Rev. Rul. 64-278, 1964-2 C.B.120.
  - d. A constant interest rate method is to be used whenever fee income is in the nature of original issue discount (OID). Some loan fees, such as points, may meet the definition of OID. This will be discussed in more detail later in this chapter.

Revenue Rulings 54-367 and 64-278, *infra*, which permitted amortization under the composite and liquidation methods, were issued before the original issue discount (OID) rules were changed by DRA 1984 and TRA 1986. You are very likely to encounter taxpayers using those methods who should instead be including income on a constant interest rate method.

- e. Rev. Rul. 54-367, 1954-2 C.B. 109, and Rev. Rul. 64-278, 1964-2 C.B. 120, were made obsolete by Rev. Proc. 94-29. Thus, a taxpayer may no longer rely on these rulings for any loan required to be accounted for in accordance with the final OID regulations.

A discussion of the mechanics of each of these methods is beyond the scope of this guide. If a taxpayer that you are examining is amortizing fees into income you will need to (1) determine which method is being used, (2) do research to determine whether it is an appropriate method, and (3) analyze the taxpayer's workpapers to evaluate whether the method is being utilized properly.

6. Determine whether the bank you are auditing sells its loans, such as mortgages, shortly after they are originated. When the loans are sold any unamortized fee income would be recognized immediately. If you determine the bank was improperly deferring loan fees and required them to include the fees in income

when the loans were originated, your adjustment would be reversed as soon as the loans were sold. Although this would result in a permanent timing difference, it may not be significant enough to warrant spending the time needed to examine this area.

## **LAW**

Section 451 of the Internal Revenue Code states "the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Treas. Reg. section 1.451-1 provides that under the cash method of accounting items of income are includible in gross income when actually or constructively received. Under the accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Rev. Rul. 70-540 discusses the taxable year in which lending institutions are to include in income commitment fees and service fees charged by them in connection with real estate mortgage loans. The conclusions reached in this ruling were explained previously. Rev. Proc. 94-29, 1994-1 C.B. 616, made obsolete the discussion in Rev. Rul. 70-540 concerning the treatment of points by a lender.

## **ORIGINAL ISSUE DISCOUNT**

Original issue discount or OID is the excess (if any) of the stated redemption price at maturity over the issue price of a debt instrument (for example, a loan). See IRC section 1273(a)(1). OID consists of all "interest" that is payable on a debt instrument other than interest that is payable at a fixed rate at least annually over the entire term of the instrument.

### **Example 1**

A debt instrument is issued on January 1, 1995, for \$750. The debt instrument provides for a payment of \$1,000 on January 1, 1998. The debt instrument has \$250 of OID. (The debt instrument is a "Zero-coupon bond.")

### **Example 2**

A debt instrument is issued on January 1, 1995, for \$500. The debt instrument provides for a payment of \$500 on January 1, 1999, and for interest payments of \$125 on January 1, 1997, and January 1, 1999. The debt instrument has \$250 of OID. (The debt instrument is an "Installment obligation.")

### Example 3

<http://www.getirshelptoday.com>

A debt instrument is issued on January 1, 1995, for \$500. The debt instrument provides for a payment of \$500 on January 1, 1999, and for interest payments of \$40 on January 1 of each year, beginning on January 1, 1996, and ending on January 1, 1999. Because all interest is payable annually at a fixed rate over the entire term of the instrument, the debt instrument has no OID.

In Example 1, it would make no difference if the \$250 payable at maturity in excess of the \$750 amount loaned was designated either as interest or principal by the parties - the \$250 would be taxed as interest under the OID provisions.

The Tax Reform Act of 1984 revised the rules for original issue discount, including the extension of the OID rules to loans issued by individuals, such as mortgage loans. Proposed regulations relating to OID were issued on December 22, 1992, which substantially revised the proposed regulations issued on April 6, 1986.

On February 2, 1994, the Service published final rules for the treatment of OID, de minimis OID, stated interest, and unstated interest. See generally sections 1.163-7, 1.446-2, 1.483-1 through 1.483-3, 1.1001-1(g), 1.1012-1(g), and 1.1271-0 through 1.1275-5 of the Income Tax Regulations (the final OID regulations). In general, the final OID regulations are effective for debt instruments issued on or after April 4, 1994. A taxpayer, however, may rely on the final OID regulations for debt instruments issued on or after December 22, 1992, and before April 4, 1994.

On April 4, 1994, the Service released three revenue procedures dealing with accounting method changes for OID and de minimis OID, including any discount attributable to points: (1) Rev. Proc. 94-28, (2) Rev. Proc. 94-29, and (3) Rev. Proc. 94-30.

Rev. Proc. 94-28 provides taxpayers with procedures to obtain automatic consent to change their methods of accounting to conform to the final OID regulations. This revenue procedure applies only to changes in methods of accounting for taxable years that end on or after December 22, 1992, or begin on or before April 4, 1994. If a taxpayer is making a change under this revenue procedure, the taxpayer generally must choose one of the following cut-off dates to make the change: (1) December 22, 1992, (2) the first day of any taxable year beginning after December 22, 1992, and before April 4, 1994, or (3) April 4, 1994. Because the changes made under this revenue procedure are made only for debt instruments (loans) originated on or after the cut-off date, no section 481(a) adjustment is necessary, and taxpayers do not obtain audit protection for loans originated before the cut-off date.

Rev. Proc. 94-28 also provides special rules for any change in method of accounting for de minimis OID, including de minimis OID attributable to points. For example, if a taxpayer is making a change under this revenue procedure for de minimis OID, the taxpayer also may choose the first day of the taxpayer's first taxable year beginning after April 4, 1994, as the cut-off date for the change.

Rev. Proc. 94-29 allows a taxpayer to use the principal reduction method of accounting, an aggregate method of accounting for de minimis OID, including de minimis OID attributable to points, on certain loans originated by the taxpayer. The principal reduction method of accounting, which is based on the principles of Treas. Reg. section 1.1273-1(d)(5), allows a taxpayer to take aggregate de minimis OID into account as principal on the underlying debt instruments is liquidated, in the proportion that the liquidated principal bears to the total outstanding principal. The revenue procedure specifies certain categories into which loans and related de minimis OID must be classified to perform the calculations, and requires that the calculations of liquidated principal be performed monthly. In addition, the revenue procedure requires that detailed books and records be kept to support a taxpayer's calculations. Because this method gives taxpayers an immediate increase in basis for the de minimis OID amount even though the income recognition is spread over the period principal is received, a potential problem exists if the related loan is then "marked to market" at yearend under IRC section 475. The Service published Notice 96-23, 1996-16, I.R.B. 23 (April 15, 1996) to solicit comments on the interaction of the two provisions and to put the taxpayers on notice that they cannot take an inconsistent position until the conflict is resolved.

Rev. Proc. 94-29 also prescribes exclusive procedures for taxpayers to use in changing to the principal reduction method of accounting. Taxpayers that follow the procedures receive automatic consent to make the change. In general, taxpayers may change to this method for loans originated on or after the "cut-off date" chosen by the taxpayer. For purposes of this revenue procedure, the cut-off date is the first day of any taxable year ending on or after December 22, 1992. Special rules are provided, however, to determine the cut-off date if the year of change includes either December 22, 1992, or April 4, 1994. Because the change made under this revenue procedure is made only for loans originated on or after the cut-off date, no IRC section 481(a) adjustment is necessary, and taxpayers do not receive audit protection for loans originated prior to the cut-off date.

Finally, Rev. Proc. 94-9 obsoletes several earlier revenue rulings that provided taxpayers additional methods of accounting for points, including the composite method and the loan liquidation method. See section 10 of this revenue procedure for the list of obsolete revenue rulings.

If a taxpayer is changing its method of accounting for de minimis OID, including de minimis OID attributable to points, under either Rev. Proc. 94-28 or Rev. Proc. 94-29, the change only applies to loans originated on or after the applicable cut-off date.

Rev. Proc. 94-30 provides the exclusive procedures for a taxpayer to obtain the Commissioner's consent to change its method of accounting for points on loans acquired before the cut-off date, and prescribes the only methods of accounting for points to which a taxpayer may change for these loans. Under Rev. Proc. 94-30, the year of change may be no later than the first taxable year beginning after April 4, 1994.

For points previously accounted for under the current inclusion method (that is, included in income on origination of a loan), the taxpayer may change to a deferred recognition method known as "the revised loan liquidation method." This method is modeled on the principal reduction method described in Rev. Proc. 94-29, with certain modifications. Taxpayers also may change to a loan by loan basis of accounting for points originally subject to the current inclusion method of accounting, taking points into account as stated principal payments on each loan are made. The change in method of accounting for points previously recognized under the current inclusion method is made for all loans held by the taxpayer as of the cut-off date. Accordingly, a negative IRC section 481(a) adjustment is necessary for this change.

For points previously accounted for under some type of deferred recognition method (that is, a method other than the current inclusion method), taxpayers may change only to "the revised loan liquidation method" of accounting. This change is effected on a cut-off basis, and no IRC section 481(a) adjustment is allowed. Special rules apply if the taxpayer, at the time of the filing of the Form 3115 to make the change is under examination, before an appeals office, or before any federal court.

## **SUMMARY**

When examining a bank consider the proper tax treatment of the fee income it receives. As discussed earlier, the fees may be reportable in the initial year or deferred over time depending on whether they represent interest and whether they were paid when the loan was originated.

Review the loan documents carefully to determine when the fees are reportable for tax purposes, since this often differs from book reporting. Unless the loan documents clearly show that there is a clear understanding between the bank and the borrower that the fees are being financed and the loan documents confirm this agreement, the fees (other than points) should not be deferred. If the taxpayer is allowed to defer fee income, the amortization method being used should be evaluated.

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## INCOME RECEIVED IN ADVANCE

### INTRODUCTION

Under the accrual method of accounting, the right to receive income generally determines when to report that amount for tax purposes. However, prepaid income received without restriction must be included in taxable income when received. This is true even if these amounts have not yet been earned by the bank.

Prepaid amounts must be included in taxable income even if the bank may be required to repay the amount at some future time. A deduction may be taken by an accrual basis bank in the year in which the bank satisfies the "all events" test for liability to repay the income. The all events test will not be met earlier than when economic performance with respect to such liability occurs.

The general rule involving prepaid income assumes the bank is using the accrual method of accounting which is defined later in this chapter. Example applications of these provisions are also provided below.

### LAW

Treas. Reg. section 1.451-5(b)(1) defines the taxable year of inclusion. This provision provides in general that:

Advance payments must be included in income either--

- (1) In the taxable year of receipt; or
- (2) In the tax year in which properly accruable under the method used for tax purposes unless the method used for financial purposes results in an earlier accrual.

In addition, in *Schlude v. Commissioner*, 372 U.S. 128 (1963), the Supreme Court required the taxpayer to report not only advance cash payments but other payments falling due, but not paid, that were for future services. However, although this is the general rule, it may not apply to certain types of financial transactions. For example, the regulations under IRC section 446 that apply to swap transactions and the OID regulations discussed elsewhere provide different rules.



Rev. Rul. 66-347, 1966-2 C.B. 196, discusses the year income must be recognized when it is received without restriction as to its disposition, use, or enjoyment. It also discusses income which has been received subject to a contingent liability requiring a portion of the income to be returned. This ruling holds that the income must be reported in the year of receipt and a deduction is taken only in the year that a refund is made.

The theory behind this position can be applied to any type of an advanced payment of income issue. Although the tax treatment of prepaid interest has been affected by the final OID regulations, the analysis in *Continental Illinois*, T.C. Memo. 1989-636, *aff'd* 998 F.2d 513 (7th Cir. 1993), can be cited as the authority for an adjustment in some other situations. The following is a summary of the Tax Court opinion.

1. The burden of proof was on the accrual basis taxpayer to show that the income should not be taxed when received.
2. The Commissioner has broad discretion in determining the proper method of accounting that a taxpayer may use. Also, the Commissioner did not exceed his discretionary powers in this case.
3. The court determined that since *Continental Illinois* met the two prong claim of right doctrine test, income should be included upon receipt.

### **ACCRUAL METHOD OF ACCOUNTING**

One of the most important requirements of a method of accounting is that it must clearly reflect income. The Tax Reform Act of 1986 substantially limited a bank's flexibility in selecting a method of accounting. For taxable years after 1986, banks with gross receipts of more than 5 million dollars are required to use the accrual method. Under this method, it is the right to receive the income, as opposed to the actual receipt of the money, that determines when to include the amount in gross income. The advantage of the accrual method over any other method of accounting is that it more accurately reflects income on a periodic basis.

Treas. Reg. section 1.451-1(a) provides that under the accrual method of accounting, income is included in gross income in the taxable year in which:

1. All events have occurred which fix the right to receive the income and
2. The amount of such income can be determined with reasonable accuracy.

When a bank earns a fee for services or receives cash payments in advance, determining the point in time that it must report these amounts as income can sometimes be confusing. Simply put, is the bank required to report income when received or when earned? The general rule is that advance payments are income when received, even to an accrual basis taxpayer, unless an exception applies. To better understand this area, several potential issues are discussed below. In each situation, the bank receives an advance payment and could attempt to defer a portion of this income until future years.

CREDIT CARD FEES

Most commercial banks that offer customers credit card services will charge the user an annual fee for the use of the card. The fee is charged to the customer at the inception of the account and on each anniversary date of the issuance of the card. The fee is approximately \$25 per card holder, and covers the use of the card for the subsequent 12 months. The fee is usually nonrefundable.

The issue is whether the entire annual fee for the use of the credit card should be included in income in the taxable year in which the payment is made, or should the fee be included in income on a ratable basis over the time period covered by the use of the card.

The IRS views these credit card fees as amounts received for the right to utilize the credit card rather than as income for services rendered. The annual credit card fee does not represent a charge for the use of money and also, does not represent a fee for future services. Therefore, the credit card fees should be reported in income when received by the bank. The amounts should not be deferred and subsequently reported as income evenly over a 12-month period.

Many commercial banks have taken the position that credit card fees are amounts received for services to be performed ratably over a 1-year period. The banks therefore claim to be entitled to use the 1-year deferral of income provisions of Rev. Proc. 71-21, 1971-1 C.B. 549. There is frequently a factual question whether the annual fees are actually intended to compensate for services. Two cases, issued the same day by the United States Tax Court, highlight this dispute. In *Barnett Banks of Florida, Inc. v. Commissioner*, 106 T.C. 163 (1996), the court after receiving testimony of bank officers, concluded that the fees were for services and allowed the fees to be included ratably over the 12 month period. However, in *Signet Banking Corporation v. Commissioner*, 106 T.C. 117 (1996), based upon the language of the written agreement between the bank and credit card customers and the nonrefundable nature of the fees, the court found that the fees were not for future services and denied the deferral of income.

