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Disclaimer: This outline is intended for the general information of the attendees of the Seventeenth Annual Community Bank Tax Workshop. It is not intended to provide tax advice. Attendees of the Workshop must perform their own research to confirm the effect of the topics discussed herein to the facts and circumstances of their respective clients.

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I. 2011 Developments and Year End Tax Planning

A. There has been no new legislation affecting banks since the Small Business Jobs Act of 2010, enacted September 27, 2010.

B. There is no new litigation affecting banks since the Circuit Court decision in *Vainisi* and the Tax Court decision in *PSB Holdings, Inc*.

C. Several provisions important to banks expire at the end of 2011 or 2012

1. There are several changes in Section 179.

a. The allowable deduction:

(1) $250,000 in 2007 through 2009.

(2) Increased to $500,000 for taxable years beginning in 2010 and 2011.

(3) $125,000 in 2012.

(4) Without legislation, it will revert to $25,000 in 2013.

b. The phase-out of the deduction begins at:

(1) $800,000 for 2007 through 2009.

(2) $2 million for 2010 and 2011.

(3) $500,000 in 2012.

(4) Without legislation, it will revert to $200,000 in 2013.

c. Computer software is included in Section 179 property for one more year through 2011. [Sec 179(d)(1)(A)(ii)]

d. Through the end of 2011, certain real estate is also Section 179 property.

(1) The only classification which has application to banks is "qualified leasehold improvements" to rented bank premises. [See the descriptions of "qualified leasehold improvements" in Sections 168(e)(6) and (k)(3)]

(a) There is a separate sub-limit of a $250,000 deduction for real property.

e. S corporations have tended to avoid Section 179 deductions because of the prospect that shareholders will exceed the shareholder limitation on deductions.

(1) For 2011, the 100% bonus depreciation may be a useful alternative to Section 179.

(2) In 2012, unless some of the shareholders have material other S corporation, LLC, or partnership investments creating Section 179 deductions, S corporation banks are likely to consider the Section 179 deduction.

2. Bonus depreciation [Sec 168(k)]

a. Bonus depreciation for qualified assets placed in service in 2011 is 100% of cost.

b. Bonus depreciation for assets placed in service during 2012 is 50% of cost.

c. Computer software and "qualified leasehold improvements" are eligible for bonus depreciation in 2011 and 2012.

3. S corporation built-in gains recognition period.

a. 7 years in 2009 and 2010.

b. 5 years for 2011.

c. Absent legislation, the recognition period will revert to 10 years January 1, 2012.

d. The recognition period is determined by the closing date of the asset sale, not the definitive agreement date, or even the effective date.

D. Provisions that were not extended.

1. The temporary increase in the first-year deduction for Section 195 start-up expenses was not extended beyond 2010. [Section 195(b)(3)][1]

2. The exclusion of self-employed health insurance costs from self-employment income was not extended beyond 2010. [Section 162(l)(4)]

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[1] There was not a temporary increase in organization expenses under Section 248.

E. Employer provided cell phones - Notice 2011-72 - September 14, 2011 - The Service provided guidance on the tax treatment of employer provided cell phones as no longer listed property under the 2010 Act.

II. Loan Modifications - Reg. § 1.1001-3

A. "Significant modifications" are treated as a sale of the pre-modification loan. The proceeds of the sale are the modified loan. The "sale" is taxable and gain or loss may result.

1. The modification regulation applies to any modification of a debt instrument, regardless of form.

   a. An example cited in the Regulation states that it makes no difference whether the existing loan document is merely changed or a new loan document is substituted for the old one.

   b. This, of course, raises some question regarding whether the renewal of a loan is a "modification" or a payment of the old loan and extension of a new loan. One can certainly read the Regulation to conclude that most "renewals" are really modifications.

   c. Unless the loan is troubled debt, it is unlikely to make a difference. The interest rate on voluntarily "renewed" loans will virtually always be at least the applicable federal rate, in which case the "modification" results in no gain or loss, and the distinction makes no difference.

2. The modification Regulation applies equally to accrual and cash method banks.

B. Definitions.

1. Modification - Any alteration, in whole or in part, of a legal right or obligation of the lender, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

   a. Substitution of a new obligor, the addition or deletion of a co-obligor, or a change in the recourse nature of the debt is a modification.

   b. Conversion into an instrument or property right that is not debt for federal income tax purposes is a modification, but it may also be a tax free reorganization under Section 368(a)(1)(E) if (i) the borrower is a corporation, and (ii) the conversion is to equity.

c. Exercising an option provided to the lender to change a term of a debt instrument is a modification unless the option is unilateral, or if the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal.[2]

2. Exceptions to "Modification" - An alteration of a legal right or obligation that occurs by operation of the original terms of the debt instrument is generally not a "modification."

   Examples:

   a. Changes in interest rates according to the floating rate terms of the loan are not modifications.

   b. Exercise by the Trust Preferred borrower of the election to defer interest payments for up to five years is not a modification.[3]

   c. Adding a deferral option to a loan after the borrower has encountered financial difficulties would be a modification.

3. "Significant modification"

   a. "A modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination, all modifications to the debt instrument are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant."

   b. General Rule - Significant modifications include changes in:

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[2] Be especially cautious of unspecified sanctions under a "deemed insecure" clause. For example, a loan provision might state in effect, "Borrower shall provide additional collateral or guarantees to the extent required by lender upon the lender's determination, communicated in writing to the borrower, that lender deems itself inadequately secured." The author is unable to locate any guidance whether a change pursuant to such a "deemed insecure" clause would be a "modification," but because neither the criteria for the lender to deem itself insecure nor the added collateral is specified in the loan agreement, it would seem not to be exempted from a modification under the Regulation.

On the other hand, as with renewals, it probably makes no difference if there is not an adjustment in the principal due or an adjustment to interest below the AFR.

[3] However, see below the discussion that exercising the deferral option does change the Trust Preferred Debt to an OID obligation.

(1) Yield by more than the greater of 25 basis points or 5 percent of the annual yield of the unmodified instrument;

(2) Timing of payments if it results in the material deferral of scheduled payments, unless within the safe-harbor period:

(a) The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument.

(3) The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period.

c. Changing the nature of the debt instrument, including a change in the obligor or collateral, with some exceptions, is usually a "significant modification."

C. A "modification" that does not rise to a "significant modification" is not a sale or exchange of the loan and has no tax consequences.

D. Tax consequences of a "significant modification" on the bank/lender.

1. The bank will recognize gain or loss for the difference between the "amount realized" and its adjusted income tax basis in the old debt.

a. The amount realized is the "issue price" of the modified debt as determined under the OID rules in Section 1274 and the related Regulations. Here is where the AFR becomes so important.

(1) If the modified debt has "adequate stated interest," then the "issue price" is the stated principal amount. [Reg. 1.1274-2(b)(1)]

(2) If the modified debt does not have "adequate stated interest," then the issue price is the present value of the scheduled cash flow, both principal and interest, under the modified debt, discounted at the appropriate AFR rate. [Reg 1.1274-2(b)(2)]

(3) Whether the modified debt has "adequate stated interest" is based on whether the stated interest is at least the "test rate" in Reg. 1.1274-4(a), which interestingly is the 3 month AFR rate.

(a) The 3 month AFR rate for November 2011 is 0.19%. [Rev. Rul. 2011-25]

(4) If the modified debt is issued in a "potentially abusive situation," then the issue price is the "fair market value" of the modified debt.[4] [Reg. 1.1274-2(b)(3)]

b. The income tax basis in the debt is the principal advanced, plus interest recognized in income and any capitalized costs, and minus payments and charge-offs.

2. Example - Facts:

The original loan was for $500,000 at 6% fixed interest rate, payable $50,000 principal plus interest annually for ten years.

The outstanding principal is $250,000.

The most recent payment is four months past due, and the accrued interest is $18,750. The bank is an accrual basis taxpayer, and the accrued interest has been included in income.

The terms of the modified loan are (i) the borrower will pay the accrual interest immediately, (ii) the borrower will pay the $250,000 outstanding principal balance at 4.5% interest, fixed for the modified term, in 16 equal semi-annual installments of principal and interest of $18,779.

a. The modification is significant because the interest rate has been changed by more than 25 basis points. It is not important that no payment was deferred by more than one-half the original ten year term of the loan.

b. Tax gain or loss on the modification is calculated as follows:

"Proceeds" - i.e. "issue price" of the modified note:		
Interest payment	$ 18,750	
Since the modified note has "adequate stated interest", the issue price is the stated principal	250,000	$268,750
Basis in the "old" note exchanged [the accrued interest has been recognized in taxable income]		268,750
Gain (loss) on modification		$ 0

[4] This is important for loans purchased at substantial discounts discussed below.

c. For income tax purposes, the bank will:

(1) Recognize no gain or loss at the time of the modification.

(2) Recognize interest income at 4.5% of the unpaid principal balance for the new eight year period to maturity.

d. The book accounting will be identical.

(1) No change in the book value of the loan occurs.

(2) Interest will be recognized at 4.5% on the unpaid principal balance.

e. There will be no Schedule M-3 adjustments.

3. Change the terms of the modified loan as follows:

The lender will forgive the accrual interest, and the borrower will pay the $250,000 outstanding principal balance $15,625 immediately and the balance at no interest in 15 equal semi-annual installments of $15,625.

a. The modification is still significant because the interest rate has been changed by more than 25 basis points.

b. However, now there is not adequate stated interest, and the tax gain or loss on the modification is calculated as follows:

"Proceeds" - i.e. "issue price" of the modified note if the present value at the AFR of the scheduled payments:		
Payment at closing	$ 15,625	
Since the modified note does not have "adequate stated interest," the issue price is the present value of the scheduled future payments discounted at the mid-term, semi-annual AFR [1.20% for Nov 2011]	223,497	$239,122
Basis in the "old" note exchanged [the accrued interest has been recognized in taxable income]		268,750
Gain (loss) on modification		$(29,628)

c. For income tax purposes, the bank will:

(1) Recognize a loss of $29,628 on the modification.

(a) The bank will not reverse the $18,750 of accrued interest included in taxable interest income against interest income. Recognized, accrued interest is not reversed against income when it is not collected.

(b) It is either (i) a charge-off that becomes part of the deduction for bad debts, or (ii) part of the loss on modification, whichever is applicable.

(2) Recognize interest income at 1.20% of the unpaid principal balance for the new seven year and six month period to maturity.

d. The book accounting will be:

(1) There may be some differences among banks, but most banks will treat the modified loan as a non-interest bearing asset. There will be no charge-off.

(2) If the interest which was forgiven accrued this year, the bank will reverse the $18,750 against interest income. If it accrued in a prior year, it will be charged-off to the reserve.

(3) The bank will recognize no interest income for the balance of the loan.

e. Schedule M-3 adjustments:

(1) There will be two Schedule M-3 adjustments in the year of the modification:

(a) If the forgiven interest was reversed against interest income, book interest income will be increased by $18,750.

(b) An opposite adjustment recording the loss on the modification of $29,628.