The National Office is considering whether, even if the fees are for credit card processing or other potential services, banks may utilize Rev. Proc. 71-21 for their credit card businesses. Contact the National Office if this issue arises. However, the examining agent should always request the credit card agreement to ascertain whether the credit card fees are provided for future services.

## **RENTAL/LEASE INCOME**

Banks frequently own buildings and other commercial property which are leased out to tenants. This includes property obtained by the bank through foreclosure proceedings.<sup>1</sup> The rental or lease income of the bank is treated in the same manner as rental income received by any other taxpayer. The amount is includible in the gross income of the bank when received regardless of the period covered or the method of accounting employed by the taxpayer. See Treas. Reg. section 1.61-8(b).

Rents received in advance are includible in gross income, regardless of the bank's accounting method. However, gross income usually does not include amounts received as security deposits or the value of property attributable to improvements made by the tenant, unless such improvements were made in lieu of rent.

On occasion, you may come across a lease agreement which provides for uneven rental payments over the term of the lease, with no reasonable basis for this type of payment arrangement. These uneven payments may constitute an attempt to defer a portion of the rental income. In these cases, the lease agreement should be reviewed to determine potential tax implications. See IRC section 467.

## **PREPAID INTEREST**

The treatment of prepaid interest has been changed by the final OID regulations. Under the regulations, a payment generally is treated first as a payment of interest (or OID) to the extent of accrued but unpaid interest (or OID), and then as a payment of principal. Thus, no portion of any payment is treated as prepaid interest. See Treas. Reg. sections 1.446-2(e) and 1.1275-2(a). Because there is no accrued but unpaid interest (or OID) at the time of a "prepayment," the payment is treated as a principal payment, which is not includable in income. In effect, the payment reduces the issue price (or adjusted issue price) of the loan.

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<sup>1</sup> The tax treatment of foreclosure property by thrifts under IRC section 595 is beyond the scope of this document. IRC section 595 was repealed for property acquired after December 31, 1995, and by section 1616(b)(8) of P.L. 104-188 (August 20, 1996). Contact the Savings and Loan Industry Specialist in Los Angeles if you are examining a thrift.

These types of fees normally comprise the major portion of the fee income earned by a bank. A complete discussion of the tax implications of these items is included in the "Fee Income" chapter and will not be repeated at this time.

**AUTOMOBILE LEASE PAYMENTS - CAPITAL COST REDUCTION PAYMENTS**

One important issue that has arisen is whether the down payments (either voluntary cash payments or vehicle trade-ins to the dealer) made by the lessee to an automobile dealership at the inception of an automobile lease should be treated as an advance payment to the bank or finance company under the facts described below. These payments made by a customer (lessee) at the inception of the lease are often referred to as Capital Cost Reductions (CCR) payments.

**FACTS**

A bank or other financial institution (financial institution) extends credit (for both sales and leasing transactions) to customers of unrelated vehicle dealerships. Typically, the leasing agreement is designed by the financial institution to facilitate its purchase of leased vehicles and names the dealer as lessor. As "lessor," the dealer originates the lease with the Customer. The financial institution then purchases both the vehicle and the lease from the dealer. The financial institution records the vehicle as a depreciable asset. In a typical transaction, the dealer is neither contractually responsible for the customer's performance during the lease period nor for the value of the vehicle at the time of lease maturity.

The financial institution generally approves a dealer for its program by executing a Dealer Agreement. The Dealer Agreement sets forth the terms under which leases (between the customer and dealer) and under-lying vehicles are sold to the financial institution. If the dealer fails to follow the requirements of the agreement such as submitting incomplete or inaccurate information, the financial institution is not obligated to accept the lease. The Dealer Agreement provides that the dealer's participation in the program is at its discretion and the dealer is free to engage in leasing transactions with the financial institution of its choice.

The lease agreement is executed by the customer as lessee and by the dealer as lessor. Prior to executing the lease agreement, the customer negotiates the product price and, if applicable, the CCR payment with the dealer. Frequently, the Dealer Agreement requires the dealer to submit the lease application to the financial institution for review and approval prior to finalizing the transaction. After finalizing terms and documentation requirements with the customer, the dealer sells the lease and related vehicle to the bank or financial institution.

In many cases, the customer makes a CCR payment in the form of a voluntary cash payment or vehicle trade-in to the dealer. The CCR payment reduces the customer's monthly lease payment over the lease term by reducing the capitalized cost of the leased vehicle. The capitalized cost of the vehicle is the starting point in calculating the customer's monthly payment.

The dealership records the transaction as a sale of the vehicle at the negotiated sales price whether or not a customer makes a CCR payment. Frequently, the financial institution records the CCR payment as a reduction in the financial institution's basis in the lease vehicle.

#### **Situation 1**

Dealer purchases vehicle from an unrelated vehicle manufacturer for \$20,000. Dealer sells vehicle to Bank (a bank or other financial institution) for a price of \$24,000. Dealer is not a party to the Lease Agreement. Customer leases vehicle from Bank for a 24-month period and makes a \$2,000 CCR payment at lease inception. Dealer receives the CCR payment and consummates the lease on the financial institution's behalf, as agent. The financial institution actually pays the negotiated price less the CCR payment, (already in Dealer's possession), to purchase the vehicle. The \$2,000 CCR payment reduces Customer's monthly payment from \$400 per month to \$315 per month.

#### **Situation 2**

Dealer purchases a vehicle from an unrelated vehicle manufacturer for \$20,000. Dealer independently negotiates with Customer and executes a lease with the following conditions: Term - 24 months; Capitalized Cost - \$24,000; Capital Cost Reduction Payment (CCR) - \$2,000; Monthly Payments - \$315. Dealer sells/assigns the lease and underlying vehicle to Bank (a bank or other financial institution.) Dealer reports a vehicle sale of \$24,000. Bank records the basis of the vehicle as \$22,000 (\$24,000 reduced by the \$2,000 CCR payment)

### **LAW AND ANALYSIS**

Income derived from property is taxable to the owner of the property. *Helvering v. Horst*, 311 U.S. 112 (1940). A lessor (that is, owner or legal possessor) of the property being leased is entitled to receive the rentals or rental income. Further, rental income includes the expenses of the lessor paid by the lessee. Treas. Reg section 1.61-8(c). Additionally, advance rentals must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. Treas. Reg. section 1.61-8(b).

Regarding the issue of who is the lessor or seller of vehicle in a three party transaction involving a dealer, customer, and finance company, it is helpful to look at the Supreme Court opinion in *Hansen v. Commissioner*, 360 U.S. 446 (1959). In *Hansen*, taxpayers were retail automobile dealers who sold cars on credit to car purchasers. The notes for the car generally were on a form supplied by the finance company to which the dealers planned to sell the note and the instrument was signed by the customer, delivered to the dealer, and made payable to dealers in monthly installments over an agreed period. The dealers argued that, in substance, the car

purchasers obtained the loans directly from the finance companies because the notes were soon discounted or sold to the finance companies. Under the facts of that case, the Supreme Court rejected the dealers' arguments.

An important holding that can be taken from *Hansen* is that a taxpayer can be the lender or lessor even if the loan or lease agreement is executed on a form provided by a third party that may or may not later acquire the loan or lease.

Regarding the purchase and sale of property, the basis of property acquired by purchase is usually its cost, which also includes amounts paid for property in cash or other property. Treas. Reg. section 1.1012-1(a). Additionally, the cost or basis includes the amount of any liability incurred or assumed by the purchaser in acquiring the property and liabilities to which the property is subject at the time of purchase, whether or not the purchaser assumes liability for the obligations. See for example, *Crane v. Commissioner*, 331 U.S. 1 (1947).

The amount realized from the sale or other disposition of property is the amount of money received plus the fair market value of property other than money received. IRC section 1001(b). The amount realized also includes the amount of liabilities from which the taxpayer is relieved. Treas. Reg. section 1.1001-2(a)(1).

When an obligation of a taxpayer is paid by a third party, the effect is the same as if the third party had paid the money to the taxpayer who in turn paid his creditor. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929); *Sachs v. Commissioner*, 32 T.C. 815, 819 (1959), *aff'd*, 277 F.2d 879 (8th Cir. 1960). The amounts paid on behalf of the taxpayer are included in the taxpayer's income. *O'Malley v. Commissioner*, 91 T.C. 352 (1988).

In *Hyde Park Realty v. Commissioner*, 20 T.C. 43 (1953), *aff'd*, 211 F.2d 462 (2nd Cir. 1954), the Tax Court and Second Circuit addressed the issue of the treatment of rents received before the purchase of property but pertaining to the period after the date of purchase. The taxpayer, the purchaser, received a credit for prepaid rent against the purchase price, and argued the prepaid rent was income to the seller and was a reduction of the purchase price of the leased property. The Tax Court and Second Circuit disagreed with the taxpayer that the credit represented an adjustment or reduction of the sale price. See also *Pokusa v. Commissioner*, T.C. Memo.1978-93.

It should be noted that the issue of whether and to what extent a CCR payment is advance rental income to a dealer in an arrangement where a lease and the underlying vehicles are sold by the dealer after execution of the lease by the customer is factual. Thus, resolution of the issue as well as the issue of the basis of the underlying vehicle depends on the facts and circumstances.

The substance, rather than the form of a transaction, determines its tax consequences. *Gregory v. Helvering*, 293 U.S. 465 (1935). Despite the fact that the dealer is the named lessor in the lease agreements, the form in which these transactions are cast is inconsistent with their true nature. *Packard v. Commissioner*, 85 T.C. 397, 419 (1985); see also *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). Reliance on the step-transaction doctrine may be appropriate in these matters.

Under the step-transaction doctrine, an interrelated series of steps is examined as an integrated whole in determining the tax consequences of the result. *Packard*, 85 T.C. at 420. Courts have applied three alternative tests to the step-transaction doctrine. The "mutual interdependence test" inquires whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. *American Bantam Car Co. v. Commissioner*, 11 T.C. 397, 405 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949). The "end result test" links actions together if they are component parts of a single transaction intended from the outset to be executed for the purpose of reaching the ultimate result. *Penrod v. Commissioner*, 88 T.C. 1415, 1429 (1987). The "binding commitment" test treats a series of actions as a single, integrated transaction if, at the time the actor took the first step, he was under a binding commitment to take the later steps. *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968); *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1245 (5th Cir. 1983).

#### **For Situation 1**

The facts reveal that Bank was the owner of the leased vehicle at the time the vehicle was leased and throughout the period of the lease. The facts also reveal that Customer leased the vehicle from Bank, and Dealer acted as agent in receiving the \$2,000 CCR payment at lease inception. Therefore, Bank is the lessor of the leased vehicle because it is the owner of the leased property. The \$2,000 down payment that Customer paid to Dealer should be treated as an advance rental income to Bank. This amount represents payments in lieu of future rental payments to Bank during the period the Bank is or will be the owner and lessor of the vehicle.

In this regard, Bank should be treated as having received the advance payment at the point in time Dealer as agent for Bank received the \$2,000 from Customer. See *Hyde Park Realty*, 211 F.2d at 462 and *Treas. Reg. section 1.61-8(c)*.

Bank's cost basis in the leased vehicle is \$24,000, the negotiated price or cost of the vehicle. The \$2,000 advance but unearned rental payment did not reduce the consideration paid by the financial institution and, as noted, should be treated as income to Bank.

Bank should treat the entire \$2,000 payment made by Customer to the Dealer as advance rental income. As discussed in Situation 1, the amount represents the portion of the rent collected that is in lieu of rent that is otherwise payable for the period in which Bank is and will be the owner of the vehicle. Bank is treated as having received the \$2,000 advance payment at the point in time Dealer received and credited the \$2,000 toward the purchase price of the vehicle. See *Hyde Park Realty*, 211 F.2d at 462 and Treas. Reg. section 1.61-8(c). Bank's cost basis in the vehicle is the \$24,000, the cost or negotiated price of the vehicle.

Additionally, the facts of Situation 2 support arguments under at least two of the step transaction doctrine tests. Dealer must be pre-approved by Bank to engage in lease transactions. Guidelines setting parameters on the terms of the lease agreements and specific instructions for managing the transactions are provided by Bank to Dealer. The lease agreements are then negotiated pursuant to the guidelines established. The customer's credit is approved prior to execution of the lease and title to the merchandise is immediately registered in the Bank's name after the lease is executed.

These facts indicate that the ultimate result -- purchase of the merchandise and assumption of the lease -- is a virtual certainty at the time the lease is executed. This result comports with the initial leasing arrangements instituted Bank. The steps of the lease transactions, established by Bank, are interdependent. Although the Bank argues it is not bound to accept a lease and Dealer is free to find other financing, leases are only rejected in the unlikely event that Dealer has not been pre-approved, Dealer has failed to comply with the terms of the agreement, or Dealer has misrepresented material facts concerning the terms of the lease. Thus, Dealer can control whether the lease will be acceptable. Given Dealer's motivation to sell merchandise, rather than finance such sales, it seems evident that the steps of these transactions are designed to lead to Bank's purchase of the merchandise and assumption of the lease.

### EXAMINATION TECHNIQUES

1. Banks normally follow a somewhat conservative approach to accounting and reporting their income. Therefore, it is important to identify any reserve accounts existing in the trial balance or chart of accounts. The liability section of the balance sheet should disclose the existence of any deferred income accounts.
2. Banks usually have manuals which provide explanations or descriptions of all accounts available to the bank. These manuals are used by employees for reference purposes and can provide the agent with valuable information as to the purpose of each of these accounts. These manuals should be requested from the bank since they will assist in determining the purpose of any deferred income accounts and whether any portion of this income should be reported currently.



3. Review the "significant accounting policy" section of the bank's annual report along with the SEC filings for clues as to the existence of any deferred income accounts. Determine how these accounts were handled for tax purposes.
4. Request all internal policy statements from the bank which stipulate how they handle advance payments for tax purposes.
5. Review the schedule M-1 for book and tax differences in the reporting of income items. Also, ask the tax manager to explain any deferred income accounts and how the bank handles them for tax purposes.
6. Review any leasing or rental activity in the consolidated banking return and look for deferred income accounts. Verify that all amounts were properly reported for tax purposes.
7. Review the consolidated return for other entities which may be involved with advance payments or deferred income items.
8. Included in this guide is a chapter titled "Specialization Within the IRS". That chapter, which discusses the use of a CAS to assist the examining agent in determining the amount of fee income reported by the taxpayer and other potential issues, should be referred to for additional information.

## **SUMMARY**

It is important that all deferred income accounts be analyzed to determine whether amounts were properly reported for tax purposes. Many of the issues will be straight forward but others may be difficult to find. It is very important that an agent understand the numerous business operations of the bank to locate potential deferred income items.

## TAX-EXEMPT OBLIGATIONS

### INTRODUCTION

The money deposited by a customer can be invested by the bank in many ways. Municipal obligations are one of the most common investments of a bank. The major advantage for purchasing this type of investment is the tax benefit. IRC section 103 provides that interest received on obligations of a state, territory, a possession of the United States, or any political subdivision thereof, is specifically exempt from federal income tax. Potential examination issues in this area follow.

### DETERMINATION OF TAX-EXEMPT STATUS

Not all municipal bonds are tax-exempt. There are many rules and restrictions which limit the tax-exempt status of a particular obligation. During our examinations, very few adjustments were found in this area. Since the IRS is examining the bank and not the municipality, it is difficult to accurately determine the taxable status of a bond by simply looking at the prospectus or other information on the bond offering.

It has been our experience that the bank will adequately review the obligation to verify that it qualifies for tax-exempt status. Often, the taxpayer will have a file containing background information such as the purpose for the bond, authorization for the bond, a legal opinion with respect to taxability, copies of forms registering the bonds as tax-exempt, and any IRS rulings which may have been secured.

In many cases, it was found that the banks have inserted a provision in the purchase agreement for the municipal bonds that guarantee that the investments would qualify for tax-exempt status. If for any reason a bond's tax-exempt status was disqualified, the bank would be adequately reimbursed by the issuing party.

### EXAMINATION TECHNIQUES

1. Interest income received on tax-exempt obligations is not included in taxable income. However, these amounts are reported for financial purposes. A schedule M-1 adjustment will indicate the total amount of tax free interest income received by the bank. A complete breakdown of this amount should be requested from the taxpayer and tied directly into the M-1 adjustment. These amounts should be scanned for any large or unusual items, or items which do not appear to be municipal obligations.

- <http://www.getirshelptoday.com>
2. If the tax-exempt status of any portion of the bank's portfolio is in question, contact Exempt Organizations. The listing provided by the taxpayer in item 1 above, can be used to select several items to be reviewed.
  3. The taxpayer should always be asked to provide all available information it maintains on the tax-exempt obligations which may be helpful. If the taxpayer does not have any information, contact Exempt Organizations for assistance.
  4. A bank may exclude the interest from tax-exempt obligations from gross income only if it actually owns the bonds. If the bonds are being held as collateral for a loan the interest is not tax-exempt to the bank because it holds the securities as collateral, and not as the owner. While reviewing the bond file, this should be considered as a potential adjustment area.
  5. In addition, interest will not be tax-exempt if it is paid with respect to an obligation in which the principal or interest is guaranteed by the Federal Government. This item should also be kept in mind while reviewing the files.
  6. Smaller bond issues where a single bank has purchased the entire bond issue should receive the closest scrutiny. That's because there usually is no other regulatory supervision with respect to this issue and, therefore, may be subject to an oversight on the part of the taxpayer.

The Cumulative Bulletin Digest index will identify recent rulings that have questioned the taxability of various types of bond issues and may provide information that is similar to an issue in your case.

### **INTEREST AND EXPENSES RELATING TO TAX-EXEMPT INCOME**

As a general rule, a nonbank taxpayer could not deduct expenses incurred in connection with acquiring or carrying assets that produce tax-exempt interest. Historically, banks were not subject to these rules. Thus, a bank could deduct interest and other expenses on indebtedness incurred in the ordinary course of business where the expenses were not directly related to the purchase of tax-exempt bonds.

Effective for tax years beginning after December 31, 1982, the scaleback provisions of IRC section 291(a)(3) were enacted. This section became a major disadvantage for banks that invested heavily in tax-exempt obligations. Even though a financial institution could deduct interest incurred in the ordinary course of its business, IRC section 291(a)(3) provided that the amount of interest a bank incurred to purchase and carry tax-exempt obligations was considered to be a tax preference item. Accordingly, the law provided that the amount of interest expense deducted for debts incurred to carry tax-exempt securities acquired after 1982, was subject to a 15-percent reduction.

The Tax Reform Act of 1984 increased the disallowance of the interest expense from 15 percent to 20 percent for securities purchased after December 31, 1982.

Specifically, IRC section 291(e)(1)(B)(i) provides that a financial institution preference item includes the following.

**EXTRACT**

IRC section 291(e)(1)(B)(i)

\* \* \* In the case of a financial institution which is a bank \* \* \* the amount of interest on indebtedness incurred or continued to purchase or carry obligations acquired after December 31, 1982, and before August 8, 1986 the interest on which is exempt from taxes for the taxable year, to the extent that a deduction would \* \* \* be allowable with respect to such interest for such taxable year.

To summarize, IRC section 291 disallows a portion of the interest expense deduction claimed by the bank attributable to its investment in tax-exempt securities.

The Tax Reform Act of 1986 significantly changed the rules governing the tax exemption of interest for obligations issued after August 7, 1986.

IRC section 265(b)(1) was added to the Code and was effective for tax years beginning after December 31, 1986. This section provides in part that "no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest." In other words, 100 percent of a financial institution's interest expense allocable to tax-exempt income on obligations acquired after August 7, 1986, is not allowed as a deduction. The 20 percent disallowance rule under IRC section 291, continues to apply to obligations acquired before August 8, 1986.

IRC section 291 and IRC section 265 both provide that, unless the taxpayer can establish otherwise, the portion of the taxpayer's interest expense which is allocable to tax-exempt obligations is an amount which bears the same ratio to such interest expense as:

1. The taxpayer's average adjusted basis of tax-exempt obligations bears to
2. Such average adjusted basis for all assets of the taxpayer.

The average adjusted basis of tax-exempt obligations is generally computed by determining the adjusted basis of such obligations at the end of each month and averaging them over the taxable year.

The average adjusted basis for all assets is generally determined by averaging the basis of all assets at the beginning of the year, with the basis in all assets existing at the end of the year. There usually is no need to use monthly figures since a bank's total asset base does not fluctuate significantly during the year.

As with most sections of the Code, there is an exception to the general rule. IRC section 265(b)(3) provides that the 100 percent disallowance rule does not apply to qualified tax-exempt obligations. Under IRC section 265(b)(3)(B)(i), a tax-exempt obligation must meet three criteria in order to qualify for this exception.

1. First, the obligation must be issued by a qualified small issuer which reasonably anticipates that it will not issue more than \$10 million of tax-exempt obligations during a calendar year.
2. Second, it cannot be a private activity bond.
3. Finally, the issuer must specifically designate the bond as a qualified tax-exempt obligation.

In the event that the bank meets the three requirements listed above, the amounts are still subject to the 20 percent disallowance per IRC section 291, instead of the 100 percent disallowance.

### **EXAMINATION TECHNIQUES**

1. The amount of interest expense treated as being disallowed by the bank under IRC section 291 and IRC section 265 will normally be reflected as a schedule M-1 adjustment on the tax return. These amounts should be reconciled to the general ledger and the tax workpapers. They should also be tied to the taxpayer's computations of the disallowed interest.
2. During the examination of a bank, it is important to properly determine the date the tax-exempt securities were issued and subsequently acquired by the bank. The reissuing of tax-exempt securities after August 7, 1986, trigger the provisions of IRC sections 291 or 265.
3. During our examinations, adjustments were found in two separate areas. These issues were discovered by reviewing the computations the bank had already compiled for the tax return. Both of the adjustments we came across were apparent after reviewing the taxpayer's work papers and related computations.
  - a. In the first issue, the taxpayer incorrectly applied the percentage of interest to be disallowed for tax purposes. (20 percent of the interest rather than 100 percent.) Specifically, the date the municipal bond was acquired by the bank, did not correspond to the proper percentage of interest expense to be disallowed.

- b. In the second issue, errors were found in the mathematical computation of the interest expense allocable to the tax-exempt obligations. The adjustment was based on the equation discussed above. We simply recomputed the amounts used in the equation to determine the correct amount of interest expense to be disallowed.

### **SALE OF TAX-EXEMPT OBLIGATIONS**

It is important to remember that the gain on the sale of a state, municipal, or governmental security is fully taxable, even though the interest earned on the obligation is tax-exempt. The gain or loss on the sale of these securities gives rise to ordinary income/loss and is not subject to the capital gain/loss provisions.

### **EXAMINATION TECHNIQUES**

1. Our examinations did not result in any adjustments in this area. However, fluctuating interest rates may result in adjustments if the municipal bonds are currently trading at a premium. The bank may want to take advantage of this opportunity to sell some of their bonds in the open market. The sale of these bonds will not be reflected anywhere on the tax return if they consider the gain to be tax-exempt.

Therefore, a complete review should be made of the municipal bonds in the bank's portfolio at year end to look for any changes from one year to the next.

2. A review of the annual report may indicate sales of tax-exempt obligations. Obligations of states and other municipal obligations will usually be separately stated on the balance sheet. You may also find information on the sale of tax-exempt obligations in the executive committee minute book.
3. Finally, a request should be made for the bank to document all municipal bond sales which occurred during the year to determine if they were properly handled for tax purposes.

### **BOND PREMIUMS ON TAX-EXEMPT OBLIGATIONS**

Generally, if a bond is purchased for an amount in excess of the face value of the bond, the difference in price is considered to be a bond premium. A bond premium is considered a reduction of the interest income received by the purchaser. This premium is amortized over the life of the bond for taxable securities. However, since the interest from tax-exempt obligations is not taxable, the reduction in interest attributable to the premium is not deductible.

While the premiums paid for the purchase of municipal bonds are nondeductible, any premium received by the bank due to the early redemption of the bond is considered an amount received from the sale of the bond and, therefore, is taxable.

This latter issue may be significant when there are declines in interest rates. A premium may be paid by the issuer when a bond is called prior to maturity. This additional payment is fully taxable to the bank.

The audit techniques for this issue are similar to those discussed under the sale of tax-exempt obligations, discussed above.

## **ORIGINAL ISSUE DISCOUNT ON TAX-EXEMPT OBLIGATIONS**

If the original bond is issued at a discount from its face value, the difference between the issue price and the redemption price is the original issue discount (OID). The OID on obligations issued by a governmental unit is considered tax-exempt interest income. This income is apportioned ratably over the term of the obligation. See IRC section 1288.

Only the discount, when the bond is first issued, qualifies as tax-exempt interest. A discount arising from a subsequent repurchase of a bond, does not qualify for the tax exemption. Thus, if a dealer purchases exempt obligations at par or above, and subsequently resells them at a discount, this discount does not qualify as tax-exempt interest income in the hands of the subsequent holders. That's because it is not part of the original issue discount.

If the obligation originally issued at a discount is sold prior to the redemption date or the maturity date of the obligation, the original issue discount is apportioned between the original holder and subsequent purchaser of the obligation.

## **SUMMARY**

IRC section 103 generally allows interest on obligations of a state or political subdivision to be exempt from federal tax. However, recent changes in the law have limited the benefit of tax-exempt obligations. The agent should reconcile the amount of tax-exempt income and the portion of interest expense disallowed under IRC sections 291 and 265 shown on schedule M-1. The examiner should also identify the source, and verify all computations made by the taxpayer in determining the amount of interest expense to be disallowed. In most cases, the taxpayer will maintain adequate records enabling the agent to verify the computations without too much trouble.

## DISCHARGE OF INDEBTEDNESS

### INTRODUCTION

Gross income includes income from the discharge of indebtedness, except as otherwise provided in the Code. The most common situation in which a bank may have had discharge of indebtedness income is when an institution purchased its own bonds on the open market at less than their face amount.

IRC section 108 provides the criteria under which income from discharge of indebtedness can be excluded from gross income. If the taxpayer is entitled to exclude income under IRC section 108, an election must be made to adjust the bases of assets by the amount of income excluded, in accordance with IRC section 1017.

IRC sections 108 and 1017 were enacted to provide relief for bankrupt and insolvent entities. By allowing taxpayers to recognize the discharge of indebtedness income over time through the reduction of depreciation expense, borrowers would not be discouraged from renegotiating or repurchasing their debt for fear of an immediate increase in their tax liability.

Prior to 1987, taxpayers could exclude discharges which occurred (1) in a title 11 case, (2) when the taxpayer was insolvent, or (3) if the discharged debt was qualified business indebtedness. The 1986 Tax Reform Act repealed the third provision which allowed the exclusion of discharged qualified business indebtedness.

The Omnibus Budget Reconciliation Act of 1993 added another category for exclusion if the indebtedness which is discharged is qualified real property business indebtedness per IRC section 108(a)(1)(D). This exclusion is not available to a C-Corporation. Thus, it could apply to a borrower, but would not be available for the bank. Refer to Temporary Treas. Reg. section 1.108(c)-1T which was published December 27, 1993, in TD 8509.

The procedures used when a taxpayer elects to defer income per IRC sections 108 and 1017 will not be reviewed here since they are not any different for banks than for other entities. Instead, issues that are related to the discharge of a bank's indebtedness will be discussed.



During the early 1980's, when interest rates were rising, many bank customers were cashing in their certificates of deposit (CD's) prior to maturity. The interest or principal that the depositors forfeited were more than offset by the higher interest rates being offered on new CD's. Banks were receiving significant income from these prepayment penalties. Some banks elected to defer this income as income from discharge of indebtedness.

In Revenue Ruling 83-60, 1983-1 C.B. 39, the Service concluded that premature withdrawal penalties were not income from discharge of indebtedness and, therefore, could not be excluded from income under IRC section 108. The penalties were the consideration the bank received because it lost the right to use the funds through the maturity dates of the certificates.

The Supreme Court in *United States v. Centennial Savings Bank, FSB*, 499 U.S. 573, 91-1 U.S.T.C. ¶ 50188 (1991) stated with respect to this issue:

Penalties collected by a savings and loan institution when its customers prematurely withdrew their certificates of deposit could not be treated as discharge of indebtedness income and excluded from the savings and loan's taxable income. No discharge of indebtedness occurred, because the customers did not forgive or release any repayment obligation of the financial institution when they accepted an amount equal to the principal and accrued interest minus the penalty. Such amount was exactly what the bank was obligated to pay under the terms of the certificate of deposit agreements.

Therefore, taxpayers should be including all premature withdrawal penalties in income in the year the CD's are cashed in. Banks should not be deferring this as discharge of indebtedness income. You should not see this issue on any returns after 1986, since the provision for excluding discharged qualified business indebtedness was repealed. However, you may encounter this item if your taxpayer has carrybacks to years prior to 1987 or if the bases of assets being depreciated or sold in the year you are examining have been adjusted per IRC section 1017.

## **REPURCHASE OF BONDS**

It is not uncommon for banks to repurchase bonds that they previously issued. Treas. Reg. section 1.61-12(c)(3) states, "If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue

price plus any amount of discount already deducted. \* \* \* minus any amount of premium already returned as income, the amount of such excess is income for the taxable year." In other words, this is considered a discharge of a portion of the amount that the company owed to the bondholders and it is therefore, taxable. A debenture, note, or other evidence of indebtedness, issued by a corporation and bearing interest is given the same treatment as a bond. Proposed regulations under IRC section 61 were issued in 1996. Therefore, Treas. Reg. section 1.61-12(c)(3) may not be effective when you face this issue.