(2) There will a Schedule M-3 adjustment each year for the seven year six month term of the modified note increasing interest income by the OID on the modified note at 1.20%.[5]

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[5] The bank would considerably simplify the post-modification accounting if its reduced the principal amount by the amount of "forgone" interest and then charge the 1.20% interest on the modified note. That would eliminate the post-modification Schedule M-3 adjustments. However, for financial reporting purposes, it would result in a "charge-off" to the reserve in the modification year.

E. Regulation 1.166-3(a)(3) provides a special "deemed charge-off" rule for significantly modified loans that have been the subject of a partial charge-off prior to the modification.

1. The deemed charge-off is equal to the *lesser* of:

a. The gain recognized on the modification; or

b. The amount by which the tax basis of the modified debt exceeds the *greater* of:

(1) The fair market value of the modified debt, or

(2) The amount of the modified debt recorded on the taxpayer's books and records.

2. The deemed charge-off rule of Regulation 1.166-3 applies to both banks which have made the conformity election and those which have not.[6]

3. Example - Facts

Assume the same facts as in the modification example except that the original principal amount was paid down to $350,000 instead of $250,000.

The bank has recorded a $100,000 charge-off, reducing the book value to $250,000, and put the loan on nonaccrual, so the accrued interest of $18,750 has not been included in interest income.

The terms of the modified loan are (i) the borrower will pay the accrued interest immediately, (ii) the principal amount will be $300,000, and (iii) the interest rate will be 4.5%, and (iv) the borrower will make 16 equal semi-annual installments of principal and interest of $22,535 each.

The following table illustrates the income tax accounting for the modification:

[6] The only requirements for the deemed charge-off are that a deduction for partial worthless was allowed under subparagraph (a)(1) of the Regulation and that a charge-off was made on the books as required in subparagraph (a)(2). Those two subparagraphs apply equally to banks with and without the conformity election.

Issue price of the "new" modified note:		
Accrued interest	$ 18,750	
The issue price is the stated principal	300,000	$318,750
Income tax basis in "old" note:		
Unpaid principal balance	$350,000	
Partial charge-off	-100,000	
Accrued interest	$ 0	250,000
Gain on the modification		$ 68,750
Deemed charge-off is the lesser of:		
(i) Gain recognized on modification; or	$ 68,750	
(ii) The greater of:		
(a) Tax basis of the modified debt over its FMV		
Fair market value of modified note[7]	$318,750	
Tax basis in the modified debt[8]	318,750	
Excess tax basis, or	$ 0	
(b) Tax basis in the modified debt over book value		
Tax basis in the modified debt	$318,750	
Book value of the modified debt[9]	268,750	
Excess tax basis	$ 50,000	
Deemed charge-off - lesser of (i) or greater of (ii)(a) or (ii)(b)		**$ 50,000**

[7] Note that the fair market value includes the nonaccrued interest that will now be collected.

[8] The tax basis in the modified debt includes the tax gain of $68,750.

[9] The book value includes the nonaccrued interest which will be collected at closing on the modification, and becomes for an "instant" accrued interest receivable.

4. For income tax purposes the bank:

    a. Will recognize a gain on the modification of $68,750.

    b. Will recognize a charge-off of $50,000 [the deemed charge-off].

    c. Interest income will be recognized at 4.5% of $300,000, the stated principal amount of the modified debt, declining as payments are made.

    d. Will recognize the $50,000 recovery of the deemed charge-off after the $250,000 tax basis in principal is collected.

5. For financial reporting purposes the bank:

    a. Will recognize $18,750 interest income at the modification date for the collection of nonaccrual interest;

    b. Will recognize interest at 4.50% on $250,000 original book balance of the loan, declining as payments are made over the balance of the loan.

    c. Will recognize:

        (1) The $50,000 recovery of the prior charge-off as principal payments exceed the $250,000 book value of the modified loan;

        (2) The $19,704 difference in interest income on the stated principal balance of $300,000 and interest income on the book value of $250,000 after the principal is recovered in full.

6. Schedule M-3 adjustments:

    a. There will be three Schedule M-3 adjustments in the year of the modification:

        (1) Increasing book income by the $68,750 gain on modification of the loan.

        (2) Decreasing book interest income by the $18,750 of nonaccrued interest that will be recognized on the books.

        (3) Increasing book charge-offs by the $50,000 deemed charge-off.

        (4) Note, the net effect of the adjustments in the modification year is zero.

b. There will be adjustments increasing book interest income every year for the term of the modified loan by the difference between 4.5% interest on the book value of the loan and 4.5% on the stated principal amount of the modified loan.

c. The recovery of the $50,000 deemed charge off will be the same for book and tax purposes.

d. There will be adjustments reducing book interest income by the "recognition" of the nonaccrued interest on the $50,000 difference between the book value and stated principal amount of the modified loan; i.e. to reverse the adjustments in "b".

e. Book and taxable income will exactly equal over the eight years - $110,560.

F. Gains and losses on significant modifications should technically be reported on Form 4797 and Line 9 of the return. However, the author's experience is that most preparers include gains and losses net in either other income or other deductions. and there is no apparent tax effect of doing so.

G. Effects of a significant modification on the borrower

1. Unlike normal charge-offs which have no impact on the obligation of the borrower to repay the debt, a significant modification is an "exchange" with the borrower that will result in gain or loss to the borrower.

2. If the bank has a loss on the modification, the borrower is likely to have an equal discharge of indebtedness income which will been to be reported on Form 1099-C, except where the deemed charge-off rule applies.

a. However, if the borrower is a cash basis taxpayer, the borrower will not have deducted the accrued interest involved in the modification, and will be allowed a deduction for the interest if it is paid, or will not have discharge of debt income if the interest is not paid.

3. The borrower could also have a loss on the modification, but in practice that is likely to be rare because the borrower would have little incentive to agree to the modification.

III. Loan Losses

A. Charge-offs.

1. Regulation 1.166-2(d) includes a “conclusive presumption” that a charge-off ordered by the examiners is a proper charge-off for tax purposes. Regulation 1.1662-(d)(1)

states in relevant part:

"(1) Worthlessness presumed in year of charge-off. If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either (i) In obedience to the specific orders of such authorities, or (ii) In accordance with established policies of such authorities ..., then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year."

2. Unfortunately, this Regulation was issued in the 1950s when banks waited for the examiners to order charge-offs, and has never been updated.

   a. For the past couple decades, since the agricultural and energy crises of the 1980s, the presumption was seldom of material assistance because banks recorded their charge-offs voluntarily during their monthly or quarterly review of the financial reporting reserve for losses, and the examiners did not review voluntary charge-offs or comment on them in the examination report.

   b. Now during the recession the presumption has re-emerged as an important tax provision relating to losses because of massive examiner ordered charge-offs.

      (1) Unfortunately, a new issue has emerged just this year with IRS examining agents regarding how to "implement" this conclusive presumption for examiner ordered charge-offs because of the confidentiality of examination reports.

B. What is a "Charge-Off" for tax purposes?

1. The issue centers specifically on "specific reserves" and also focuses generally on what constitutes a "charge-off" on the books.

   a. For partially worthless debt, Section 1.1 66(a)(2) indicates that financial institutions can deduct such losses, but that it should be accompanied by a "charge off or similar entry" in the books of the bank for the year deducted. Some controversy exists over what accounting entries need to be made to meet this standard.

   b. If a loan is classified for regulatory purposes as having a "specific reserve" under FAS 114 at year end, and is subsequently charged off in the first two quarters of the following year, does this meet the "similar entry" of Reg 1.166(a)(2)?

      (1) There is a history of specific reserves in the thrift industry, and the Service has

consistently taken the position with thrifts that a specific reserve is a "charge-off."

(a) Regulation 1.166-2(d)(4)(ii) states:

"Charge-off . For banks regulated by the Office of Thrift Supervision, the term "charge-off" includes the establishment of specific allowances for loan losses in the amount of 100 percent of the portion of the debt classified as loss."

(2) The Tax Court, in *Kentucky Rock Asphalt Co v Helburn* stated that "if, before an income tax return is due, entries were made on the books showing the charge off, the provisions of the statute would be met."

c. In summary, an entry that removes the asset from the books should be a "charge-off" for purposes of the deduction for partial or complete worthlessness of a loan or security.

C. When the is charge-off deductible?

1. This issue has become really material during the current recession because examiners are requiring banks to "charge-off" loans in previous periods and file amended call reports.

   a. Are the charge-offs deductible in the period that the examiners designate, or during the period that the actual entry is made in the books.

2. The author is not aware of specific guidance on point.

   a. The *Kentucky Rock Asphalt Co.* would be helpful if the return was still under extension when the examiners required the charge-offs and amended call reports, but often the return will already have been filed.

3. If the bank has made the conformity election, it appears that the bank is nearly required to claim the deduction in the year that the examiners designate for the charge-off and amend returns.

   a. To do otherwise is inconsistent with the conformity concept.

   b. The contrary view would be that the general principal that the annual accounting period must be honored should control to defer the deduction to the year of the examination.

4. If the bank has not made the conformity election, it would still appear that the deduction should occur in the period designated by the examiners.

   a. A third party, representing the government, has determined that the loan became a "loss asset" in that period, so on a factual basis, that should be the period for the loss.

   b. The period designated by the examiners will also be consistent with the book accounting.

D. Tax accounting for charge-offs. No conformity election.

1. The working position is to follow the books.

2. There is precious little "official" precedential guidance on exactly how a bank which has not made the conformity election "supports" a charge-off that is taken voluntarily between examinations.

   a. Again, the working position is, in general, to follow the books.

   b. The IRS audit examination guide addresses "charge-offs" in Chapter 10, but there are few "bright line" criteria listed for the examining agents.

      (1) One "bright line" requirement is that the loan must be classified loss for the charge-off to be deductible.

      (2) A second "bright line" requirement is a book charge-off.

         (a) Most charge-offs, except for small, unsecured consumer debt, are really charge-offs for "partial worthlessness."

         (b) The Code is clear that partial charge-offs are not deductible in excess of the amount charged off on the books.

         (c) A working position has also evolved that wholly worthless loans must also be charged-off the books to support a deduction.

      (3) A third, less specific "bright line" requirement is that the burden of proof is on the bank to document the reduced value of the debt.

         (a) This is established through the support in the loan file regarding the troubled

loan, efforts to collect, the value of collateral, et. al.

c. From the perspective of challenging specific charge-offs, the following quotes from the examining guide are instructive:

"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.

"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.

"... 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.

"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. ... 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. ... many of the adjustments we [make are] 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. "

d. The industry can concur with much of what is said in the examination guide, but several statements require some analysis.

(1) The tenor of the guide's commentary is misleading to examining agents who are not well versed in banking. The most critical financial ratio to banks is their Tier I capital, not their effective current income tax rate.

(a) To the extent that charge-offs reduce the reserve, and require the reserve to be replenished by a book provision for bad debts, the charge-off will represent at least a 65% charge to Tier I capital for a C corporation bank.

i) It may be higher for small banks that have a less than 35% effective federal tax rate.

ii) It will be 100% for S corporation and QSub banks.

(b) All C corporation banks of every size are required by the federal and state regulators to account for income tax expense on an accrual method. While charge-offs may affect the current tax liability, only in rare instances will it effect income tax expense. Accordingly, most bankers no longer view the deduction for bad debts as a "tax shelter" as may have been the case 20 to 30 years ago.