The reportable income is increased by any premium that was not previously included in income and decreased by any discount that was not previously taken as a deduction.

The amount of income is also decreased by any unamortized bond issuance expense remaining when the bonds are repurchased. The issuance expense is treated the same as unamortized discount and cannot be deducted in the year of the discharge if the taxpayer elected to exclude income under IRC sections 108 and 1017. See Rev. Rul. 68-288, 1968-1 C.B. 53.

### **Example 1**

ABC Bank issued 5 percent interest bearing bonds with a total face value of \$100,000 for \$90,000. (Since market interest rates were greater than 5 percent, the bonds were issued at a discount so that the effective interest rate was greater than 5 percent.) The bank incurred issuance expenses of \$5,000.

When market interest rates rose higher, the value of these fixed rate bonds declined. ABC Bank repurchased all of the bonds on the open market for \$60,000. At the time of the repurchase there was unamortized discount of \$6,000 and unamortized issuance expenses of \$3,000. The taxpayer's gain is computed as follows:

Face value of bonds	\$ 94,000
Repurchase price	<u>60,000</u>
Gain before adjustments	34,000
Less: Unamortized expenses	<u>(3,000)</u>
Net gain	<u><u>\$ 31,000</u></u>

For years prior to 1987, taxpayers could elect the provisions of IRC sections 108 and 1017 to exclude this discharge from income. However, beginning in 1987 taxpayers should be reporting the discharge of debt from the repurchase of bonds as income in the year they are repurchased. Therefore, it is unlikely you would examine a taxpayer who made this election in current years. However, you may want to determine whether the bank you are examining repurchased any bonds to ensure that any discharge income was reported.

### **EXAMINATION TECHNIQUES**

1. Review the tax return to see whether the taxpayer filed Form 982 to adjust the bases of its depreciable assets. If so, information should be requested from the taxpayer to determine the nature of the deferred income.
2. If the deferral is allowable, the taxpayer's depreciation schedule should be reviewed to verify that the bases of the assets were reduced. The taxpayer should have work papers showing these computations. The current year's depreciation schedule can be compared with the prior year's schedule to ensure the reduction was made.
3. Review the bank's annual report and minute book to see whether they discuss any repurchased bonds, renegotiated loans, etc. If so, ensure that any discharge of indebtedness was properly reported.
4. If you have a carryback loss to a year where the taxpayer improperly made an election to exclude income, such as from premature withdrawal penalties, you may want to consider adjusting that item. Consider the amount of deferred income, the amount of the carryback, and whether the taxpayer has since recognized most of this income through reduced depreciation deductions.

### **FORGIVENESS OF A BORROWER'S INDEBTEDNESS**

Banks sometimes renegotiate borrower's loans for less than the original loan amount. This is common in markets where the value of real estate has declined significantly. If the value of the collateral has decreased below the loan amount, the borrower may choose to walk away from the property, rather than continue to make the loan payments. Even if the borrower is solvent, he or she may stop making payments if not personally liable for the loan.

If the value of collateralized property has decreased significantly, the banks may have a lot of nonperforming loans. In most situations, it is better for a bank to refinance the loan than to repossess the property. If the FDIC/RTC has taken over an institution, it may also prefer to renegotiate the loan, rather than to sell the asset. See IRC section 108(e)(10) to determine the amount of forgiveness of indebtedness income in a refinancing.

When the principal balance of the loan is decreased, the borrower is likely to have forgiveness of indebtedness income. Consider a review of the borrower's return if the decrease in the loan balance is significant.

Financial institutions described in IRC sections 581 or 591(a) which discharge (in whole or in part) the indebtedness of any person must file information returns under IRC section 6050P provided (1) the discharge is at least \$600.00 and (2) the discharge occurs after December 31, 1993.

Temporary Treas. Reg. sections 1.6050P-0T through 1.6050P-1T (TD 8506) were published December 27, 1993. In addition to discussing the general reporting requirements on Form 1099-C, these regulations provide guidance on when an indebtedness is considered discharged and the determination of the amount discharged.

These information reporting requirements also apply to the FDIC and the RTC for discharges occurring after August 10, 1993. See Notice 93-52, 1993-2 C.B. 337, which provides for interim governmental entity reporting via Form 1099-G (with modifications) for 1993.

Since this text was written, the Service has issued final regulations under IRC section 6050P which become effective December 22, 1996 (T.D. 8654, 1996-11, I.R.B. 14) and final regulations on backup withholding (T.D. 8664, 1996-20 I.R.B. 7).

## **SUMMARY**

Prior to the changes made by the 1986 Tax Reform Act, banks frequently elected to reduce their depreciable assets, rather than report income from discharge of indebtedness. Since this election can now be made only by insolvent or bankrupt taxpayers, it will not be applicable for most banks. Instead they should be reporting discharge of indebtedness income in full in the year of the forgiveness. For tax years after December 31, 1993, banks may be required to file Forms 1099-C with respect to incidents of forgiveness of borrowers' indebtedness.

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## LOAN SWAPS

### INTRODUCTION

A loan swap is when a bank exchanges or "swaps" loans for other loans, rather than cash. Often, they will do this for valid business purposes. However, sometimes loans are swapped primarily to obtain tax benefits. The following types of exchanges will be discussed:

1. Mortgages swapped for mortgage backed securities
2. Mortgage pools swapped for other mortgage pools
3. Foreign loans swapped for other foreign loans
4. Repurchase agreements
5. Real estate mortgage investment conduits (REMICs)
6. Loan restructuring.

### MORTGAGES SWAPPED FOR MORTGAGE BACKED SECURITIES

The Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), and the Government National Mortgage Association (GNMA) have mortgage swap programs. Under these programs, banks can exchange pools of mortgages for mortgage backed securities issued by the agencies. Ownership of a mortgage backed security represents ownership in the exact same mortgages that were exchanged.

One reason financial institutions swap mortgages for mortgage backed securities is that the agency guarantees that the bank will be paid the interest and principal, even if the homeowners become delinquent on the mortgages. The interest rate for these participation certificates is less than the interest rate on the mortgages that were transferred. For swaps with Freddie Mac and Fannie Mae, a portion of the difference between the interest rate on the mortgages and the rate on the mortgage backed security is retained by the agency to cover the cost of the guarantee. The balance of the difference between the mortgage rate and the pass through rate is the servicing fee that is kept by the bank.

Payment on Ginnie Mae mortgage backed certificates are guaranteed by the Federal Government since they are represented by FHA and VA mortgages. Therefore, no guarantee fee is paid to Ginnie Mae. The difference between the mortgage rate and the pass through rate is the servicing fee retained by the bank.

Another reason financial institutions securitize their mortgages is to make them easier to sell. Mortgage backed securities are actively traded. They are purchased by other banks, pension plans, insurance companies, etc. Therefore, if a bank needs an influx of cash, it can quickly sell a certificate in the open market. It would be much more difficult to sell a group of unsecuritized mortgage loans.

The Service has treated the transfer of mortgages to the FHLMC in exchange for participation certificates as a nonrecognition event under IRC section 1001. This is illustrated in PLR 8327008. Banks are also not required to report a gain or loss on these swaps for book purposes. Therefore, you will not see any indication on the income statement or M-1 Schedule that this transaction has occurred. Mortgage loans will be recategorized on the balance sheet as mortgage backed securities or participation certificates, but the dollar amount of the assets will not change.

Since it is not a taxable event, you would not have any examination issues in this area at the time the mortgages are swapped for the mortgage backed securities. However, if the bank later sells the mortgage backed securities, you should consider the servicing rights issue which is explained in detail in the chapter on mortgage servicing rights. That chapter also has information on mortgage backed securities, the agencies involved, related terminology, etc.

## **MORTGAGE POOLS SWAPPED FOR MORTGAGE POOLS**

When interest rates increased significantly in the late 1970's, many financial institutions continued to hold numerous old mortgages with low interest rates. These banks were receiving interest at a low rate while simultaneously paying their depositors at a high rate. One way to become more liquid would have been to sell the old loans. Since newly originated mortgages were paying higher interest, the old mortgages would have been sold at large losses. These losses could then be used to generate tax refunds.

However, selling the mortgages at losses would have decreased the institutions' net worth and possibly put them in danger of closure by the regulatory agencies. The Office of Examination and Supervision of the Federal Home Loan Bank Board responded to this situation by issuing Memorandum R-49 in June 1980. R-49 provided that savings and loans did not need to report losses from the exchange of mortgages for substantially identical mortgages held by another institution. The memorandum provided 10 criteria for evaluating whether mortgages were substantially identical, such as: Type of mortgages, same interest rates, same terms to maturity, etc.

The FHLBB acknowledged that it issued R-49 to facilitate transactions that would generate tax losses, but that would not substantially affect the economic position of the institutions. In essence, the sole purpose of the mortgage swaps was to generate tax refunds.

The Internal Revenue Service responded by issuing Revenue Ruling 81-204, 1981-2 C.B. 157. It held that the losses upon the exchange of mortgage loans that were similar in type, term, and rates were not deductible. The ruling states:

The taxpayers have not met the requirements of Treas. Reg. section 1.1001-1(a) since they have exchanged mortgage pools that do not differ materially either in kind or in extent and, therefore, pursuant to IRC section 1001 and the regulations thereunder, no loss may be recognized on the exchange. Furthermore, deduction is also precluded because the exchange had no purpose or utility apart from the anticipated tax consequences.

Later Revenue Ruling 85-125, 1985-2 C.B. 180, was issued which similarly disallowed losses from interdependent sales and purchases of mortgage pools. It ruled that these transactions were in essence mortgage swaps which resulted in the institutions acquiring assets that were not materially different from the assets they transferred.

The Supreme Court addressed this issue in *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), 91-1 U.S.T.C. ¶ 50,187. The Court held that Cottage Savings Association realized deductible losses when it exchanged participation interests in its residential mortgages for participation interests in residential mortgages held by other savings and loans. The exchange was a realization event, because the interests that were exchanged were materially different. The underlying mortgages were made to different obligors and were secured by different homes, therefore, the participation interests embodied legally distinct entitlements. Additionally, the losses were treated as bona fide, because no contention had been made that the transaction was not at arm's length or that the taxpayer retained ownership of the participation interests that were traded.

The Court concluded that Treas. Reg. section 1.1001-1, which requires that an exchange of property can be treated as a disposition only if the properties exchanged are materially different, is a reasonable interpretation of IRC section 1001(a). However, it disagreed with the IRS that these exchanges were not for materially different assets. The court stated that "mortgages can be substantially identical for Memorandum R-49 purposes and still exhibit 'differences' that are 'material' for purposes of the Internal Revenue Code." The loans were considered to be materially different since the mortgages were made to different obligors and secured by different homes, resulting in legally distinct entitlements.



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If the swap of mortgage pools results in an exchange of property under IRC section 1001, the financial institution has an amount realized on the disposition of the mortgage pool. In this case, the general rule of IRC section 1001(b) applies and the amount realized is the fair market value of property received in the exchange.

Note, that in the swap of mortgage pools, two holders are exchanging instruments that have already been issued. The borrower now owes its debt to a new party. Since there has not been an issuance of a new debt in exchange for property, the amount realized is not determined under Treas. Reg. section 1.1001-1(g) or, for transactions prior to enactment of the OID provisions, Revenue Ruling 79-292, 197-2 C.B. 287. [Revenue Ruling 79-292, which required accrual basis taxpayers to realize the face amount (and not the fair market value) of debt instruments that were received in exchange for property sold to the issuer does not apply to an exchange of debt instruments by two holders.]

When mortgage interest rates are low, it is unlikely that you will encounter transactions where an institution is exchanging loans to generate a tax loss. However, if you examine a taxpayer who is deducting losses which were not reported for books, review the transactions to determine whether loans were swapped. If so, you will need to evaluate whether the swapped loans are materially different assets. The *Cottage Savings* case can be used as a guide. However, the particular facts for each transaction will need to be reviewed.

### **FOREIGN LOANS SWAPPED FOR FOREIGN LOANS**

Many banks have made loans to lesser-developed-countries (LDC). Shareholders, regulators, depositors, and creditors of these banks have been concerned about whether the banks' balance sheets overstated the value of these loans since payment of the principal and interest was doubtful. The banks have written off many of these loans for book purposes. However, it is the IRS' position that the loans cannot be presumed worthless for tax purposes unless the regulators have issued assigned transfer risk reserves (ATRR) designations to them. In the absence of an ATRR, the taxpayer must establish worthlessness on a loan-by-loan basis from all of the facts and circumstances.

Some banks have swapped this foreign debt for the foreign debt of other banks. The banks may swap identical debt, such as Mexican loans for Mexican loans. However, they usually swap debt that is different, such as Mexican loans for Brazilian loans. One party to the transaction may also pay cash if the value of the loans received is greater than the value of the loans given up.

Regardless of the type of debt that has been exchanged, the banks often take a loss for the difference between their basis in the loans and the "fair market value" of the loans. Frequently, the banks have purchased similar loans from third parties prior to the exchange to establish their fair market value. They may also use a broker familiar with dealing in foreign debt to value the loans.

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If a bank has swapped its foreign loans with another bank for different foreign loans, that is, Mexican for Brazilian, the swap results in an exchange under IRC section 1001. This assumes, however, that the wash sale rules of IRC section 1091 do not apply to prevent the recognition of loss on the sale and repurchase of substantially identical securities (that is, loans issued by the same country with identical interest rates and maturity dates).

If there is an exchange, the general rule of IRC section 1001(b) applies and the amount realized by the bank is the fair market value of property received (the foreign loan) in the exchange.

Note, that in the swap of foreign loans, two holders are exchanging instruments that have already been issued. The borrower now owes its debt to a new party. Since there has not been debt issued in exchange for property, the amount realized is not determined under Treas. Reg. section 1001-1(g) or, for transactions prior to the enactment of the OID provisions, Revenue Ruling 79-292.

Note, that if a bank agrees with a foreign country to modify the terms of a debt instrument, the transaction is a "loan restructuring" which is discussed below.

## **REPURCHASE AGREEMENTS<sup>1</sup>**

Repurchase agreements (repos) are simultaneous contracts to sell and repurchase identical securities within a specified time at a specified price.<sup>2</sup> The agreements may cover securities such as, Treasury bonds, bills, notes, mortgage backed securities, or commercial paper. Since the agreements are entered into simultaneously, the transactions are considered to be equivalent to borrowing and lending funds equal to the sales price of the related securities. This is recorded as a financing transaction, not as a sale. The difference between the sale and purchase prices represents interest for use of the funds.

For example, Bank A may sell a particular Treasury bond to Bank B for \$1,000,000. At the same time, they agree that Bank A will repurchase the same security 180 days later for \$950,000. The difference of \$50,000 represents the interest on the "borrowed" funds. The interest earned on the security and the pay down of the principal balance will also affect the transaction.