(c) If the bank is significantly overcapitalized, the management might be tempted to reduce its current tax liability by accelerating charge-offs, but during the current recession, that is highly unlikely.

(2) Comments and notes by the loan officer on the possibility of subsequent events that could affect the collectibility or recoveries needs to be read in the context of the Fifth Circuit's discussion of worthlessness in *Echols*.[10] The fact that future circumstances might result in some speculative recovery does not establish that the asset is not "virtually worthless" now.

(3) The implication of the comment that a loan officer's notations in the loan file are "self-serving" is open to misinterpretation. Indeed, the officer's comments in the loan file may be "self-serving," but the loan officer's incentive is to make the loan appear as sound as possible, not the opposite.

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[10] *Echols v. Commissioner*, 935 F.2d 703, 91-2 USTC 50,360, 5 CA (7/15/1991). See a discussion of the *Echols* decision beginning at page 24.

3. Tax accounting for charge-offs - Conformity election

   a. If the bank has a valid conformity election, then loans which are classified loss and charged-off on the books are conclusively presumed to be worthless if:

      (1) They are wholly or partially charged-off on the books and

      (2) The Bank has obtained the "express determination letter" at the end of *every* examination by the primary *Federal* regulator.

   b. All of the facts and circumstances issues discussed above regarding the banks without a conformity election are by-passed.

4. Differences between book and tax amounts of loan charge-offs most commonly occur as a result of:

   a. Accrued interest

      (1) Accrual basis taxpayers - Tax charge-offs will exceed book charge-offs to the extent of accrued interest reversed against interest income.

      (2) Cash method banks - Tax charge-offs will be less than book charge-offs to the extent of accrued interest receivable charged off to the reserve for losses. Cash basis banks have no "basis" in the accrued interest.

         (a) In practice, however, the problem is more confusing than practical.

         (b) Because of the way that cash method banks calculate their accrual to cash adjustment, charging off accrued interest receivable to the reserve has the effect of artificially increasing the reported cash basis income by the same amount.

   b. If the bank is deferring loan origination costs per books and deducting them for income tax purposes, the charge-off of the unamortized origination cost has no income tax basis and should not be included in the tax deduction.

   c. If the bank is deferring loan fees per books and using the current inclusion method for tax purposes.

      (1) The tax charge-off should exceed the book charge-off to the extent of the recognized loan fees.

d. If the book value of loans was adjusted as part of the purchase accounting adjustments under FAS 141R resulting from a change of control that was not an asset purchase, then the tax basis in the charged-off loans may be different from the book value.

E. What is the tax implications of a charged-off loan which is restored to the books?

1. The IRS held in a 1980 Revenue Ruling that an unsecured loan to a bankrupt corporation, which was charged off at the direction of the examiners in 1974, but was rebooked in 1976 based on a letter from the examiners reconsidering the prior charge-off, was not a recovery in 1976 when it was rebooked. The Ruling states in relevant part:

   "Section 1.111-1 (a)(2) of the regulations provides that recoveries result from the receipt of amounts in respect of the previously deducted section 111 items, such as from the collection or sale of a bad debt. For there to be a recovery of a bad debt there must be a receipt of amounts attributable to such debt or an event inconsistent with the prior deduction. In this context, an event is inconsistent with the prior deduction only if the taxpayer's actual dealings with, as opposed to book entries with respect to, the item are inconsistent with such deduction. The mere expression of doubt does not constitute a receipt or an inconsistent event."

2. This Ruling was before the Conformity Election was added to the Regulations, but the Ruling should apply equally to banks that have not made the conformity election and those that have made the election.

   a. The conformity election applies only to charge-offs. There is no reference in the Regulation to recoveries. Regulation 1.1 66-2(d)(3) states in relevant part:

      "Conformity election ... a bank ... may elect under this paragraph (d)(3) to use a method of accounting that establishes a *conclusive presumption of worthlessness for debts ... .*"

   b. Recoveries are described in Regulation 1.11 1-1(a)(2), which states in relevant part:

      "(2) Definition of "recovery". Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, *such as from the collection or sale of a bad debt,* refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which

was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery". ...” [italics added]

3. Accordingly, a bank does not recognize taxable income from a “recovery” until there is “a receipt of amounts attributable to such debt or an event inconsistent with the prior deduction.”[11]

IV. The Conformity Election. [Reg. Sec. Section 1.166-2(d)(3)(i) and Rev. Rul. 2001-59] Principal issues surrounding the conformity election.

A. The "Express Determination Letter."

1. The first Express Determination Letter is required for the last federal examination before *the first day* of the year for which the election is made.

   a. If the election is to be made with the 2011 return, the bank must have an Express Determination Letter for the last federal examination date before January 1, 2011; which could be as early as the second six months of 2009 depending on the examination cycle.

2. The bank must obtain an Express Determination Letter for every federal examination after the first letter.

   a. Failure to obtain an EDL letter automatically revokes the conformity election.

   b. The bank should add a request for the EDL to the President's permanent checklist for the initial examination interview with the federal examiners. This will assure that not only the first letter, but all subsequent letters, are requested.

      (1) The federal regulators' examination manuals state that the field examiners should not issue EDL letters after the examination is finished.

3. An issue which has emerged during the recession is that the regulators' examination manuals state that the EDL letter will not be issued if the bank has not taken its charge-offs in accordance with regulatory standards, either by taking the charge-offs too early or too late. We are experiencing automatic revocations of conformity elections because the examiners have ordered significant additional charge-offs during the examination.

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[11] The author recalls a rather old case involving a bank in Florida where the court held that the bank did not have a recovery when the borrower, a real estate partnership, was reconstituted , added some new partners and raised additional capital, and the loan was rebooked. However, the author has not been able to locate that decision.

B. The election is made by including Form 3115 in a timely filed return. Common questions about the Forms 3115:

1. The Form 3115 is more directly controlled by Regulation 1.166-2(d)(3)(C) than by Revenue Procedure 2011-14.

2. The Regulation requires that the words "ELECTION UNDER section 1.166-2(d)(3)" be typed or legibly printed at the top of page 1 of the Form 3115.[12]

3. In the space provided for "Other Changes of Method" the Regulation states that the preparer should insert "Election Under §1.166-2(d)(3)."

4. Regulation 1.166-2(d)(3)(C)(1) states in relevant part

   "The ... Form 3115 must include ... a declaration that the express determination requirement of paragraph (d)(3)(iii)(D) of this section is satisfied for the taxable year of the election). When a Form 3115 is used, the declaration must be made in the space provided on the form for "Other changes in method of accounting."

   When the Regulation was adopted in 1992, the Form 3115, Schedule D, Miscellaneous Changes in Method of Accounting, Part V was captioned "Other Changes in Method of Accounting." That section no longer exists in the current Form 3115. The author is told, however, that the declaration is still required, and should be made on a statement attached to the Form 3115.

5. There is no Section 481(a) adjustment.

6. In Part I, Line 1, insert "6" as the automatic change number.

7. Part II, Line 9a - This question asks about *any* change of accounting method within the last five years, not just a prior conformity election.

8. Part II, Line 10 similarly asks about *any* request for a private letter ruling, change of accounting method, or request for technical advice.

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[12] The author has been told by a representative of the Service that this caption is still technically required because the Regulation has not been revised, despite the fact that after the Regulation was published, the Service assigned the conformity election an automatic change number (6) so that the caption makes no particular sense. The author recommends that the caption be inserted, but I would be very surprised if an examining agent tried to void the conformity election simply because the caption is missing.

9. The correct answer to Part II, Line 14 regarding consistency with financial reporting is "yes."

10. Part II, Line 16 regarding the request for a conference should be marked "yes," Even though this is an automatic change and the prospect of needing a conference should be remote, if there is some problem, one wants the National Office to contact the preparer, not just send a rejection letter.

11. Similarly, the author recommends that even though the change is automatic, that a power of attorney authorizing the Service to contact the preparer be attached to the Form. Again, any questions which the Service might have will be expedited if they contact the preparer rather than the bank.

12. The correct answer to Part IV, Line 1 is "yes;" the change is made using the cut-off method.[13]

13. It is not clear whether a copy of the Form 3115 must be timely filed with the IRS National Office.

    a. The copy requirement is in Revenue Procedure 2011-14.

    b. There is no copy requirement in Regulation 1.166-2(d).

    c. However, since the bank gets only one "free" opportunity to make the election, the author suggests from an abundance of caution that a copy be timely filed with the National Office.

C. Documenting the loss classification of charged-off loans.

1. Revenue Ruling 2001-59 refers to a Board of Directors resolution authorizing the Bank's officers and employees to make partial or complete charge-offs when loans are classified "loss" under the loss classification standards of the regulators is adequate under the Revenue Ruling to establish the presumption that the charge-offs are good charge-offs providing the bank obtains the express determination letter.

   "... under the resolution adopted by [the Bank's] board of directors, [the Bank's] officers and employees are authorized to charge-off loans (or portions thereof) only if the charge-offs are required under applicable loan loss standards issued by [the Bank's] supervisory authority. Under these circumstances, [the Bank's] charge-offs

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[13] Regulation section 1.166-2(d)(3)(iii)(B).

of certain loans (or loan portions) are sufficient to demonstrate classification of those loans (or loan portions) as loss assets under standards issued by [the Bank's] supervisory authority."

2. This resolution is not required for a valid election, but it should solve the question whether loans were classified "loss" when they were charged off.

3. From an abundance of caution, the author encourages conformity banks to adopted a Rev. Rul. 2001-59 resolution.

D. The Conformity Election can be revoked by including Form 3115 in a timely filed return.

E. The election is automatically revoked for failing to conform to the requirements for the election.

1. The most common issue is failure to obtain the Express Determination Letter from the federal examiners at an examination.

2. The second most common issue is an election that was technically invalid when it was made.

a. The author has been told by IRS personnel that if an election is attempted, but is invalid [for example, the Express Determination Letter was not obtained for the correct examination], the bank will be treated as having made the election, which was then immediately revoked.

F. The bank has only once try in the lifetime of the bank to make the conformity election automatically and without a user fee.

1. If a previous election has been revoked, a new election can only be made with IRS consent pursuant to the normal procedures for requesting a change of accounting method.

2. That bank cannot ever make the election without filing the Form 3115 with the National Office and paying the user fee for a change of accounting method; currently $4,200.

a. There is no "five year" period as there is for many other changes of accounting method.

G. Should the bank ask for the Express Determination Letter even if it does not know whether it will make the conformity election, or if its election was revoked because a letter was not obtained at some interim federal examination?

1. There is no tax issue with obtaining the Express Determination Letter as a matter of course without making the conformity election if the field examiner will give it.

2. Even without the conformity election, the author has been told by practitioners that the letter has been helpful during IRS examinations of bank returns.

V. Nonaccrual Interest on Loans - Accrual method taxpayers only.

A. Financial reporting.

1. Banks normally stop accruing interest when any one of the following occurs:

   a. Deterioration of the borrower's financial condition warrants principal recovery basis of accounting, with income recognized last; or

   b. Payment of principal and interest in full is not expected; or

   c. Payment of principal and interest is in default for 90 days or more, or

   d. Sometimes if the borrower, or a related party to the borrower, becomes delinquent on other loans.