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<sup>1</sup> Please note that the terminology used in this chapter may vary between tax, accounting, and regulatory sources. For example, the AICPA Audit and Accounting Guides for banks and savings and loans use different terminology when discussing repurchase agreements.

<sup>2</sup> The other side of the transaction, a contract to purchase and resell at a later date, is known as a reverse repurchase agreement.

Although the transactions are similar, dollar rolls are different from repurchase agreements. Dollar rolls are contracts to sell and repurchase similar but not identical securities, generally mortgage backed securities. Dollar rolls are recorded as financing transactions for books only if the securities that are sold and repurchased are similar enough to consider the transaction borrowing and lending of funds. Otherwise, the transaction is considered a sale and purchase of securities.

Banks enter into these agreements to obtain funds by leveraging their investment portfolios. The terms of the agreements are generally for 1 to 6 months, but can range from only a day to in excess of a year. Sometimes the agreements are extended beyond the original terms.

Generally, repurchase agreements have been treated as financing transactions for tax, as well as, for books. However, the facts for the transaction were considered to determine whether the taxpayer had substantially relinquished its ownership and whether there was a shifting of the economic risk of loss. See Rev. Rul. 79-195, 1979-1 C.B. 177; Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196; *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970), *cert. denied*, 400 U.S. 819 (1970); *Citizens National Bank of Waco v. United States*, 551 F.2d 832, 843 (Ct.Cl. 1977).

The proposed regulations, for IRC section 1001, clarify when a modification of a debt instrument will be deemed to be an exchange of properties that differ materially either in kind or extent. The theory behind the regulations is to avoid recognition of gains or losses unless the exchanges are material. Although the proposed regulations do not apply to dollar rolls, they do give some guidance on what differences in the terms of debt instruments are considered to be material. Consideration should be given to the regulations when determining whether recognition is required for dollar rolls.

Practically speaking, most repurchase agreements and dollar rolls are resolved in a very short time, sometimes a few days. Therefore, it may not make any difference whether the transaction is treated as a sale and subsequent repurchase or a financing transaction. Hopefully, additional guidance will be issued on this issue in the near future.

## **REAL ESTATE MORTGAGE INVESTMENT CONDUITS (REMIC)**

REMIC's were created by the 1986 Tax Reform Act as a vehicle for the securitization of mortgages. The tax law relating to REMIC's is extremely complex and, therefore, will not be discussed in this guide. However, some general background information will be provided.

A REMIC may be formed as a partnership, trust, corporation, or other agreed upon entity. A REMIC may also be formed as a segregated pool of assets rather than as a separate entity. An organization, such as a bank, transfers real estate loans to the REMIC in exchange for interests in it. Interests are then sold to third party investors and gain or loss is recognized on the sale. There are both "regular interests" and "residual interests."

REMIC's are generally not subject to taxation. Instead, the income of the REMIC is taxable to holders of interests in the REMIC. The regular interests are treated as debt obligations. The residual interest holders are taxed on the net income of the REMIC. A portion of the income allocable to a residual interest, referred to as an "excess inclusion," is, with an exception for thrift institutions, subject to Federal income taxation in all events. Residual interest holders other than thrift institutions may not offset excess inclusions with otherwise allowable deductions.

You may audit a bank that holds either a regular interest, a residual interest, or both. If you decide to examine this area you will need to do considerable research. The law relating to REMIC's is found in IRC sections 860A through 860G. Also, Tax Management has a portfolio that discusses REMIC's.

## **LOAN RESTRUCTURINGS**

Final regulations under IRC section 1001 were published as T.D. 8675 (1996-29, I.R.B. 5 (July 15, 1996)). The discussion which follows was written before these regulations were finalized so any resulting changes have not been incorporated in this text. For questions concerning application of the final regulations, contact the Industry Specialist.

Banks, often, will renegotiate the terms of a debt instrument with a borrower. If the changes are material, there is a deemed exchange for tax purposes of the original debt instrument for a new debt instrument with the modified terms. Sometimes, this type of exchange is referred to as a swap, though it differs from the transactions discussed above that involve an exchange between holders of instruments of different obligors.

If the modification of the debt rises to the level of a deemed exchange, the bank will have gain or loss on the disposition of the original instrument. In addition, the bank will hold a new instrument that may be subject to the rules for original issue discount under IRC sections 1272 through 1275 or the unstated interest rules of IRC section 483.

Treas. Reg. section 1.1001-1(a) provides that gain or loss is realized on the sale of property or on the exchange of property for other property differing materially either in kind or in extent. This rule applies not only to actual exchanges of properties between owners, but also to deemed exchanges arising from the modification of the terms of debt instruments. However, see Treas. Reg. section 1.1001-1(g) for special rules for using issue price to determine the amount realized for OID instruments.

After the opinion in *Cottage Savings*, there was considerable discussion as to how the Court's interpretation of the definition of a material difference should be applied to debt modifications.

The IRS responded by proposing changes to the Regulations for IRC section 1001. Proposed Treas. Reg. section 1.1001-3 provides the rules for determining when a modification of a debt instrument will be deemed to be an exchange of properties that differ materially either in kind or in extent. Gain or loss recognition is not required if the modification of the debt instrument is not significant.

A brief outline of the proposed regulations is provided below.

1. A significant modification of a debt instrument is treated as an exchange of the original instrument for a modified instrument that differs materially either in kind or extent. If the modification is not significant, it is not an exchange.
2. An alteration of a legal right or obligation of the holder or the issuer is a modification unless the alteration was provided for in the original terms of the instrument and does not require consent or consideration from the other party. However, a temporary waiver of a default or similar right by the holder after the issuer fails to perform an obligation is not a modification.
3. Rules are provided which determine whether changes in (a) yield, (b) timing or amounts of payments, (c) obligor or security, or (d) the nature of the instrument are considered significant.
4. If multiple, simultaneous changes are made to the debt instrument which are not significant, they do not collectively constitute a significant modification.
5. Multiple changes to a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification.

If the taxpayer you are examining has renegotiated debt with its customers, you will need to consider whether it resulted in a taxable event. Usually when debt restructuring occurs, it is because the borrower is having financial trouble. Therefore, the restructured loan will have more favorable terms for the borrower and therefore, be worth less. Since this would result in a loss, the taxpayer may want to treat changes that are not material as being significant modifications. Although the proposed regulations have not yet been finalized, you may want to review them to get a better understanding of the issue.

The proposed regulations, for the most part, follow the existing authorities as to when a debt modification would rise to the level of an exchange under IRC section 1001. The proposed regulations, however, are prospective only. For transactions occurring before the proposed regulations take effect, rely on existing authorities.

The main issue on the deemed disposition of the original note is the amount realized. Banks may try to claim that the amount realized is the fair market value of the new debt instrument.

Under Treas. Reg. section 1.1001-1(g), if a debt instrument is given in exchange for property, the amount realized on the disposition of the property is the issue price of the debt instrument received as determined under the OID rules. The regulation is effective as of April 4, 1994, but has been proposed in substantially the same form since 1986. Amendments were made to this section in 1996. (This regulation was part of the OID package and is separate from Proposed Treas. Reg. section 1.1001-3.)

Under rules in IRC sections 1273, 1274, and the regulations, the issue price of the new debt that provides for interest at or above the applicable Federal rate (AFR) will generally be the debt instrument's face amount. If either the old or new debt instrument in the exchange is publicly traded (listed on an exchange or regularly quoted by dealers in the over-the-counter market), however, the issue price of the new debt instrument will be fair market value, as measured by the traded debt. Narrow bid/ask spreads for bonds (based on evidence of contemporaneous quotes) are a strong indication that the bonds are regularly quoted.

For exchanges occurring prior to the enactment of the OID rules in 1984, Revenue Ruling 79-292 requires accrual basis taxpayers to realize the face amount, not the fair market value, of the debt obligations that are received upon the disposition of property. Since the taxpayer has an unconditional right to receive the face amount of the note, the fair market value is not relevant.

## **EXAMINATION TECHNIQUES**

1. The taxpayer should be questioned extensively to determine whether they have exchanged any loans during the years under examination. Ask specifically about mortgage loan swaps, foreign loan swaps, repurchase agreements, etc.
2. Keep in mind that some of these swaps might not require book recognition. If the principal amount has not changed during the swap, there usually would not be any book entries. Therefore, the tax department may not be aware that any swaps took place. A person from the bank that is knowledgeable in this area should be interviewed.
3. Review the M-1 schedule and related work papers to see if there are any book/tax differences in the reporting of loan losses. Large and unusual items should be analyzed further.
4. If the taxpayer has exchanged loans, you will need to do research to determine whether the exchange resulted in a taxable event. Since there have been new interpretations of the law in this area, you may want to discuss the issue with the industry specialist or a financial product specialist.

5. If the taxpayer has restructured loans, obtain copies of both the new and old loan documents to determine whether there are substantial modifications.
6. Once you determine that the taxpayer had a taxable exchange, do research to determine whether face value or fair market value should be used for the amount realized. The taxable gain or loss can then be computed.
7. Additional examination techniques were discussed in each of the above sections. Those should be reviewed when you encounter that particular type of swap.

## **SUMMARY**

As discussed above, there are several types of loan swaps that banks may enter into. Each type of exchange must be evaluated to determine whether the taxpayer properly reported the gain or loss from the transaction. The Supreme Court's opinion in *Cottage Savings* should be considered when determining the proper tax treatment of the swaps.

## MISCELLANEOUS ISSUES

### INTRODUCTION

During the examination of a bank, you may encounter issues which are not explained elsewhere in this guide. This miscellaneous issues section is included to provide a brief explanation of these topics. This portion of the guide was not meant to consider all of the potential aspects of an issue. The explanations are simply a starting point to be used when developing a new issue.

### ACCRUAL OF ORIGINAL ISSUE DISCOUNT AND MARKET DISCOUNT

Original issue discount (OID) is simply the excess of a debt instrument's stated redemption price at maturity over its issue price.

IRC section 1272(a)(1) provides that:

#### EXTRACT

IRC section 1272(a)(1)

\* \* \* For purposes of this title, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

In other words, the holder of any debt instrument having original issue discount must include in income a ratable portion of the discount computed on a daily basis.

In February 1994, the Service published final rules for the treatment of OID, de minimis OID, stated interest, and unstated interest. See, generally, Treas. Reg. sections 1.163-7, 1.446-2, 1.483-1 through 1.483-3, 1.1012-1(g), and 1.1271-0 through 1.1275-5.

Original issue discount should not be confused with market discount. A market discount involves the purchase of a security at a discount after its original issuance. This discount is generally not taxed until maturity or disposition. However, the Tax Reform Act of 1986 provides that some of the market discount would be currently taxable if a portion of the principal is included with the interest payment. If a financial institution is not required to report all of the accrued market discount, IRC section 1277(a) may require the deferral of a portion of the bank's interest expense deduction that is allocable to obligations purchased at a discount.



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Banks normally invest a significant amount of funds in mortgage backed securities issued by the Governmental National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Association (FHLMC). These obligations can be purchased at a discount from the face value of the note. Payments on these obligations include the interest due, plus a portion of the principal of the original obligation. Therefore, each payment contains a portion of the discount. The amount of the discount is taxable income when received or accrued by the bank.

### **CAP INTEREST**

The tax treatment of prepaid interest was, generally, changed by the final original issue discount (OID) regulations. A debt instrument with an overall instrument rate cap is subject to the OID rules, either under the rules for variable rate debt instruments or for contingent payment debt instruments.

Prior to December 1992, CAP interest was one of the five coordinated issues in the commercial banking area. The CAP interest issue was formally decontrolled in December 1992, thus it is no longer a coordinated issue. In the event you come across an issue in this area, contact the Industry Specialist for Commercial Banking for an update.

### **CHANGE OF ACCOUNTING METHOD**

Rev. Proc. 92-20, 1992-1 C.B. 685, was issued in March 1992 to provide new procedures for changes in accounting methods. It modified and superseded Rev. Proc. 84-74, 1984-1 C.B. 118. In general, the revenue procedure provides incentives for taxpayers to file requests to change from improper accounting methods before they are contacted by the IRS for an examination. The terms and conditions for accounting method changes are dependent on when the method change is requested and upon the impropriety of the method that had been used.

The revenue procedure states that if the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, it involves timing and is therefore considered a method of accounting.

In other words, timing adjustments fall under the rules for changing accounting methods.

These procedures apply to all taxpayers, not just banks. It is being mentioned in this guide so that it is properly considered during the course of your examination. A complete analysis of this revenue procedure is available in most research libraries.

It is important that you inform the taxpayer whenever you change the bank's accounting method so that there is no question which method they should use in subsequent years.

### **CURRENCY TRANSACTION REPORTING (CTR)**

In an attempt to track the flow of cash by individuals and businesses, the Federal Government has imposed strict reporting requirements in recent years. One of the most common requirements for banks involves currency transaction reporting. Forms must be filed with the Internal Revenue Service by financial institutions for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to such financial institution which involves a transaction in currency in excess of \$10,000.

Treasury Form 4789 is used to report cash transactions over \$10,000 which are deposited with the financial institution in one or more related transactions. It is the obligation of the bank to properly file these forms when appropriate. The form identifies the individual making the transaction, the person or organization for whom the transaction was conducted, the institution reporting the transaction, and the amount of cash deposited. As explained in Chapter 5, the IRS does not have jurisdiction to examine this area for federally regulated banks.

Treasury Form 8300 is required for cash payments over \$10,000 which are received by the bank other than from depositors. It identifies the customer and provides a description of the transaction and method of payment.

Forms filed by taxpayers are available to the revenue agent through the Currency and Banking Retrieval System.

### **DIVIDEND RECEIVED DEDUCTION**

The dividend received deduction is disallowed on any stock which was not held for the required holding period. In addition, no dividend received deduction is allowed to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property. See Revenue Ruling 94-28, 1994-1 C.B. 86, which discusses the availability of the dividends received deduction for some new financial products.

### **ENTRANCE AND EXIT FEES PAID TO CONVERT FROM AN S&L TO A BANK**

A number of savings and loans have converted to banks in recent years. There are several reasons why they might choose to do this. First, the public image of a bank is better than that of a thrift. Second, a savings and loan is required to invest primarily in mortgage loans. If the institution determines that they would be more profitable being diversified, it may be willing to give up the tax advantages afforded to savings and

loans. Third, at one point, the insurance premiums paid to the Bank Insurance Fund ("BIF") were lower than those paid to the Savings Association Insurance Fund ("SAIF"). Last, banks which acquire savings and loans may want them to be similar types of institutions.

When a savings and loan converts to a bank, it is required to pay a fee to exit SAIF and another fee to join BIF. Consideration needs to be given to whether either or both of these fees are capital in nature. Many people in the industry concur that the entrance fee should not be expensed. It is the cost of changing the institution's form of doing business and will create a future benefit. It may be argued that the exit fee should also be capitalized since it is part of the overall conversion which results in a future benefit. Some banks argue that the exit fee is a cost of ceasing to do business in the old form and therefore, should be expensed.