2. When the loan is placed on nonaccrual:

   a. Current year accrued and uncollected interest income is reversed against income.

   b. Prior year accrued income is charged-off to the reserve for losses.

   c. Subsequent payments are applied on the cost recovery method; first to principal until paid in full, and then to interest income.

B. Income tax accounting - no conformity election.

1. Without the conformity election, income tax accounting for nonaccrual interest is a "facts and circumstances" test subject to Revenue Ruling 80-361.

2. Revenue Ruling 80-361 states in relevant part:

   "Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting, *income is includible in gross income when all events have occurred that fix the right to receive such income and the amount thereof can be*

determined with reasonable accuracy.

"... [T]he right to receive interest income becomes fixed ratably over the period of the loan so long as all events have accrued to fix the right to receive income and the amount thereof can be fixed with reasonable accuracy.

"A fixed right to a determinable amount does not require accrual, however, if the income item is uncollectible when the right to receive the item arises. *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968).

"When an income item is properly accrued and subsequently becomes uncollectible, a taxpayer's remedy is by way of deduction rather than through elimination of the accrual. Moreover, this rule is applicable even when the item is accrued and becomes uncollectible during the same taxable year. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934), Ct.D. 829, XIII-1 C.B. 28 (1934). Also *Atlantic Coast Line Railroad Co. v. Commissioner*, 31 B.T.A. 730, 751 (1934), acq., XIV-2 C.B. (1935)."

a. In summary: Revenue Ruling 80-361 would indicate that:

   (1) Loans are properly nonaccrual when there is no reasonable expectation of collecting the nonaccrued interest.

   (2) All accrued interest is properly charged off to the reserve, or deducted as a bad debt, in the year that it becomes uncollectible. There is no reversal against income.

   (3) Subsequent payments are applied against principal as long as there is no reasonable expectation of collecting the nonaccrued interest.

b. How does Revenue Ruling 80-361 compare to the financial reporting standards for nonaccrual of interest?

   (1) Collection of the principal *and* interest is not reasonably expected should support nonaccrual for tax purposes as well as book purposes.

      (a) Having taken a partial charge-off should be strong evidence that the collection of the interest is not reasonably expected.

      (b) Collection of the interest should not be reasonably expected on a collateral dependent loan which is undercollateralized.

(c) Sufficient deterioration of the borrower's financial condition also probably supports nonaccrual for tax purposes because it creates the expectation that principal and interest will not be collected in full.

(d) There may be a legitimate issue from a tax perspective if the borrower is current on payments, and perhaps even if some of the payments are late or the borrower is behind the agreed upon schedule.

(e) Merely being in default for 90 days may not support nonaccrual in some cases, but if the bank can show a history that little if any of the interest is ever collected on loans that default for 90days or more, then collection of the interest should not be "reasonably expected."

3. The IRS's audit examination guide states that the key issue is whether the interest is uncollectible or merely delinquent. Delinquent loans are not necessarily nonaccrual. Uncollectible interest is not accrued.

   a. Generally speaking, we believe that the industry would agree with those general statements.

4. The examination guide also offers the examining agents examples of loans that should still be on accrual, some of which the industry would not concur with.

   a. Loans placed on nonaccrual because of a lapse of time.

      (1) We would probably concur if, historically, this bank has collected accrued interest on loans of the same category which have been in default the suggested period, such as 90 days.

      (2) However, the industry would not concur if the bank has historically collected little if any accrued interest on such loans after they have been in default for the specified period.

   b. Loans with only partial charge-offs.

      (1) The industry would not concur with this statement.

      (2) The suggestion is that loans which have been only partially charged off should accrue interest on the remaining book amount.

      (3) This is inconsistent with how partial charge-offs are determined, even for tax purposes. The bank charges off the portion of the principal which is a "loss

asset." The amount not charged off is the amount which the bank reasonably expects to collect, which is all principal.

(4) After the partial charge-off, there is no reasonable expectation of collecting any interest in addition to the principal not charged off.

c. Loans with sporadic payments.

(1) Whether loans with sporadic payments should be on accrual for tax purposes is a facts and circumstances determination, based on the source of the payments.

(2) If the borrower is in the process of liquidating assets, and is making payments from the proceeds of the asset sales, then there is a reasonable expectation of collecting interest only to the extent that the realizable value of the assets, minus other liabilities, exceeds the principal.

(3) If the borrower is making payments from positive cash flow from operations, but is "sporadic" because of "sporadic" cash flow, then perhaps the guide has a point.

d. Loans that are current, but are to borrowers which are delinquent on other loans.

(1) The industry would concur with only if the sources of payments for the delinquent loans are different from the sources of payment of the "current loans."

(2) If the sources of payments are identical, then the loans cannot be evaluated separately for the expectation of collecting the interest.

5. Note that the Revenue Ruling refers to whether collection of the interest is "reasonably expected." This clearly is not a "bright line" test.

a. Banks may want to consider the 5th Circuit Decision in *Echols v. Commissioner*,[14] regarding the extent to which the bank must concede to the examining agent's judgment regarding whether the collection of interest can be "reasonably expected."

(1) The Circuit Court in *Echols* discussed in great detail when a deduction for worthlessness of an asset is allowed. In the context relevant to both the allowance of charge-offs of loan principal and the nonaccrual of interest, the

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[14] *Echols v. Commissioner*, 935 F.2d 703, 91-2 USTC 50,360, 5 CA (7/15/1991).

Court identified two elements:

(a) A factual determination – is the property virtually worthless? The factual determination is a threshold requirement for a deduction for worthlessness

(b) A subjective determination – when did the taxpayer conclude that the property is virtually worthless to it? The subjective determination is largely at the discretion of the taxpayer and the Service is not allowed to substitute its subjective judgment for the taxpayers. The *Echols* court stated:

"As long ago as 1943, federal courts recognized that the timing of a deduction based on worthlessness is largely within the discretion of the taxpayer, given objective indicia of absence of value."

(c) The lesson of *Echols* is that so long as the bank documents that there is no "reasonable expectation" of collecting the nonaccrued interest, an IRS examining agent should not attempt to substitute his/her judgment for the bank's regarding *when* the nonaccrual is allowed.

C. Income tax accounting - Conformity election

1. If the bank has a valid conformity election, then Revenue Ruling 2007-32 applies.[15] Revenue Ruling 2007-32 is a far more bright line test for nonaccrual than Revenue Ruling 80-361. The author's experience is that banks with the conformity election have far less controversy with the Service than banks without it.

2. Loans become nonaccrual for tax purposes when they are placed on nonaccrual for financial reporting purposes; i.e. conformity.

   a. As long as the bank obtains the express determination letter, it is presumed that the loan is properly nonaccrual for tax purposes.

3. When the loan is placed on nonaccrual, all accrued interest receivable, including the current year accrual, is charged to the reserve for losses; or is a charge-off to bad debt expense if the bank is on the direct charge-off method for tax purposes.

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[15] The Revenue Ruling broke new ground by extending the conformity election to accrued income for the first time. The companion Revenue Procedure 2007-33 is a safe harbor election available to all banks, whether or not they have made the conformity election. However, the author is not aware of any bank which has ever elected this accounting method because (i) it requires information not normally available to banks through their information technology software, and (ii) there are serious mathematical issues with the application of the safe harbor calculation.

a. Nonaccrued interest is *both*:

(1) Included in gross interest income, and

(2) Charged-off as a bad debt.

b. The tax treatment of subsequent loan payments depends upon the reason that the loan is nonaccrual:

(1) If (i) the nonaccrual loan is adequately collateralized or is "performing" but not according to its terms, (ii) the reason that the loan is on nonaccrual is regulatory, and (iii) there is a reasonable expectation that the principal and interest will be collected, then:

(a) Payments are first recoveries of nonaccrued interest (included in taxable income) up to the accumulated net charged-off income, and then applied to principal.

(2) If there is no reasonable expectation that the nonaccrued interest will be collected, then Revenue Ruling 80-361 applies.

(a) Payments are applied first to principal, and any collections in excess of principal are (i) first recoveries of previous charge-offs of principal, and (ii) the balance, if any, is interest income.

(3) If subsequent payments are included in taxable income as "recoveries" but credited on the books to principal, then a basis difference develops that may be difficult to account for, and reverses later when the loan is paid in full.

(a) If the principal and interest are not ultimately collected in full:

i) There is no “charge-off” for the uncollectible principal during the payment period because the bank has made the “conformity election,” and there is no book charge-off.

ii) It is a loss under Section 165 when the loan is ultimately “disposed of,” such as being marked “paid in full” and returned to the borrower.

c. In practice, the author expects that among community banks, virtually all loans will have been placed on nonaccrual because there is an expectation that not all of the principal will be collected, much less the interest. Hopefully, the dual accounting for nonaccrual loans will be minimal.

D. One of the most common, and difficult to spot, errors in reporting interest income is failing to schedule and track nonaccrual interest that is recognized in taxable income. An error double reports the income; once when it was included in the return, and a second time when it was either collected or "lost."

1. If never collected, it should be deducted as a bad debt loss when the loan is "finished," or

2. If it is collected, it must be excluded from taxable interest income through Schedule M-3.

3. Most banks that collect nonaccrual interest simply credit interest income.

4. If the interest has already been recognized, it will take a specific inquiry to identify and exclude the income through the Schedule M-3.

VI. Other Real Estate Owned [OREO].

OREO acquired in foreclosure on defaulted loans is typically acquired in one of three methods. How the OREO is acquired has tax significance.

A. Legal foreclosure. The property is auctioned in a public auction, at which the lender is normally a bidder, and often the only bidder.

1. If all provisions of law have been satisfied, the purchaser obtains title to the property free and clear of all liens.

a. Accordingly, a first mortgage holder does not need to fear that another lien holder will appear to lay a claim to the asset.

2. In some states, the borrower has a redemption period during which the borrower can reclaim the property by paying off the debt.

a. From an income tax perspective, the transaction is not "final" until the redemption period passes.

b. Accordingly, the loan remains outstanding until the redemption period passes.

c. Tax accounting needs to reflect the state law regarding how the borrower can redeem the property.

(1) If the borrower must pay the entire loan and accrued interest, then the bank should not make any tax adjustment at the auction date. There is no "charge-off" because the loan was not extinguished.

(2) If the borrower must only pay the bid price, then the bank should record a charge-off for the difference between the bid price and the income tax basis in the loan. The bid price would be all that the bank would recover in a redemption, and the balance of the income tax basis has become a "loss asset."

d. The "exchange" of the OREO for the loan occurs on the redemption date.

e. Accordingly, it is entirely possible, and proper, that tax entries relating to the foreclosure may occur in two different years if the auction occurs toward the end of one year and the redemption period closes in the following year.

3. Financial accounting.

a. Property acquired in foreclosure is normally recorded at the lower of (i) book value of the loan, net of accumulated charge-offs, or (ii) fair value of property.

b. Note the reference to "fair value" rather than fair market value. Fair value is closer to net realizable value from an economic perspective than "fair market value" as described for income tax purposes.