The Service is treating the SAIF exit fee and the BIF entrance fee as part of an integrated transaction. Both fees are required to be paid in any conversion transaction and confer significant benefits which extend beyond the taxable year. As a result, both the exit fee and the entrance fee are capital expenditures under IRC section 263. Since the benefits of these fees continue indefinitely as long as membership in the insurance fund is retained (as opposed to continuing only for the life of the specific deposits transferred), the exit fee and entrance fee are not subject to an allowance for depreciation under IRC section 167(a).

The potential effect of new IRC section 197 has not yet been addressed as it did not apply to the years under consideration. It is not known whether entrance and exit fees paid after the effective date of IRC section 197 will be amortizable. If you encounter this situation, contact the Commercial Banking or Savings & Loan Industry Specialist for the IRS' current position.

### **EXEMPTION FOR INSOLVENT BANKS**

Under certain very restrictive circumstances, insolvent banks are exempted from federal income taxes under IRC section 7507. This section provides for payment of depositors' claims ahead of other creditors, including the U.S. Government. The fact that a bank is taken over by the FDIC does not automatically mean that it is insolvent. It is the Service position that IRC section 7507 applies only in very rare circumstances. The FDIC has attempted to discourage IRS examinations of banks it is operating by claiming that they are insolvent and, therefore, exempt from federal income taxes. If you have this issue, please contact the Industry Specialist.

Banks, generally, report many miscellaneous items of income in a manner consistent with their overall method of accounting. Service charges such as safe deposit fees, traveler checks fees, overdraft charges, and other miscellaneous fees are generally included in income as earned or received, whichever is earlier.

**NET OPERATING LOSS CARRYBACKS**

**IRC section 172(b)(1)(D)**

Pursuant to IRC section 172(b)(1)(D) for taxable years beginning after December 31, 1986 and before January 1, 1994, banks using the specific charge-off method for bad debt loss deductions, are allowed a 10-year carry-back and a 5-year carryforward for NOL's attributable specifically to bad debt losses. This differs from a regular corporation which is allowed only a 3-year carryback for net operating losses. This carryback period was changed by the Tax Reform Act of 1986. Previously, the law had allowed a 10-year carryback for all losses incurred by a bank.

Because of the extended carryback provisions, banks may file claims for a number of years if they have bad debts which create a net operating loss. If allowable claims exceed \$1,000,000, Joint Committee case procedures must be followed.

*First Alex Bancshares Inc. v. United States*, 93-2 U.S.T.C. ¶ 50,542 (W.D. Okla. 1993), held that the 10-year NOL carryback applies only to bad debt deductions claimed under IRC section 166. Banks using the reserve method under IRC section 585 cannot claim a 10-year carryback. See Rev. Rul. 93-69, 1993-2 C.B. 75.

**IRC section 172(f)**

If you have any cases involving the 10-year carryback provisions of IRC section 172(f), please contact the ISP Specialist for Savings and Loans.

**REGULATORY AGENCY PENALTIES**

The Federal Reserve and other regulatory agencies have the authority to charge a bank various penalties for failing to comply with banking regulations. IRC section 162(f) provides that no deduction shall be allowed for any fine or similar penalty paid to the government for the violation of any act. Penalties by the regulators which are punitive in nature may constitute a nondeductible civil penalty within the meaning of Treas. Reg. section 1.162-21(b)(1)(ii). However, the mere designation as a penalty is not determinative.

The easiest way to obtain penalty information is through the use of Lexis. Search the Lexis libraries for any regulatory agencies that examine your bank. Your search request should include the name of the bank and the word fine or penalty. If you come across this issue, please contact either the Industry Specialist or Industry Counsel for Commercial Banking (or Savings and Loan if you are examining a thrift).

### **STOCK DIVIDEND AND ISSUANCE COSTS**

Costs directly associated with the issuance of additional capital stock or stock dividends are not tax deductible expenses. A review of the annual report or the corporate minute book will usually indicate if any new stock or stock dividends were issued. Some examples of the type of expenses that cannot be deducted are legal fees, printing costs, mailing costs, and other distribution expenses.

### **BUILT-IN-LOSS LIMITATIONS ON NOLS**

In *Idaho First National Bank, Moore Financial Group, Inc. v. Commissioner*, 997 F.2d 1285 (9th Cir. 1993), the court ruled that losses resulting from the financial failures of the acquired corporation prior to acquisition were "built-in deductions" rather than rehabilitating deductions and thus were limited under Treas. Reg. section 1.1502-15(a).

### **S-CORPORATION STATUS**

As a result of the August 20, 1996, enactment of P.L. 104-188, the Small Business Job Protection Act of 1996, banks and thrifts not using a reserve method of accounting for bad debts are now eligible to convert to S-Corporations in tax years beginning after December 31, 1996. Prior to Act section 1315, IRC section 1361(b)(2) prohibited financial institutions to which IRC sections 585 and 593 applied from electing S-Corporation status. In a related measure, Act section 1301 increased the number of shareholders permitted in an S-Corporation from 35 to 75. Conversion from a reserve method of bad debts to the specific charge off method will trigger the recapture of some or all of the bad debt reserve.

## **RESOURCE & REFERENCE MATERIALS**

There are many resource and reference materials available which can assist you during the examination of a financial institution. The majority of these materials are published commercially for use by banks and accountants. There are also various seminars held periodically. Information regarding these items and a list of IRS personnel who are involved with the tax treatment of financial institutions is provided below. Please keep in mind that this information may have changed since the publication date of this guide.

### **BANKING RESEARCH MANUALS**

#### ***TAXATION OF FINANCIAL INSTITUTIONS***

This is a three volume set authored by partners at KPMG Peat Marwick and published by Matthew Bender. The first two volumes provide detailed, but easy-to-read explanations of bank and thrift tax issues. Sample returns are also included. Volume three includes code sections, regulations, revenue rulings, applicable federal rates, revenue procedures, and letter rulings applicable to financial institutions.

Most of the larger banks subscribe to this research service so you may be able to use the bank's copy. Ordering information is provided below:

Address: Matthew Bender & Company, Inc.  
Customer Services Department-Special Accounts  
1275 Broadway, Albany, N.Y. 12204  
Phone: (800) 833-9844  
Cost: \$525 for the first year, \$389 for each subsequent year

This manual is published each year by Warren Gorham Lamont and is written by Charles W. Wheeler, JD, and Jack B. Wilson, Jr., CPA. The manual is comprised of text, practice aids, checklists, tables, and sample tax returns. Although this is not as large as the *Taxation of Financial Institutions*, it provides very good explanations of bank tax law. It does not include information applicable to thrift institutions.

Ordering information is provided below:

Address: Warren Gorham Lamont  
Ted Ward, Federal Government Representative  
210 South Street, Boston, MA 02111  
Phone: (800) 950-1229 X8277  
Cost: \$117.76 (Government rate)

***FEDERAL INCOME TAXATION OF BANKS & FINANCIAL INSTITUTIONS***

This manual is also published by Warren Gorham Lamont and is authored by Lance W. Rook. It provides detailed information on the federal income taxation of banks and other financial institutions. The manual also includes worksheets and a table of code sections, regulations, and rulings. Ordering information is provided below:

Address: Warren Gorham Lamont  
Ted Ward, Federal Government Representative  
210 South Street, Boston, MA 02111  
Phone: (800) 950-1229 X8277  
Cost: \$505.58 per year, including 4 updates  
(Government rate) \$215 for initial yearly fill with no updates

***THE BANK TAX DESK BOOK***

This is a one volume general introduction to the tax issues currently affecting the commercial banking and savings & loan industries. It is written by Professor Ron Blasi, Professor of Law, Georgia State University. It is published by John Wiley & Sons, Inc. Additional information may be obtained from the Industry Specialists.

***THE JOURNAL OF BANK TAXATION***

*The Journal of Bank Taxation* is published quarterly by Warren Gorham Lamont. The periodical includes articles by various bank tax professionals on current topics. It also may contain information on upcoming conferences, bank tax planning, state bank developments, international banking, etc. Ordering information is provided below:

Address: Warren Gorham Lamont  
Ted Ward, Federal Government Representative  
210 South Street, Boston, MA 02111  
Phone: (800) 950-1229 X8277  
Cost: \$128.70 per year (Government rate)

***AMERICAN BANKER***

The *American Banker* is a newspaper which is published Monday through Friday. It provides current information on all banking activities, such as mergers, earnings, legislation, etc., not just bank taxation. Magazines are also published each year which include consumer surveys and rankings of banks. Ordering information is provided below:

Address: American Banker  
One State Street Plaza, New York, N.Y. 10004  
Phone: (800) 221-1809  
Cost: \$750 per year (lower group rates may be available)

**IRS MATERIALS**

***INTERNAL REVENUE MANUAL 4232.9***

This handbook was prepared to assist agents in the examination of financial institutions. Chapter 200 provides general information on records, accounting methods, issues, etc. which are applicable to bank and trust companies. This section of the manual also discusses savings and loans, mutual savings banks, cooperative banks, commercial credit agencies, regulated investment companies, small business investment companies, and bank holding companies.



***COMPTROLLER'S MANUAL FOR NATIONAL BANKS***

This manual contains selected statutes, regulations, and rulings related to the operations of banks. It is updated every few years to include subsequent changes to the law. It can be secured from the Comptroller of the Currency by written request. There generally is not a charge to the IRS if you request a complimentary copy. Ordering information is provided below:

Address: Ellen Stockdale, Director of Communication  
250 E Street SW  
Washington D.C. 20219  
Phone: (202) 622-2000  
Cost: \$0 (Government rate)

***AUDITS OF BANKS***

The AICPA publishes an audit and accounting guide which describes the accounting and financial reporting practices for the banking industry. It also discusses the audits of banks' financial statements. The guide is updated annually. It can be ordered as follows:

Address: American Institute of Certified Public Accountants  
P.O. Box 9264  
Church Street Station  
New York, NY 10256-9264  
Phone: (800) 862-4272  
Cost: \$29.75 (\$27 for AICPA members)

***ANNUAL BANK TAX INSTITUTE***

Executive Enterprises sponsors the Bank Tax Institute which is held each December. Approximately 20 general sessions and workshops are held on various topics such as, bad debts, financial products, mortgage banking, IRS developments, international banking, mergers, etc. The sessions are intended for individuals who are familiar with the banking industry and the specific bank tax issues. Speakers include the IRS banking and savings and loan industry specialists, accountants, and bank tax managers. Although the sessions are geared towards educating accountants and bank personnel they can also be very informative for IRS agents. There are several hundred people who attend this conference. For registration information contact the following:

Address: Executive Enterprises, Inc.  
22 West 21st Street  
New York, NY 10010-6990  
Phone: (800) 831-8333  
Cost: \$995

***THE HOTTEST ISSUES IN BANK TAXATION***

This small group training session is also sponsored by Executive Enterprises. The course leader is Ronald Blasi, a professor at the College of Law at Georgia State University. This conference covers fewer topics than the Bank Tax Institute, but explores them in more depth. The instructor encourages the class to interact and welcomes IRS agents' comments. There are usually several sessions offered each year. Registration information follows:

Address: Executive Enterprises, Inc.  
22 West 21st Street  
New York, NY 10010-6990  
Phone: (800) 831-8333  
Cost: \$995

The Bank Administration Institute is a nonprofit organization which provides this seminar as a service to its members. The structure, speakers, and topics are very similar to the Bank Tax Institute which was mentioned previously. They do not have any firm policy on IRS personnel attending the seminar, but may limit attendance at some of the break-out sessions. The Bank Tax Conference is combined with BAI's accounting conference so that students can attend either session. Several hundred people enroll in this seminar which is held in May or June. You can obtain additional information from the following:

Address: Bank Administration Institute

Attn: John Barry

1 North Franklin

Chicago, Illinois 60606

Phone: (800) 323-8552

Cost: \$1095

## **INTRODUCTION**

There are a number of recent regulations, court cases, revenue rulings, revenue procedures, etc. which affect the taxation of financial institutions. The most significant decisions have been summarized below to assist you in your research. Information on other useful reading materials is provided. Also refer to the banking coordinated issue papers for discussions of older court cases which affect the coordinated issues.

Information relating to the following issues are discussed in this chapter:

1. Bad Debts
2. Capital Expenditures
3. Core Deposits and Other Intangibles
4. Financial Products
5. Foreign Banking
6. Loan Origination Costs
7. Loan Swaps
8. Miscellaneous Issues
9. Mortgage Servicing Rights
10. Nonperforming Loans
11. Original Issue Discount
12. Premature Withdrawal Penalty Income

## **BAD DEBTS**

T.D. 8676, 1996-30, I.R.B. 4. These temporary regulations (1.166-3T) under IRC section 166 were issued in July 1996 and discuss the interaction between debt modifications under IRC section 1001 and partially worthless debt.

T.D. 8513, 1994-1 C.B. 169. These final regulations under IRC section 585 were issued on December 29, 1993.

T.D. 8492, 1993-2 C.B. 73. This Treasury decision amends Treas. Reg. section 1.166-2(d)(3) regarding the conclusive presumption of worthlessness for bad debt charge-offs.

T.D. 8396, 1992-1 C.B. 95. This Treasury decision contains final regulations under IRC section 166 relating to a bank's determination of worthlessness of a debt. The regulations provide for a conclusive presumption of worthlessness of debts based on the application of a single set of standards for both regulatory and tax accounting purposes.

Rev. Rul. 92-14, 1992-1 C.B. 93. The portion of an international loan that is subject to an allocated transfer risk reserve (ATTR) is treated as a debt charge-off in obedience to a specific order of the bank's supervisory authority for purposes of the conclusive presumption regulations.

Rev. Proc. 92-18, 1992-1 C.B. 684. The procedures are provided for obtaining an express determination letter from the bank's supervisory authority. A sample uniform express determination letter is provided.

Rev. Proc. 92-84, 1992-2 C.B. 489. Discusses requirements for obtaining an express determination letter and describes the contents of the letter.

Notice 93-50, 1993-2 C.B. 336. A bank can, under certain circumstances, elect the conformity method via an amended return for tax years ending on or after December 31, 1991.

## **CAPITAL EXPENDITURES**

*Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), *aff'g National Starch and Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990), *aff'g* 93 T.C. 67 (1989). Expenses incurred during a friendly takeover were not deductible because benefits were created that extended beyond the current year. The creation or enhancement of a separate asset was not a necessary condition to require expenses to be capitalized.

Rev. Rul. 92-80, 1992-2 C.B. 57. This ruling held that advertising costs are generally deductible under IRC section 162.

## **CORE DEPOSITS AND OTHER INTANGIBLES**

*Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd without published opinion*, 900 F.2d 266 (11th Cir. 1990), *aff'd per curiam*, 919 F.2d 1492. The deposit base which was acquired by a bank had an ascertainable cost basis distinct from goodwill and had a limited useful life. The bank was allowed to depreciate the deposit base.