(1) Fair value is net of selling costs, which include specifically the real estate fees and transfer fees likely to be paid by the seller, but may also include other anticipated expenses:

(a) Environmental studies that may be done to show prospective buyers that there is no contamination.

(b) The anticipated cost of repairs or improvements required to sell the property but which are not expected to be recoverable in the selling price.

(2) "Fair market value" for income tax purposes is the age-old definition adopted by the U. S. Supreme Court in *United States v. Cartwright*:

Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of

relevant facts."[16]

(a) Note that the "price at which the property would change hands" is not adjusted for transaction costs or other costs.

c. Loss, but not gain, is recognized for financial accounting purposes to extent of the difference between (i) book value of the loan, net of charge-offs, plus accrued interest if any, and (ii) fair value.

(1) The loss is normally recognized as a charge-off against the reserve for losses.

4. Income tax accounting.

a. Unlike financial reporting, both losses and gains are recognized, which often becomes a source of controversy between banks and IRS examining agents. Regulation 1.166-6 states in relevant part:

"If ... the creditor buys in the mortgaged or pledged property, loss *or gain* is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property."[17] [italics added]

(1) In practice, few "gains" occur. It is illogical to have a "gain" in the property. The borrower would have sold the property and kept the gain for itself.

b. Any loss, including both principal and interest which has been included in taxable income, is deductible as a bad debt.[18]

c. The foreclosure auction is a taxable sale of the loan. The proceeds of sale are the *fair market value* of the collateral acquired.

(1) In a legal foreclosure, Regulations include a very strong presumption that the bid price is the fair market value of the collateral absent very strong proof to the contrary.

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[16] *United States v. Cartwright*, 411 US 546 (1973); 73-1 USTC 12,926.

[17] Regulation 1.166-6(b)(1).

[18] Regulation 1.166-6(a).

"Fair market value defined. The fair market value of the property for this purpose shall, *in the absence of clear and convincing proof to the contrary*, be presumed to be the amount for which it is bid in by the taxpayer."[19] [italics added]

(2) Banks who "bid" their loan balance and accrued interest on the theory that if anyone wants to pay more, they are welcome to the property, forego a current loss for the difference between the loan amount and the actual value of the collateral, i.e. whatever they bid which was greater than what anyone else would have bid.

(a) That loss is deferred until the collateral is disposed by the bank.

(b) They may actually recognize income to the extent that the bid price includes either nonaccrued interest, or accrued interest not yet reported in income by a cash basis bank.

5. There is likely to be a Schedule M-3 item, or perhaps more than one, resulting from legal foreclosures.

a. To the extent that the bank books the OREO at a "fair value" less than the bid price, the difference is likely to be a Schedule M-3 item reducing the book charge-off.

b. There may also be an M-3 item relating to the recognition in the bid price for nonaccrued interest.

B. Deed in lieu of foreclosure.

1. Rather than go through the entire legal process of auctioning the property, a co-operative borrower may deed the collateral over to the lender in exchange for satisfaction of the loan.[20]

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[19] Regulation 1.166-6(b)(2).

[20] Unlike a legal foreclosure, no other lien on the property is extinguished. The author understands that in most states, if the creditor and equity interests are merged by the deed transferring the property to the lender, the lender's first mortgage is extinguished because the lender now owns the property. As a result, the lender has moved from first in line to last in line after all other liens.

Accordingly, in most such cases, the collateral is deeded to a parent, a subsidiary, or brother-sister corporation of the lender. In recent years, the property is more commonly transferred to an LLC that is a disregarded subsidiary of the lender.

Counsel have explained to the author that from a state law perspective, the transaction is not technically an exchange

a. This is a private, negotiated transaction between the lender and the borrower. Accordingly, there may be deficiency notes, or other "side arrangements" that impact the tax accounting for a deed in lieu of foreclosure that one would not encounter in a formal, legal foreclosure.

b. Being a privately negotiated transaction, most states that have a "redemption period" for formal foreclosures would not have a redemption period for deeds in lieu of foreclosure.

2. Financial accounting. Financial accounting for a deed in lieu of foreclosure is identical to the accounting for a formal foreclosure.

3. Tax accounting.

a. The practical difference between a legal foreclosure and a deed in lieu of foreclosure is that there is no "presumptive" fair market value of the property, leading to more opportunity for controversies with the Service over the amount of gain or loss recognized.

b. Otherwise, tax accounting is identical to a formal foreclosure.

4. Schedule M-3 items are likely to be the same as for formal foreclosures.

a. Simply from the practical mechanics of how banks record the foreclosures, it is more likely that the "record" will reflect reductions of the book value of the collateral from "fair market value" to "fair value" in deeds in lieu than in formal foreclosures.

C. “In-substance foreclosure.”

1. The lender obtains complete control over the collateral, but not ownership.

a. The basic requirement of an "in-substance" foreclosure is that the lender gains complete control of the management and marketing of the collateral asset.

b. Examples of "in-substance foreclosures":

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of the loan for the collateral, but rather the acquisition of the collateral by the related entity subject to the loan. There is no merger of the equity and creditor interests in the collateral, and the lender retains its place in line among liens.

This legal technicality has no effect on the tax treatment because the "acquirer" of the property is always a "related party" to the lender.

(1) The collateral is in a single-asset subsidiary corporation of the borrower. After a default on the loan, the governing documents of the subsidiary empower the lender to select all of the officers and directors of the subsidiary, giving the lender full power to manage and market the collateral without taking ownership.

(2) The collateral is in a single-asset, single member, manager managed LLC. Upon default on the loan, the lender becomes the sole manager of the LLC. Again, the lender gains full power to manage and market the collateral without taking ownership.

(3) A co-operative borrower and the lender negotiate an agreement by which the collateral is transferred to a newly organized, single member, manager managed LLC. The single member is the borrower. The manager is the lender.

(a) The transfer to the LLC has no tax significance because the LLC is a disregarded entity, and the transfer is a disregarded transaction for tax purposes.

(b) The articles of organization of the LLC make the lender the sole manager of the LLC.

(c) As in the other two scenarios, the lender gains full power to manage and market the collateral without taking ownership.

2. Financial accounting for an "in-substance foreclosure."

a. An in-substance foreclosure is accounted for as an acquisition of the collateral, exactly like an actual foreclosure.

(1) The loan is moved to OREO.

(2) Loss, but not gain is recognized on the books as in a foreclosure.

3. Income tax accounting for in-substance foreclosures.

a. “In substance foreclosure” is a regulatory and GAAP only concept. There is no tax transaction.

b. No gain or loss is recognized for tax purposes when the lender gains control of the collateral and moves the loan to OREO.

c. The post foreclosure income and expenses are income and expenses of the "owner," i.e. the borrower, not the lender.

d. To the extent that the lender advances the expenses, they are an extension of the loan, which can then be charged-off as a bad debt for tax purposes.

(1) The fact that they are expensed for book purposes should count as a "charge-off." The asset has been removed from the books. Accordingly,

(a) Bank that have made the conformity election will have a book charge-off to which the tax charge-off "conforms."

(b) Banks that have not made the conformity election would also have made the charge-off to qualify for a partially worthless deduction.

e. Since the loan is still outstanding, write-downs of the value of the collateral during the holding period should be deductible "charge-offs" of the loan for income tax purposes.

f. Gain or loss on "sale" of collateral is the borrower's gain or loss included in the borrower's return.

g. The lender has either a charge-off or recovery equal to the difference between (i) the "collection" from the net proceeds of the sale and (ii) the income tax basis in the loan.

D. Disagreements over the "value" of foreclosed collateral between taxpayers and examining agents.

1. As noted above, "fair market value" for federal income tax purposes was defined by the U. S. Supreme Court in *United States v. Cartwright* as, "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[21]

2. Regulation 1.166-6(a) reads in relevant part:

"Sec. 1.166-6. Sale of mortgaged or pledged property. (a) Deficiency deductible as bad debt. (1) Principal amount. If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt,

[21] *United States v. Cartwright*, 411 US 546 (1973); 73-1 USTC 12,926.

and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee *[i.e. the bank]* may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless.

> "(2) Accrued interest. Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income."
>
> "(b) Realization of gain or loss. (1) Determination of amount. If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.
>
> "(2) Fair market value defined. The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer."

3. Notice that there is no reference to how fair market value is determined, except for "the amount for which it is bid in by the taxpayer."

    a. In a legal foreclosure, Regulation 1.166-6(b)(2) clearly establishes that fair market value is the bid price "in the absence of clear and convincing proof to the contrary."

    b. There is surprisingly little guidance or case law regarding what constitutes"clear and convincing proof," but the plain language of the phrase should indicate that establishing some other fair market value is a relatively high hurdle.

    c. The most cited case is the much litigated *Community Bank v. Commissioner*. Unfortunately, in none of the litigation does the Tax Court actually address the issue of "clear and convincing proof."[22]

4. An often cited Private Letter Ruling also deals with the presumption in Regulation

[22] *Community Bank v. Commissioner,* 62 T.C. 503. *Community Bank v. Commissioner II,* 79 T.C. 789. Community Bank was located in Huntington, California.

1.166-6(b)(2).[23] The PLR involved an insurance company, which was originally required by its state insurance law to bid in property at a foreclosure sale for the amount of the loan. The insurance company had traditionally treated the bid price as the fair market value of the property. The state insurance regulator changed its policies. It still required the insurance company to "bid" the amount of the loan at the foreclosure sale, but required the company to obtain appraisals and record the property at the appraised value if lower. The regulator required the company to restate its prior year financial statements. The company then sought to amend its returns to deduct the losses. The National Office held that:

a. The method of determining fair market value was not a method of accounting, so changing from always using the bid price to using appraisals to determine fair market value was not a change in accounting method requiring the Service's approval.

b. The insurance company could use the appraisals to overcome the presumption in the Regulation.

(1) Note, however, that the "bid price" was established by state insurance regulation and therefore was not market driven.

(2) Accordingly, this PLR does not stand for the proposition that the presumption in the Regulation can be overcome by appraised values when the bid price is market driven.

5. In summary, despite the pivotal importance of Regulation 1.166-6(b)(2) to the banks' tax accounting for foreclosures, we do not have very definitive guidance relating to whether, and under what circumstances, the presumption in subparagraph (b)(2) can be overcome and another fair market value successfully asserted in a foreclosure.

a. It seems to the author that several common sense concepts should apply.

(1) The purpose of a presumption is to avoid controversies over immaterial amounts. It should be reasonable to expect that it requires some material difference between the bid price and the asserted fair market value for either the bank or the Service to overcome the presumption.

(2) Whether there were other qualified bidders at the auction, and whether or not they actually bid for the property, should be relevant. If there was some

[23] PLR 9222017

exchange of bids and all of the other bidders dropped out before the bidding reached an amount acceptable to the bank, it should be obvious that the "winning" bid was the maximum fair market value, regardless of any appraisals which either the bank or the borrower might have obtained before or after the foreclosure.

6. Fair market value is a factual determination. The evidences of fair market value should be subjected to some hierarchy of credibility in order to evaluate which evidence is more factually reliable. This is particularly important when the Service is asserting some higher fair market value based on some pre-foreclosure appraisal obtained by the borrower.

   a. The fact that the borrower did not sell the property and retain for itself the equity in the property should, absent special circumstances, ordinarily bias the determination of fair market value against being greater than the loan balance.

   b. The selling price of the property within a reasonable period after the transfer of ownership to the bank is highly credible evidence of fair market value. The definition of fair market value is the price at which the property will change hands between a willing buyer and a willing seller, and sale of the property, especially if the bank does not provide below market financing, should by definition be its fair market value.

   c. The highest *bona fide* offer received by the borrower from an unrelated third party to sell the property reasonably soon before the transfer of ownership to the bank should be considered credible evidence of fair market value.

      (1) The offer evidences the amount of money that a "willing buyer" was prepared to put at risk to acquire the property. This is only half of the "willing buyer and willing seller" equation, but the fact that neither the borrower nor the lender were willing to accept that amount does not necessarily indicate that it was not fair market value. It probably indicates that the lender believed that the "investment value" from holding the property for some period was greater than the current value.

      (2) The bank will usually know about these offers because the borrower will talk to the lender, especially if the offer would result in a "short sale."

   d. Similarly, *bona fide* offers received by the bank from unrelated third parties to purchase the property within a reasonable period of time after the transfer of ownership should be considered credible evidence of fair market value.

e. A requirement by the regulatory examiners that the property be further written down within a reasonable period after the transfer of ownership is very strong evidence that the fair market value was not greater than the amount recorded on the books.

f. A formal appraisal of the property obtained after the transfer of ownership and commissioned by either the real estate department or the "loan work-out" department of the bank should normally be a stronger indicator of value than an appraisal obtained by either the borrower or commissioned by the responsible loan officer before the transfer of ownership. While appraisals are supposed to be independent, the incentives before and after the transfer are starkly different.

(1) The borrower before the foreclosure has incentives (i) to show the bank that the loan is not undercollateralized, and (ii) to show potential purchasers that the property has maximum value.

(2) The loan officer before the foreclosure also has an incentive to show his/her employer and the banking examiners that the loan is not undercollateralized, and perhaps to show the borrower why the bank should not compromise the loan.

(3) After the transfer of ownership, the incentive of the real estate or the loan work-out department is to estimate the actual value at which the property can be marketed.

g. The listing price for the property after the transfer of ownership. The listing price is not a very reliable indicator of fair market value because it may represent the bank's hoped for realization rather than the current fair market value. Nevertheless, in practice, it is some indication of what the seller will accept, and probably the maximum fair market value.

7. Facts to remember about appraisals.

a. Appraisals are always "behind the market," whether the market is appreciating or depreciating. Comparable sales are a staple of determining appraised value, and comparable sales are always at "yesterday's values."

b. The appraiser has nothing at risk. In fact, the "independence" of the appraiser is that he/she has no interest in the value. Accordingly, in the author's view, it is difficult for the appraiser's opinion to compete with other evidences of value which involve real money put at risk, or an offer to put money at risk, by *bona fide* third parties.

c. Because the appraiser has no money at risk, other factors are more likely to influence an appraiser's opinion of value, including sources of repeat business.

VII. Accounting for Foreclosed Collateral.

A. Pre-Foreclosure Costs - Banks are commonly faced with paying a number of unpaid pre-foreclosure obligations of the borrower. These costs commonly include delinquent real estate taxes, utility bills, perhaps mechanics liens, et. al.

1. Both GAAP and regulatory accounting require that these payments be expensed for financial reporting purposes as incurred.

2. Income tax accounting.

a. They have typically been deducted in the tax return.

b. *Costs Paid Before Taking Possession* - The IRS' examination guide states that pre-acquisition expenses incurred by the debtor and paid by the lender before the change of ownership increase the bank's *income tax basis in the loan*.

(1) Consistent with the Board of Tax Appeals decision in *Estate of Schieffelin v. Commissioner.*[24]

(2) Also consistent with most loan agreements, which provide that advances by the lender to pay real estate taxes, utilities, et. al., are added to the loan principal.

(3) The correct tax accounting will result in including these costs in the charge-off associated with the foreclosure.

c. *Costs Paid After Taking Possession* - The IRS' examination guide states that real estate taxes allocated to the period that the borrower owned the property, and paid by the lender after taking possession of the property, are treated as acquisition costs of the property.

(1) The guide is consistent with the revision to Section 164(a) by the Tax Reform Act of 1986.[25]

(2) It is also consistent with The Board of Tax Appeals decision in *Estate of Schieffelin v. Commissioner*, and with two later Tax Court decisions in *Riordan*

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[24] *Estate of Schieffelin v. Commissioner*, 4 BTA 137 (1941).

[25] Public Law. 99-514.

v. Commissioner and *Casel v. Comm*issioner.[26]

B. Foreclosure Costs

1. GAAP requires that foreclosure costs be expensed as incurred for financial reporting purposes.

2. Income tax accounting.

   a. The foreclosure costs are also commonly deducted in the tax returns.

   b. The IRS' examination guide states that foreclosure costs are added to the income tax basis in the property as an acquisition cost.

   c. The guide is in direct conflict with the factual recitation in the Tax Court's opinion in *Community Bank v. Commissioner*.[27] and with most loan documents.

      (1) In *Community Bank*, the Tax Court set the scenario in relevant part as follows:

> "During 1966 and 1967 petitioner acquired, through foreclosure proceedings, 19 parcels of real property. All foreclosure and sale proceedings were conducted in accordance with the provisions of the California Civil Code and Code of Civil Procedure, the requirements of which include the giving of notice of default to the borrower, giving of public notice of the trustee's sale, and sale of the subject property at public auction to the highest bidder.
>
> "In each instance, petitioner determined the fair market value of the property to be its bid price plus prior liens on the property, in accordance with its understanding of the provisions of section 1.166-6(b)(2), Income Tax Regs., in the amounts set forth above. In no instance was the property acquired for more than the amount of the note outstanding to petitioner, and in all but one instance petitioner acquired the property for considerably less than the unpaid portion of the note which the property secured. *Petitioner, as authorized by section 1.166-6(a), Income Tax Regs., charged against its bad debt reserve an amount equal to the difference between (1) the balance due under the note plus costs of foreclosure and (2) the bid price of the property*

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[26] *Riordan v. Commissioner*, TC Memo 1978-194, and *Casel v. Comm*issioner, 79 TC 424 (1982).

[27] *Community Bank v. Commissioner.* 62 T.C. 503 (7/9/74), Interestingly, the Audit Guide cites *Community Bank* approvingly on another topic.

acquired. With respect to each of the notes, the portion of the indebtedness remaining unsatisfied after the foreclosure sale was wholly uncollectible and wholly worthless in the year of the foreclosure sale." [italics added]

(2) The addition of foreclosure costs to the loan was unchallenged by the Service in *Community Bank*. In fact, later in a discussion of each of the Service's arguments to the Court, the Court states again:

"Respondent [the Service] alternatively argues that petitioner's deduction for bad debts should reflect an amount equal to the difference between the balance due under the notes plus costs of foreclosure and the fair market value (rather than the bid price) of the property acquired."

C. Post-Foreclosure Holding Period Costs

1. GAAP and regulatory accounting requires that the holding period costs be expensed as incurred.

2. Income tax accounting.

a. Most banks have deducted these costs in returns.

b. *Non-operating Properties*; i.e. non-income producing properties.

(1) The IRS' examination guide states in relevant part, without citing authorities:

"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.

(2) The obvious support for this statement is the definition of Section 263A property in Section 263A(b)(2), which reads in relevant part as follows:[28]

"(b) Property to which section applies. Except as otherwise provided in this section, this section shall apply to ... (2) Property acquired for resale. (A) In general. Real or personal property described in section 1221(a)(1) which is acquired by the taxpayer for resale."

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[28] See FSA 1998-170. The date on the FSA is 1992. It was not numbered and published until 1998.

Section 1221(a)(1) reads in relevant part:

"(a) In general. For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or *property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business* ... ." [italics added]

(3) Regulation 1.263A-3 addresses the application of Section 263A to property acquired for resale. The only remotely applicable reference to OREO is in paragraph (a) which reads in relevant part:

"(a) Capitalization rules for property acquired for resale. (1) In general. Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). ... Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. ..."

(4) The examination guide appears to be incorrect because it fails to address the rest of the sentence in Section 263A(b)(2).

(a) Foreclosed property is property described in Section 1221(a)(1); it is held by the bank primarily for sale to customers in the ordinary course of business.

(b) However, Section 263A(b)(2) establishes that not all property held primarily for sale to customers in the ordinary course of business is Section 263A property. Only that property "which is *acquired* by the taxpayer for resale" is Section 263A property. If this were not the case, the last phrase of the section would have no meaning.

(c) In the case of foreclosed collateral, the bank "acquired" the property in the normal course of collecting a secured loan, not to speculate in the real estate market by acquiring and reselling real estate.

(d) In summary, the foreclosed collateral should be Section 1221(a)(1) property because it is *held* for sale to customers in the ordinary course of business, but it should not be Section 263A property because it was not *acquired* for

resale.

(e) Accordingly, non-operating properties:

i) Should be Section 1221(a)(1) property, and therefore gain or loss is ordinary.

ii) Should not be Section 263A property, and therefore the holding period costs should not have to be capitalized into the cost of the OREO.

c. *Operating Properties*, i.e. income producing properties..

(1) The IRS' examination manual states that banks may deduct the holding period costs of "operating OREO," and may claim deprecation.

(2) This position is not controversial.

D. Holding period adjustments to book value of OREO and other foreclosed collateral.

1. Once the "fair market value" of the collateral is determined at the foreclosure date, that is the beginning income tax basis in the OREO until it is sold.

a. GAAP and regulatory accounting requires that the book value of OREO be reduced by a charge to expense if the fair value, i.e. realizable value, decreases during the holding period.

b. These write downs are not tax deductible. They become part of the loss on dispositions.

c. The exception is “in-substance foreclosures.” A write-down of the collateral in an in-substance foreclosure is a “charge-off” of the loan that is still outstanding for tax purposes, especially if there is no conformity election.

2. Basis is increased by any capitalized costs, such as improvements made to the property, capitalized holding period costs, et. al.

3. Rent income is taxable income during the holding period, and operating expenses are deductible if the property is rented.

E. Disposing of other real estate owned.

1. Sale of OREO is ordinarily a simple taxable transaction on which gain or loss is

recognized at the time of the sale.

a. All of the accumulated timing differences reverse.

2. Gain or loss is ordinary if the OREO has remained Section 1221(a)(1) property during the holding period, which will normally be the case.

a. This is consistent with the IRS' examination guide and FSA 1998-170.

b. S corporations are more prone to consider challenging the ordinary treatment if there are significant gains.

(1) Real estate which has been actively rented and held for some material part of the five year period that banks are permitted to hold foreclosed real estate may have become capital assets under the principals of the decision in *Arkansas Best.*

3. The principal other difference from book accounting involves sales in which the lender provides the financing to the borrower - FAS #66 - Accounting for Sales of Real Estate.

a. Financial Accounting

(1) Losses are recognized at the date of sale.