*Colorado National Bankshares, Inc. v. Commissioner*, T.C. Memo. 1990-495, *aff'd* 984 F.2d 383 (10th Cir. 1993). The core deposit intangible was held to have an ascertainable value separate and distinct from the goodwill and going-concern value of the acquired banks. The core had a limited useful life. Therefore, the taxpayer was entitled to a depreciation deduction.

*IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. 496 (1991). The core deposit intangible asset is separate and distinct from goodwill and has a limited useful life. It may be depreciated on an accelerated basis. However, the bank erroneously calculated the value of the core deposit by including interest sensitive deposits, by failing to reduce the core for reserve requirements and float on deposits, by using an inappropriate alternative funding source, and by using an incorrect discount rate.

*Newark Morning Ledger Co. v. United States*, 507 U.S. \_\_\_\_, 113 S. Ct. 1670, 123 L.Ed.2d. 288 (1993), *rev'g* 945 F.2d 555 (3d Cir. 1992), *rev'g* 736 F. Supp. 176 (D.N.J. 1990). If the taxpayer can successfully meet its burden of proving that an asset has value and a limited useful life, it is depreciable even if its value is related to the expectancy of continued patronage.

*Peoples Bancorporation v. Commissioner*, T.C. Memo. 1992-285. The core deposits were determined to be separate from goodwill and amortizable. They had limited useful lives of 18 and 20 years. The values were determined using a modified cost-savings method.

*Trustmark Corp. v. Commissioner*, T.C. Memo. 1994-184. The court allowed the use of subsequent studies of account closings to corroborate the reasonable accuracy of the taxpayer's projections.

IRC section 197. The capitalized costs of specified intangible assets are ratably amortized over a 15 year period. A bank's core deposit base is now defined under the provisions of IRC section 197.

T.D. 8528, 1994-1 C.B. 81, and PS-55-93, 1994-1 C.B. 830. The temporary and proposed regulations under IRC sections 167 and 168 relate to certain elections for intangible property.

#### Other Useful Reading:

Intangibles Settlement Initiative, IRS Document 9233 (2-94), Catalog No. 20566N. The settlement initiative gives taxpayers a one-time opportunity to resolve intangibles disputes in tax years not affected by the Omnibus Budget Reconciliation Act of 1993.

## **FINANCIAL PRODUCTS**

*Arkansas Best Corporation v. Commissioner*, 485 U.S. 212 (1988), 88-1 U.S.T.C. ¶ 9210. The Supreme Court determined that an ordinary loss is allowable upon the sale of an asset only if the property is specifically excluded from capital asset treatment per IRC section 1221. The case discussed the treatment of hedging transactions.

*Federal National Mortgage Association v. Commissioner*, 100 T.C. No. 36 (1993), 65 T.C.M. (CCH) 4178 (1993). Certain hedging transactions were allowed ordinary loss treatment. The hedges were surrogates for mortgages and were excepted from the definition of a capital asset. Foreign currency swap transactions were also discussed.

*Circle K Corp. v. United States*, 23 Cl. Ct. 665, 91-2 U.S.T.C. ¶ 50383 (1991), vacating and reissuing, 23 Cl. Ct. 161, 91-1 U.S.T.C. ¶ 50260 (1991). The court allowed a gasoline retailer to deduct a loss on the sale of stock it purchased in an oil company as an ordinary loss. The purchase was characterized as an integral part of the company's inventory-purchase system and was excluded from the definition of a capital asset. The decision seems to be in direct conflict with the Arkansas Best decision.

IRC section 475. Beginning in 1994, dealers in securities are required to report unrealized gains and losses at year end if the securities are not held for investment.

T.D. 8493, 1993-2 C.B. 255. These new regulations, under IRC section 1221, define what transactions will qualify as hedging transactions. Ordinary gain or loss treatment is allowed for business hedges.

T.D. 8491, 1993-2 C.B. 215. These new regulations, under IRC section 446, govern the tax treatment of notional principal contracts. They deal with the year and amounts that should be reported for tax purposes.

FI-54-93, 1993-2 C.B. 615. These proposed regulations, under IRC section 446, would require that a taxpayer's method of accounting for hedging transactions clearly reflect income.

Notice 93-45, 1993-2 C.B. 334. Dealers must identify securities for mark to market.

Rev. Rul. 93-76, I.R.B. 93-35. This ruling elaborates on who will be considered a "dealer in securities." It amplifies and supersedes Notice 93-45.

Rev. Rul. 94-7, 1994-1 C.B. 151. This ruling corrects Rev. Rul. 93-76.

Proposed regulations under IRC section 475, FI-42-4, were published in the Federal Register on January 4, 1995.

T.D. 8653, 1996-12 I.R.B. 4, covers the final hedging regulations.

Rev. Proc 96-21, 1996-4 I.R.B. 96, deals with hedging.

Notice 96-12, 1996-10 I.R.B. 29, discusses mark to market accounting.

T.D. 8676, 1996-30 I.R.B. 4, provides temporary regulations on certain assignments of notional principal contracts.

*Continental Illinois Corp. v. Commissioner*, T.C. Memo. 1991-66, *aff'd in part and rev'd in part, remanded*, 93 T.N.T. 148-11 (7th Cir. 1993), 93-2 U.S.T.C. ¶ 50400. The taxpayer was legally liable for Brazilian tax. However, the bank was entitled to foreign tax credits only when it substantiated that the withholding tax was paid.

Rev. Proc. 91-22, 1991-1 C.B. 526, superseded by Rev. Proc. 96-53, 1996-49 I.R.B. 22. This revenue procedure explains how to secure an advance pricing agreement covering the prospective determination and application of transfer pricing methodologies for international of foreign or domestic taxpayers. The revenue procedure has been corrected by and cited in several subsequent rulings.

### **LOAN ORIGATION COSTS**

Announcement 93-60, 1993-16 IRB 9. This announcement temporarily suspending the filing of accounting method change requests for loan origination costs.

*Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), *aff'g National Starch and Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990), *aff'g* 93T.C. 67 (1989). Expenses incurred during a friendly takeover were not deductible because benefits were created that extended beyond the current year. The creation or enhancement of a separate asset was not a necessary condition to require expenses to be capitalized. Notice 96-7, 1996-6, I.R.B. 22 (February 5, 1996).

### **LOAN SWAPS**

T.D. 8675, 1996-29 I.R.B. 5 (July 15, 1996). Final regulations under IRC section 1001 deal with debt modification.

*Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), 91-1 U.S.T.C. ¶ 50187, remanded, 934 F.2d 739 (6th Cir. 1992), 92-1 U.S.T.C. ¶ 50221. The taxpayer realized deductible losses when it exchanged participation interests in mortgages for mortgages that were materially different. The losses were treated as bona fide because no contention had been made that the transaction was not at arm's length or that the taxpayer retained ownership of the participation interests that were traded.

FI-31-92, 1992-2 C.B. 683. The proposed regulations under IRC section 1001 provide the rules for determining when a modification of a debt instrument will be deemed to be an exchange of properties that differ materially either in kind or in extent.

### **MISCELLANEOUS ISSUES**

*First Alex Bancshares Inc. v. United States*, 93-2 U.S.T.C. □ 50,542 (W.D. Okla. 1993). The court held that the 10 year NOL carryback applies only to bad debt deductions claimed under IRC section 166.



Rev. Rul. 93-69, 1993-2 C.B. 75. A commercial bank may not use the special 10 year net operating loss carryback provision of IRC section 172(b)(1)(D) for the portion of its net operating loss that is attributable to a deduction for an addition to its bad debt reserve.

***Idaho First National Bank, Moore Financial Group, Inc. v. Commissioner***, 997 F.2d 1285 (9th Cir. 1993). The court ruled that losses resulting from the financial failures of the acquired corporation prior to acquisition were "built-in deductions" rather than rehabilitating deductions and thus were limited under Treas. Reg. section 1.1502-15(a).

***Security Bank of Minnesota v. Commissioner***, 994 F.2d 432 (8th Cir. 1993), *aff'g* 98 T.C. 33 (1992). The court ruled that a cash basis bank was not required to accrue interest income on short term loans under IRC section 1281(a)(2). The Service's nonacquiescence to this decision was announced at 1995-2 C.B. 2 and in Notice 95-57, 1995-2, C.B. 337 and in an Action on Decision, 1995-52 I.R.B. 4. The Service will not follow this decision or allow changes of accounting method which reflect this decision outside the 8th Circuit.

Rev. Proc. 92-20, 1992-1 C.B. 685. This revenue procedure explains the new procedures for taxpayers to change their accounting methods. Taxpayers are given more favorable treatment the earlier they file for method changes.

Rev. Rul. 94-28, 1994-1 C.B. 86. The revenue ruling discusses the availability of the dividends received

## **MORTGAGE SERVICING RIGHTS**

Rev. Rul. 91-46, 1991-2 C.B. 358. IRC section 1286 is applied to sales of mortgages when the seller enters into a contract to service the mortgages. If the taxpayer is entitled to receive amounts that exceed reasonable compensation for the services to be performed, the mortgages are stripped bonds. The excess servicing rights are stripped coupons.

Rev. Proc. 91-49, 1991-2 C.B. 777. The procedure provides simplified tax treatment for original issue discount for certain mortgages that are stripped bonds under IRC section 1286.

Rev. Proc. 91-50, 1991-2 C.B. 778. Taxpayers may elect to use safe harbor rates in computing the amount of excess servicing. The safe harbor rates represent the amount of reasonable compensation that the taxpayer is entitled to receive under a mortgage servicing contract.

Rev. Proc. 91-51, 1991-2 C.B. 779. Taxpayers can elect to automatically change their accounting method for servicing rights on a cut-off basis.

*European American Bank and Trust Co. v. United States*, Cl. Ct. No. 135-82T, 92-1 U.S.T.C. ¶ 50,026 (Fed. Cir. 1992), *aff'g* 20 Cl. Ct. 594 (Cl. Ct. 1990). Interest income should be accrued unless there is no reasonable expectation that it will be paid. The accrual of interest income was not dependent on whether the principal on a loan was likely to be repaid. If a lender expects to receive payment for interest, but not necessarily payment for the principal, interest should still be accrued.

**ORIGINAL ISSUE DISCOUNT**

T.D. 8517, 1994-1 C.B. 38. [Treas. Reg. sections 1.163-7, 1.446-2, 1.483-1 through 1.483-3, 1.1001-1(g), 1.1012-1(g), and 1.1271-0 through 1.1275-5.] These regulations contain the final rules for the treatment of OID, de minimis OID, stated interest, and unstated interest.

Rev. Proc. 94-28, 1994-1 C.B. 614. This contains the procedures for taxpayers to obtain automatic consent to change their methods of accounting to conform to the final OID regulations.

Rev. Proc. 94-29, 1994-1 C.B. 616. This procedure includes special rules for any change in method of accounting for de minimis OID, including de minimis OID attributable to points.

Rev. Proc. 94-30, 1994-1 C.B. 621. This procedure allows a taxpayer to use the principal reduction method of accounting on certain loans originated by the taxpayer.

T.D. 8674, 1996-28, I.R.B. 7 (July 8, 1996), contains final regulations on contingent debt.

Rev. Rul. 95-70, 1995-2, C.B. 124, provides the definition of qualified stated interest, however, amendments contained in T.D. 8674 have affected these rulings.

Notice 96-23, 1996-16, IRB 23 (April 15, 1996), discusses the interaction between the Rev. Proc. 94-9 method and mark to market.

**PREMATURE WITHDRAWAL PENALTY INCOME**

*United States v. Centennial Savings Bank, FSB*, 499 U.S. 573 (1991), 91-1 U.S.T.C. ¶ 50188. The court held that premature withdrawal penalties could not be treated as discharge of indebtedness and excluded from taxable income. The penalty income was includible in taxable income in the current year.

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This glossary was prepared to assist the reader who is involved in the banking area to become better acquainted with some of the common terminology that will be encountered during the course of an examination. Words are tools of thought and a better familiarity with the banking terminology will certainly create a better understanding of the subject.

## A

**ACTUARIAL METHOD** -- A method of computing income under which interest income on a fixed-rate obligation is accrued over the life of the loan based on a constant rate. This method is also referred to as the interest method or the constant yield method.

**AMERICAN BANKERS ASSOCIATION (ABA)** -- A national organization of banks established in 1875 to promote the general welfare and usefulness of banks and financial institutions.

**APPLICATION FEES** -- Fees that are paid by a borrower upon application for a loan. An application fee may include charges for property appraisals and credit reports.

**ARBITRAGE** -- Generally, the contemporaneous purchase and sale of the same security or commodity in different markets in order to benefit from a price differential in the marketplace.

## B

**BALLOON PAYMENT** -- A lump-sum payment due at the expiration of a loan that is substantially larger than preceding payments.

**BANK HOLDING COMPANY** -- Any company which directly or indirectly owns, controls, or holds the power to vote 25 percent or more of the voting stock in each of two or more banks.

**BASIS POINT** -- The smallest measurement of yield. One basis point equals 1/100 of 1 percent. For example, the difference between 5.75 percent and 5.78 percent is 3 basis points.

**BONDS** -- Interest bearing obligations or discounted debt instruments issued by a government or corporation obligating the issuer to pay bond holders stipulated amounts at specific intervals.

**BOOK VALUE** -- Tangible assets in excess of liabilities on a per share basis.

**BULK PURCHASE** -- The purchase of a group of loans, receivables, servicing rights, or similar assets in a single transaction.

**CALL REPORTS** -- The consolidated Reports of Condition and Income filed four times a year by all insured commercial banks. The Comptroller of the Currency may call upon all National banks to submit a complete financial report of their activities at any given date up to two times a year.

**CAP** -- A ceiling placed on the interest rate charge on a variable interest rate loan over the term of the loan.

**CERTIFICATE OF DEPOSIT (CD)** -- A time deposit with a specific maturity evidenced by a certificate. Interest rates on large denomination CD's are typically negotiable. CD's with a face value of at least \$100,000 are often referred to as Jumbo CD's.

**CLOSING COSTS** -- Fees paid at the closing of a mortgage or other loan transaction. These amounts include attorney fees, fees for preparing and filing the mortgage, property taxes, title search fees, and title insurance.

**COLLATERAL** -- Securities or other property pledged by a borrower to secure repayment of a loan. For consumer loans, collateral typically includes automobiles, furniture and appliances. For commercial loans, collateral typically includes account receivables, inventory, equipment, real estate, or other business property.

**COLLATERALIZED MORTGAGE OBLIGATIONS (CMO)** -- Debt obligations that are secured by a pool of mortgages or mortgage-backed securities such as Ginnie Maes.

**COMAKER LOAN** -- Loans made by more than one debtor and which are generally unsecured. The second debtor may be required because of the insufficient or unknown credit standing of the first debtor.