(2) Gain is recognized when sold if the sales price is reasonably assured of collection and the earnings process is virtually complete. Factors considered:

(a) Substantial initial and continuing investment by buyer (5% to 25%).

(b) Buyer's credit standing.

(c) Property's age, location and cash flow.

(d) Binding sale with all conditions met.

(e) Seller's receivable not subordinated.

(f) Incidents of ownership transferred.

(3) If the conditions for current recognition are not satisfied, profit recognition is deferred over the life of the Bank's "seller financing" or until subsequent satisfaction of the required conditions.

b. Tax accounting.

(1) Both gains and losses are recognized at the date of sale.

(2) A sale with seller financing is not an installment sale for tax purposes because the property is probably not a capital asset.

VIII. S Corporations - Character of Income or Losses on Foreclosed Operating Assets

A. The question is whether the net loss , or income if any, of an S corporation on foreclosed operating assets is "passive income or loss," even to the active shareholders. There are really two questions:

1. If an S corporation bank forecloses on a real estate loan and either (i) takes possession of the property subject to the existing leases or (ii) rents the property during the holding period until it can be sold, is the foreclosed real estate a “rental activity” that must be separately disclosed on Schedule K, Line 2 of Form 1120-S and Form 8825, and income or loss from a passive activity?

2. A similar question arises if an S corporation bank leases out part of its premises, either headquarters building or branch building, to one or more tenants.

3. If an S corporation bank forecloses on an operating business, such as a restaurant, bar, hotel, etc. and operates the business until it can be sold, is the operating business a passive activity to the shareholders, including the active shareholders of the bank?

B. Operating Foreclosed Real Estate

1. The rental and passive activity issue has a number of tax implications:

a. If the rental of the foreclosed collateral is a real estate rental activity, it is also a passive activity for all of the shareholders.

(1) That may not be a material issue for the shareholders who do not actively participate in the banking business because, as long as the bank itself is profitable, the passive income from the banking activity will exceed the passive loss from the rental.

(2) However, it is material to the shareholders who actively participate because their allocated shares of income from the banking business will not be passive income. Unless they individually have other passive income, they are likely to be disallowed their share of the loss as an excess passive activity loss.

b. If the rental of foreclosed collateral is a real estate rental activity, does the bank have one passive activity, renting foreclosed collateral, or is each property a passive activity?

(1) If the bank has only one passive activity, when is that activity "disposed of" for purposes of allowing the deduction of accumulated excess passive losses under Section 469(g)?

(2) If the bank deducts operating expenses and depreciation of foreclosed property that is rented, does the bank risk changing the character of its gain or loss from ordinary to capital?

c. Regulation 1.469-1T(e) defines a passive activity, a rental activity, and the exceptions to a rental activity. The Regulation is long and complex, but the major problem fitting within one of the exceptions to a passive rental activity is the requirement that gross rental income for the entire tax year be less than 2% of the lesser of the fair market value or income tax basis in the rented property.

d. The author discussed the issue orally with an attorney in the National Office of the IRS, and was told that, while the bank's issue is sympathetic, except for the 2% exception, he believes that the income and expense from the operating OREO is probably passive rental income and expense.

e. In summary:

(1) If the gross income on a property is less than the 2% threshold, then the property is not a rental activity and is not a passive activity. It would be reported on Page 1 of the Form 1120-S return.

(2) If the gross income on a property is greater than the 2% threshold, then the property is a rental activity, is a passive activity, would be reported on Form 8825 and Line 2 of Schedule K, and is a passive activity.

(3) Whether the 2% threshold is met is determined on a property-by-property basis.

2. Should the bank make the election in Regulation 1.469-9(g)(1) to group all foreclosed rental properties as a single passive activity?

"(1) In general. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity."

a. The election is made by the S corporation.[29]

b. It may be tempting to make this election, especially if the practitioner concludes that it would then be permissible to group all of the rental properties in one column on Form 8825[30] and avoid the compliance issue of completing that form property-by-property.

(1) If the gross income on some operating properties is less than 2% of value, making the single activity election may include those properties in passive rental income when they might not otherwise be included.

(2) Suspended excess passive losses may not be allowable under Section 469(g) until all of the foreclosed properties that are grouped as a single activity are sold.

C. Operating Foreclosed Businesses

1. The foreclosed business probably becomes a passive activity for all of the bank shareholders for a different reason.

a. In most cases, the bank employees will not operate the business directly. The bank will retain someone experienced in operating that kind of business to operate it for the bank; perhaps even in hopes that the operator will eventually also be the purchaser.

2. Three questions arise in the S corporation context.

a. First, has the S corporation bank "leased" the business to the operator, or is the bank operating the business?

(1) Leasing the business is not uncommon. The answer turns on who has the

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[29] Regulation 1.469-9(h).

[30] The instructions to Form 8825 appear to be clear that rental properties must be separately listed by property. Line 1 to the Form states, "Show the type and address of each property." The instructions to the Form include the following example where more than one property are a single passive activity.

"If there are more than eight properties, attach additional Forms 8825.

"The number of columns to be used for reporting income and expenses on this form may differ from the number of rental real estate activities the partnership or S corporation has for purposes of the passive activity limitations. For example, a partnership owns two apartment buildings, each located in a different city. For purposes of the passive activity limitations, the partnership grouped both buildings into a single activity. Although the partnership has only one rental real estate activity for purposes of the passive activity limitations, it must report the income and deductions for each building in separate columns."

opportunity for gain and risk of loss from operations.

(2) If the bank collects rents from the operator, and the opportunities and risks of operations are with the operator, except perhaps for some percentage rents, then the bank has leased the business, and the previous section on rental activities would apply equally to the foreclosed business.

(3) If on the other hand, the bank is operating the business with a hired manager, and the bank has the risk of loss, then this section applies.

b. Second, if the bank is operating the business, how does the income or loss of the business pass through to the bank's return? In most cases the bank will have acquired the entity operating the business, and the operating business will not be a division of the bank.

(1) If the entity was a partnership, or more likely a limited liability company taxed as a partnership, and the bank acquired all of the partnership or LLC interests in foreclosure, then

(a) If the entity was an LLC, the LLC became a disregarded entity when the bank became the sole owner, and the operations will pass through to the return of the S corporation bank.

(b) If the entity was a partnership, then the partnership dissolved when the bank became the sole owner,[31] the business became a division of the bank, and the operations will pass through to the return of the S corporation bank.

(2) If the entity was a C corporation, an S corporation, or an LLC which had made the election to be taxed as a C or an S corporation, then the entity became a C corporation subsidiary of the bank when the bank took control.[32] Unless the bank makes a timely QSub election for the new subsidiary, the entity will file its own, separate C corporation return, and the income and expenses will not pass through to the bank's S corporation return.[33]

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[31] There is no provision in most state laws for a partnership to have a sole partner.

[32] Unless, of course the bank took control in an "in substance foreclosure," in which case the borrower still owns the entity, and the business operations, for income tax purposes.

[33] I expect that in most cases, the bank will want to make the QSub election, despite the passive loss implications discussed below. In most cases, the business is not likely to be operating profitably or it would not have become subject to foreclosure. The accumulated net operating loss carried forward by a C corporation is not likely to be very valuable to the eventual buyer because of the limitations under Section 382 after two changes of control in less than three years.

c. Third, is the operating business a separate passive activity to the shareholders of the S corporation?

(1) Section 469(c) states in relevant part:.

"(c) Passive activity defined. For purposes of this section (1) In general. The term "passive activity" means any activity (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."

(2) There are a number of criteria for determining whether the shareholder "materially participates" in a trade or business, but the most common test is whether the shareholder devotes at least 500 hours of work to the business.

3. It is unlikely that, unless a particular shareholder has experience in operating the foreclosed business, that any shareholder will qualify as an active participant in that business.

IX. "Bad Debt" Losses on Investment Securities - "Other Than Temporary Impairments"

A. Section 582(a) treats credit losses on securities as "bad debts" under Section 166 rather than as losses under Section 165. Section 582(a) reads in relevant part:

"Subsections (a) and (b) of Section 166 (relating to the allowance of deduction for bad debts) shall apply in the case of a bank to a debt which is evidenced by a security... ."

B. While the loss is a "bad debt," note that it is a bad debt under Section 166. Section 585 does not apply.

1. If the bank is using the reserve method for bad debts, losses on debt securities are not included in the reserve calculations.

C. Must be a "debt security" for Section 582(a) to apply. Section 582(a) does not apply to equities.

1. *Investments in Trust Preferreds* - The question frequently arises whether Trust Preferred Securities which the bank purchased as an investment are "debt" or "equity." The bankers typically think of them as equity securities.

Even as passive losses, the net losses will usually be materially more valuable to the bank's shareholders.

a. In most cases, the community bank has purchased its trust preferred investments from a pool that was organized by one of the large investment banks.

b. According to the prospectuses which the author has reviewed, the bank appears to have purchased debt securities from the special purpose corporation organized by the investment bank to market the investments and to accumulate the investment proceeds.

c. These "Trust Preferred Pools" are typically structured as follows:

(1) The issuer is a special purpose corporation, which issues a series of different "notes" to the "public." These are what the bank owns.

(2) The "issuer" uses the funds from the public to purchase "capital securities" from the individual trusts established by each participating bank, often several hundred trusts. These are the "trust certificates" that, when the trust is consolidated with the borrowing bank, are treated as Tier I Capital for regulatory purposes.

(3) The individual trusts then "lend" the proceeds from sale of the "capital securities" to the borrowing bank.

d. Assuming this structure, the investor should own "debt securities" that would be subject to Section 582(a).

D. Whether an "other than temporary impairment" is tax deductible depends entirely upon whether the measure of the “impairment” is a credit loss or a market value loss.

1. If the measure of the impairment was determined on the basis of a “normal” credit analysis of what can be collected from the borrower, then the impairment is a tax deductible charge-off of a bad debt under Sections 582(a) and 166.

2. If the measure of the impairment is based on an analysis of the fair market value of the security, i.e. what some other investor will pay to purchase the security, then the impairment is a market loss, Sections 582 and 166 do not apply, and the impairment would not be deductible as a bad debt.

3. In practice, the impairment is likely to be some of each; i.e. partly a credit loss based on the lack of a prospect for collections from the borrower, and partly a greater loss in “market value” because of greater discounts in the market of what a third party would pay for the security.

a. In this case, the deductible bad debt is limited to the credit portion of the loss.

E. The bad debt deduction is limited to the "lesser" of the credit loss or the impairment taken on the books. The bad debt deduction cannot exceed the amount charged off on the books.

1. Example - Assume for example that the face value of the security is $5,000,000, that the interest rate is 5%, due semi-annually, and that the principal is due $500,000 annually. The book evaluation of the OTTI adjustment is likely to appear somewhat as follows:

Year	Projected cash payments
1	$ 0
2	250000
3	300000
4	350000
5	400000
6	400000
7	500000
8	500000
9	600000
10	700000
Total	$4,000,000
PV, Discounted @ 5%, of Projected Pay'ts[34]	$2,896,000
Book OTTI - The difference between the $5 million cost and the PV of the Projected Pay'ts	$2,104,000

a. The book OTTI loss is $2,104,000.

b. The credit loss is $1,000,000 (i.e. the projected cash collections less than the income

[34] The 5% discount rate is merely an assumption used for the example. In practice, the bank will determine the market discount rate to use to calculate the OTTI charge.

tax basis in the security.