**COMMERCIAL PAPER** -- Unsecured promissory notes of corporations which mature in 270 days or less and are usually sold on a discount basis.

**COMMISSION** -- A fee paid for arranging a transaction involving the sale or purchase of assets or services.

**COMMITMENT** -- An agreement to lend money at a future date to a borrower.

**COMMITMENT FEE** -- Consideration paid by a potential borrower to a potential lender for a promise to lend money in the future. It may also refer to an amount paid by a lender to a third party for its promise to purchase a loan or pool of loans from the lender.

**COMPTROLLER OF THE CURRENCY** -- A bureau in the Department of the Treasury charged with the execution of all laws passed by Congress relating to the issue and regulation of currency of the United States. The Comptroller is also in charge of regulating and examining all National banks.

**CONSUMER REVOLVING CREDIT** -- Contracts with consumers to finance personal lines of credit that are continuously available to the consumer either for the purchase of goods or for a direct advance of cash. A line of credit generally is limited to a specified amount or time period.

**CONVERTIBLE BOND** -- Bonds in which the holder has the option to convert the bond into company stock as repayment of the loan, instead of cash. The terms of conversion, such as when the holder will be allowed to make the conversion, and how much stock each bond can be exchanged for, are specified at the time the bond is purchased.

**COUPON** -- A fixed dollar amount of interest on a debt obligation stated as an annual percentage of principal value, usually payable in semi-annual installments.

**CREDIT LIMIT** -- The maximum amount that is available to borrow under any existing loan provisions.

## D

**DEBENTURE** -- A debt obligation which is backed only by the good credit of the organization issuing it (unsecured debt).

**DEMAND LOANS** -- A loan that has no fixed maturity date but is payable upon demand of the lender.

**DISCOUNT** -- Most often refers to the excess of an obligation's stated redemption price at maturity over its current market price (or its acquisition price or issue price if applicable).

**DISCOUNT RATE** -- The interest rate that the Federal Reserve charges its member banks. It also means an interest rate, such as the applicable Federal rate, used in determining the present value of future cash flows.

**DRAFT** -- A draft is an order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment in lawful money at a determinable future time. Drafts generally arise from a commercial transaction, whereby a seller makes an agreement with a buyer in advance for the transfer of goods.

## E

**EFFECTIVE INTEREST RATE (YIELD)** -- The implicit rate of interest based on the amount advanced, costs incurred, and the amount and timing of specified repayments over the period of the contract.

**EURODOLLARS** -- U.S. dollars on deposit with a bank outside of the United States and consequently outside the jurisdiction of the United States. The bank could be either a foreign bank or a subsidiary of a U.S. bank.

**EURODOLLAR BONDS** -- Bonds issued in Europe by corporate or governmental interests and denominated in dollars.

**EXCHANGE RATE** -- The price of one currency in terms of another currency.  
<http://www.getirshelptoday.com>

**EXPOSURE** -- The risk of gain or loss because of the ownership of an asset, or the net amount of various assets and liabilities, denominated in a foreign currency. There are "exposures" other than currency risk, for example, exposure to interest rate fluctuations.

## F

**FACE VALUE** -- The stated principal amount. Also designates the original dollar amount of indebtedness incurred. Face value is not necessarily an indication of market value.

**FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)** -- A government corporation which insures the customer deposits of all member banks up to \$100,000 per account. The FDIC was created in 1933 and is managed by a Board of Directors, including the Comptroller of the Currency, that is appointed by the President.

**FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC)** -- A publicly owned corporation chartered by Congress to assist in developing and maintaining a secondary market in conventional residential mortgages. The corporation, often referred to as Freddie Mac, purchases conventional mortgages from financial institutions. The FHLMC securitizes the mortgages and sells these mortgage backed securities to investors.

**FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA)** -- A publicly owned corporation chartered by Congress to support the secondary mortgage market. It purchases residential mortgages insured by FHA or guaranteed by the Veterans Administration (VA). Fannie Mae then securitizes these mortgages, which are sold to investors.

**FEDERAL RESERVE** -- The Federal Reserve functions as the central banking system of the United States. It was created in 1913 to stabilize and secure the nation's financial system. The Federal Reserve is run by a seven member Board of Governors appointed by the President and confirmed by the Senate. It is accountable to the Government but is actually owned by its member banks. The Federal Reserve supervises, coordinates and controls the operations of the Federal Reserve Banks.

**FEDERAL RESERVE BANKS** -- There are 12 Federal Reserve Banks with 25 regional branches. They have regulatory power with respect to member banks. The U.S. Treasury and many other Governmental agencies maintain their accounts at the Federal Reserve Banks.

**FEDERAL RESERVE MEMBER BANKS** -- These are banks which operate under the Federal Reserve System. Each bank that becomes a member of the system must subscribe for an amount of Federal Reserve bank stock equal to 6 percent of the paid in capital and surplus of the member bank.

**FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC)** -- A former instrumentality of the Federal Government which insured the savings accounts of S&L's. Its function was similar to the FDIC before it was eliminated due to the S&L crisis of the 1980s. The FDIC currently insures the savings accounts of the remaining S&L's in the Savings Association Insurance Fund (SAIF), which is kept separate from the Bank Insurance Fund (BIF).

**FLOATING EXCHANGE SYSTEM** -- A system in which the values of various countries' currencies relative to each other are established by supply and demand forces in the market without government intervention.

**FLOATING RATE** -- A rate of interest that, by the terms of the loan, fluctuates up or down depending on other widely followed market rates of interest, such as the prime rate, Treasury bill rate, or Federal Reserve discount rate. A rate of exchange that is completely determined by market forces with no floor or ceiling vis-a-vis the dollar, gold, SDR's, or any other currency.

**FORECLOSURE** -- The legal process by which a bank obtains title to mortgaged property upon default by the borrower.

**FUTURES CONTRACT** -- Exchange traded contract specifying a future date of delivery or receipt of a certain amount of a specific tangible or intangible product for a particular price. The commodities traded in futures markets include stock index futures, agricultural products, metals, and financial products. Futures are used by a business as a hedge against unfavorable price changes and by speculators who hope to profit from such changes.

## G

**GARNISHMENT** -- The attachment of salaries through court action to collect on a defaulted obligation.

**GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)** -- A bureau of HUD formed to assist in developing and maintaining a secondary market in conventional residential mortgages. GNMA guarantees interests in mortgage pools that are formed by lenders and generally consists of VA or FHA guaranteed mortgages less than 1 year old.

## H

**HEDGING** -- The purchase or sale of a derivative security (such as an option or a futures contract) to reduce or neutralize all or some portion of the risk of owning another security (such as a mortgage).



**INTEREST METHOD** -- A method of computing income under which interest income on a fixed-rate obligation is accrued over the life of the loan based on a constant rate. This is also called the actuarial method or the constant yield method.

**INTEREST RATE** -- The periodic charge for the use of money expressed as a percentage of principal.

**INVESTMENT BANKER** -- Also known as an underwriter. The "middleman" between the corporation issuing new securities and the public. The usual practice is for one or more investment bankers to buy outright from a corporation a new issue of stocks or bonds. The group forms a syndicate to sell the securities to individuals and institutions. Banks often pay substantial fees to investment bankers who are involved with mergers and acquisitions.

## L

**LEASE** -- An agreement conveying the right to use property, plant, or equipment in exchange for cash payments over a stated period of time.

**LETTER OF CREDIT-COMMERCIAL** -- A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller, authorizing the buyer to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide eventual payment for drafts drawn.

**LETTER OF CREDIT-GUARANTEED** -- A letter of credit guaranteed by the customer (applicant) and often backed by collateral security.

**LETTER OF CREDIT-IRREVOCABLE** -- A letter of credit in which the issuing bank waives all right to cancel or in any way amend without the consent of the beneficiary or seller.

**LETTER OF CREDIT-REVOCABLE** -- A letter of credit in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been availed of prior to the actual payment or negotiation of drafts drawn.

**LEVERAGE** -- The ratio of total debt to equity. Rating agencies commonly monitor a finance company's leverage in determining its credit rating.

**LIBOR (LONDON INTERBANK OFFERED RATE)** -- The rate at which, theoretically, banks in London place Eurocurrencies/ Eurodollars with each other.

**LIEN** -- The right to satisfy a claim, if default occurs, by seizing the debtor's property subject to the lien and converting the property in accordance with procedures provided by law.

**LINE OF CREDIT** -- An agreement to lend a specified amount of money at an agreed rate as long as there is no material adverse change in the credit worthiness of the borrower. The funds are normally available upon request.

**LOAN FILE** -- A file that usually contains the loan application and documents, credit checks, references, records of past loans, current status of the loan, and other matters. Notes, contracts, titles, and collateral usually will be physically stored elsewhere for security reasons.

## M

**MANAGER OF PARTICIPATION** -- The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders.

**MARK TO MARKET ACCOUNTING** -- The method of accounting that adjusts the carrying value of inventories, futures contracts, forward contracts, securities, and other assets for changes in market prices. Unrealized gains and losses are recognized through adjustments that are made to the basis of the assets.

**MATURITY** -- Date or time period in which repayment of a loan or bond is to be made.

**MORTGAGE-BACKED SECURITIES** -- A participation interest in an organized pool of residential mortgages.

**MORTGAGE LOANS** -- Loans collateralized by real estate.

**MUNICIPAL BOND** -- A bond issued by a state or a political subdivision, such as a county, city, town, or village. In general, interest paid on municipal bonds is exempt from federal income taxes and local income taxes within the state of issue.

**MUTUAL SAVINGS BANK** -- A banking organization without capital stock and which operates under the law for the mutual benefit of its depositors. Under IRC section 591(b), the term includes certain savings banks with capital stock.

## N

**NATIONAL BANK** -- A commercial bank organized with the approval of the Comptroller of the Currency and operated under its supervision.

**NOMINAL INTEREST RATE** -- The stated interest rate of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate differs from the effective interest rate.

**NONACCRUAL LOANS (NONPERFORMING ASSETS)** -- Loans on which accrual of interest income has been suspended because collectibility of the debt is in doubt.

**NONRECOURSE** -- Type of debt in which a lender has no legal right to compel payment from a guarantor or drawer of a negotiable instrument in the event of default.

**NONREFUNDABLE FEE** -- Any charge made in connection with a loan that does not have to be returned to the borrower when the loan is prepaid.

**NOTES** -- Written promises to pay a specified amount to a party either on demand or on a specified date. <http://www.getirshelptoday.com>

## O

**OFFICE OF THRIFT SUPERVISION (OTS)** -- The OTS is the primary regulator for savings and loan associations. There are five regional offices throughout the United States.

**OPTION** -- A right to buy (call) or sell (put) property, including a fixed amount of stock, futures, and debt instruments at a specific price within a limited period of time.

**ORIGINATION FEE** -- An amount charged by a lender for originating, refinancing, or restructuring a loan. The amount may be intended to cover costs such as underwriting, loan application processing, and reviewing legal title to property.

**OTHER REAL ESTATE OWNED (OREO)** -- Property repossessed or foreclosed by the bank due to the inability of the debtor to pay off a loan.

## P

**PAR** -- For stock, par is the dollar amount assigned to the share by the company's charter. With bonds, par value is the face amount, usually in increments of \$1,000. Par value often has little relationship to market value.

**PARTICIPATION LOAN** -- A loan funded by two or more financial institutions.

**POINTS** -- A dollar amount equal to 1 percent of the principal of a loan for each point. This amount is generally expressed as a percentage of the loan and is the cost for granting the loan. Points are primarily paid to adjust yield, but may also be intended to cover costs such as underwriting, loan application processing, and reviewing title to collateral.

**PREMIUM** -- The amount by which a bond, stock, or other financial instrument may sell above its par value.

**PREPAYMENT PENALTY** -- An amount that the borrower pays to the lender, in addition to the remaining principal balance, if the borrower pays off the loan prior to contractual maturity.

**PRIME RATE** -- The interest rate charged by major banks to their most credit-worthy and largest corporate customers. Other interest rates, such as personal, automobile, commercial, and financing loans are often pegged to the prime rate.

## R

**RECOURSE** -- The legal right to compel payment from a guarantor or drawer of a negotiable instrument in the event of default.

**REPOSSESS** -- To gain custody and title to collateral from a debtor for nonpayment or default on a loan. <http://www.getirshelptoday.com>

**REPURCHASE AGREEMENT (REPO)** -- The selling of securities with the simultaneous agreement to repurchase the securities in the future.

**RESOLUTION TRUST CORPORATION (RTC)** -- An organization created by Congress, whose primary purpose is to liquidate the assets of failed thrifts. The RTC went out of existence on December 31, 1995.

**REVERSE REPURCHASE AGREEMENT (REVERSE REPO)** -- The purchase of securities with the simultaneous agreement to resell the securities to the original seller in the future.

**RULE OF 78'S** -- A method of computing finance charges on a loan using a sum-of-the-digits approach. For example, 78 is the sum of the monthly periods of a 12 month loan.

## S

**SECURITY AGREEMENT** -- An agreement between a borrower and a lender in which the borrower gives the lender a security interest or lien on equipment, accounts receivable, inventory, or other assets as security for a loan.

**SECURITY INTEREST** -- A contractual interest in or lien on collateral to secure payment of an obligation.

**SERVICING RIGHTS** -- Contracts to collect a borrower's payment on behalf of the owner of the loan and to receive amounts collected from interest payments on the loan. Servicing rights are most frequently associated with home mortgages. The servicer remits principal and interest to the investor, accumulates an escrow account, disburses the escrow funds as needed for payment of insurance and taxes, maintains records relating to the loan, and handles delinquency problems.

**SETTLEMENT DATE** -- The date on which ownership and funds are transferred between a buyer and a seller in a securities transaction.

**STRADDLE** -- A combination of offsetting positions in personal property, resulting in the diminution of risk of loss.

**SUBORDINATED DEBT** -- Borrowings that by their terms are junior in priority of payment to senior borrowings.

## T

**TRADE (TRANSACTION) DATE** -- The date on which a transaction takes place. The initiation date of a forward commitment or futures contract.

**TRANCHE** -- A term sometimes used when referring to the number of drawings of funds by a borrower under a term loan.

**TREASURIES** -- Bills, Bonds, and Notes issued by the U.S. Government. They differ according to their maturity period - the length of time until they become due. Bills mature in less than 1 year. Notes mature in 1 to 10 years. Bonds mature in 10 or more years. In addition, Bills do not pay interest but are sold at a discount to the face value.

## W

**WARRANT** -- A certificate giving the holder the right to purchase securities at a stipulated price within a specified time limit or perpetually.

**WHEN ISSUED BOND** -- The designation for a bond in the process of being issued. Settlement occurs when the bond is delivered. These bonds are interest free until delivered.

## Y

**YIELD** -- The annual rate of return to the lender on a loan.

## Z

**ZERO COUPON BOND** -- A bond that pays no interest while the bond is outstanding.