2. Depending upon the methods used to determine the OTTI adjustment, the projected cash flow may need to be evaluated for the risk that the cash will not be collected. Often, the OTTI analyses are "optimistic" to minimize the OTTI loss.

   In the following table, the bank may have used the "high" column to minimize the OTTI adjustment. The banker may tell you that the worst case scenario is the "low" column. What you are looking for in the right column is the "likely" collection that a loan officer would conclude is the "likely" recovery from a troubled loan.

Year	Projected cash payments		
	High	Low	Conclusion
1	$ 0	$ 0	$ 0
2	400000	200000	250000
3	400000	200000	300000
4	600000	250000	350000
5	800000	250000	400000
6	800000	300000	400000
7	800000	300000	500000
8	800000	300000	500000
9	800000	300000	600000
10	800000	300000	700000
Total	6.200.000	2400000	$4,000,000
PV @ 5%	$4,542,000	$1,774,000	$2,896,000

   For income tax purposes, the right hand column is still the proper credit loss. One does not have to be the eternal optimist in evaluating the prospect for collections, but unless there are contrary facts, the right column is probably the correct bad debt.

F. After the charge-off, the security is a nonaccrual asset for income tax purposes.

   1. All collections are charged to principal until $4,000,000 is collected. Any further

collections are a "recovery."

2. The bank may be recognizing income, based on 5% of $2,896,000 for financial reporting purposes.

G. What if (i) part or all of an OTTI loss is a credit loss, and (ii) no bad debt deduction is claimed in the year that the OTTI loss is charged?

1. The Regulations stated in relevant part:

"Evidence of worthlessness in later taxable year. *If such a bank or other corporation does not claim a deduction for such a totally or partially worthless debt in its return for the taxable year in which the charge-off takes place*, but claims the deduction for a later taxable year, then the charge-off in the prior taxable year shall be deemed to have been involuntary and the deduction under section 166 shall be allowed for the taxable year for which claimed, *provided that the taxpayer produces sufficient evidence to show that (i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge-off, as the case may be*; and, (ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year."[35] [italics added]

2. The difficulty with not claiming the credit loss in the year that the OTTI adjustment is charged off is that then the burden of proof is on the bank to show that the credit loss occurred in the later year. See the italicized language in the regulation.

3. If the bank is unable to show that the credit loss occurred in a later year [a tall hurdle given the work that was undoubtedly done to document the OTTI], the bank is probably precluded from ever claiming a bad debt loss under Section 166. Rather, the bank will claim a loss under Section 165 when either:

   a. The investment is disposed of, either by sale or by settlement with the issuer; or

   b. All available payments have been received and the security is then wholly worthless.

   The present value of the delayed tax benefit may be material.

X. Nonperforming Loan Pools Purchased at Deep Discounts.

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[35] Regulation Section 1.166-2(c)(2).

A. A relatively robust market has developed for "bad" loans that are purchased at deep discounts, often from the FDIC after bank and thrift failures.

1. The loans are normally in default, are under collateralized, the borrowers are poor credit risks or in bankruptcy, and the loans may have some level of documentation deficiencies.

2. Some may be international credits that are in default or have been disavowed by their governments.

B. While not officially sanctioned by the Code, Regulations, or published revenue rulings or procedures, case law has sanctioned recognizing gain or loss on these loans on the cost recovery method.[36]

1. The loans must be speculative. Factors which have been cited to establish the speculative nature of the loans include:

a. The speculative nature of the borrower's fiscal responsibility, and no guarantees or endorsements by anyone with the ability to perform;

b. Lack of marketability or negotiability;

c. Substantial default on the payments by the borrower;

d. Under collateralization; and

e. The size of the discount; i.e. as the discount becomes larger, the characterization of the loans as "speculative" becomes more certain.

2. If the loans are "speculative," then the courts allow the bank to defer income until collections and recoveries equal the income tax basis in the pool.

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[36] *W. E. Underhill v. Commissioner*, 45 T.C. 489 (1996) - The taxpayer properly used the cost recovery method to recognize income on purchased pools of notes secured by second deeds of trust. His purchase price was almost always in excess of the underlying equity in the collateral. The Tax Court help that although payments were fixed and potential profit was ascertainable, an obligation could still be speculative. The "ultimate test," was "whether, at the time of acquisition, the person acquiring the obligation cannot be reasonably certain he will recover his cost and a major portion of the discount"

M. Liftin v. Commissioner, 63-1 USTC 9465, 4 CA (1963) - Similar to *Underhill*, the taxpayer purchased highly speculative notes secured by second deeds of trust at discounts of up to 45%.

a. There are no deductions for charge-offs of individual loans.

b. Eventually, if the buyer fails to recover the aggregate income tax basis in the pool of loans, the unrecovered balance is a loss for tax purposes.

C. The more serious problem arises if the loans are "modified" through a restructuring with the borrower.

1. Example - The outstanding balance of the loan is $1, 000,000, bearing interest at 6.0%. The loan is in substantial default. The purchaser allocates $300,000 of the purchase price of the pool to this loan. The purchaser succeeds in restructuring the loan with the borrower for $500,000 at 3.0% interest, payable in 32 equal quarterly payments of principal and interest. Assume that the borrower is performing under the modified terms.

2. Under the general rule of modifications, would the purchaser realize a $100,000 gain calculated as follows:

"Issue Price" of the modified note	$500,000[37]
Basis in the "old" note exchanged	300,000
Gain on the modification	$200,000

That would be a pretty stiff tax penalty for restructuring a highly speculative note that was in default when acquired.

3. The Regulations suggest, however, that the issue price of the modified note is actually the $300,000 paid for it.

a. Regulation 1.1001-1(g)(1) states that if a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price as determined under Reg. 1.1273-2 or Reg. 1.1274-2, whichever is applicable.

b. Regulation 1.1274-2(b) defines "issue price." Subsection (b)(1) states that the issue price of a debt instrument that provides for adequate stated interest is the stated principal amount of the debt instrument.

c. Subsection (b)(3) states that, notwithstanding subsection (b)(1), if a debt instrument is issued in a "potentially abusive situation," the issue price is the fair market value

[37] The issue price is the stated principal because there is adequate stated interest.

(FMV) of the property received.

d. “Potentially abusive situations” are defined in Reg. 1.1274-3. Subsection 3(a) provides that a “potentially abusive situation” includes a recent sale transaction.

e. Even though the purchase of a pool of defaulted loans may not be viewed by business people as “potentially abusive,” it appears to fit within the definition of "potentially abusive" in the Regulation.

f. Accordingly, the issue price would not be the stated principal amount of the modified loan, but rather the recent sales price of the original loan, i.e., the amount paid for it.

XI. IRS Examination Activity - Perhaps the greatest change from last year.

A. Because of the number of calls which the author has received about examination activity during the year, we surveyed our accounting firm clients regarding the activity that they are experiencing. I received 12 responses to my survey.

1. If I had done the same thing last year or the year before, I would have receive one or two responses for perhaps one examination each.

2. The activity is clearly driven by Joint Committee Refund Claims of over $2 million. Examination of those claims is mandatory.

3. However, many smaller refund claims, and even banks with taxable income, have been examined this year.

B. Material losses, and material Schedule M-3 items reducing taxable income but not book income, are clearly attracting attention.

1. The author received numerous reports of agents opening examinations because of large ordinary losses from sales of FNMA and FHLMC preferred shares.

a. A couple of facts about these losses triggered the initial questions.

(1) In many cases, the book losses were taken in the year before the shares were sold and the tax loss was deducted. The examination office was seeing the very large Schedule M-3 adjustment reducing taxable income, but did not have the previous year's return showing the other side of the adjustment.

(2) The second question was why the loss on sales of stock was ordinary.

b. After checking this transaction, some of them closed up the examination.

2. The author received similar reports regarding book OTTI charges for losses on "securities" and credit losses on securities and trust preferred investments.

a. The Service is so unaccustomed to seeing bad debt losses on securities, and some of the losses on collateralized mortgage obligations and other securitized debt and on trust preferred securities, were so large, that they attracted attention.

b. The examination division is also unaccustomed to seeing bad debt deductions for credit losses on securities that were also subject to nondeductible OTTI charges and needed assistance in sorting out the two different charges.

3. The sheer size of bad debt deductions for partial worthless of loans attracted attention.

C. Non-accrual interest is an often reported issue on accrual basis banks.

D. Fair market valve of foreclosed OREO for purposes of measuring the bad debt loss on foreclosures is also an often reported issue.

1. The Service knows that GAAP recognizes the estimated costs to sell as a discount in the recorded book value of the OREO in accounting for the foreclosure.

2. The Service did not acquiesce in the District Court decision in *Bank of Kirksville* and it considers *Bank of Kirksville* "bad law."

3. The survey indicated that examining agents expect the add-back of estimated costs to sell to the basis if OREO to be an adjustment on most returns if there were foreclosures that were not sold by the end of the year under examination.

E. The conformity election materially expedited the examinations.

1. There were not many responses regarding examinations of banks with the conformity election. The responses that we did receive relating to conformity electing banks indicated that, as should be expected:

a. They encountered none of the usual controversies regarding charge-offs.

b. They encountered none of the usual controversies regarding nonaccrual interest.

c. They encountered no controversies regarding the valuations on foreclosed collateral

for purposes of measuring the related book charge-offs.

d. One respondent indicated that the examining agent said that he needed to "audit" the Express Determination Letter; i.e. to "look behind" the letter to see if the federal bank examiners correctly determined that the bank was following regulatory standards when they issued the EDL letter.

(1) The author understands that examination is still in progress and does not know whether that effort has in fact gone forward.

(2) Any effort to "audit" the EDL letter is likely to be very difficult because:

(a) The IRS examiner does not have access to the bank examiner's workpapers supporting the EDL letter.

(b) By definition, the IRS examiner does not have significant experience in evaluating regulatory standards, and

F. OREO costs.

1. This has been a material issue in most of the examinations.

2. Capitalization of all kinds of costs were reported to be issues, including:

a. Foreclosure costs added to the basis in the OREO.

b. Borrower's costs paid after the foreclosure added to the basis in the OREO.

(1) There were no reports of adding borrower's costs paid by the lender before the foreclosure to the cost of the OREO, which would be expected because the examination guide properly indicates those costs should be included in the loan.

c. Holding period costs of non-operating properties added to the basis in the properties.

3. There were no reports of attempts to disallow costs or depreciation on operating properties.

G. The conclusive presumption in Regulation 1.166-2(d).

1. As noted above, this is a new issue that has emerged this year.

2. Since about 1959 Regulation 1.166-2(d) has a "conclusive presumption" that charge-offs

ordered by the examiners are deductible.

a. The tradition has grown up informally that the bank will show the select pages listing the ordered charge-offs to the IRS agent, but not show him the entire report. This maintains the confidentiality of the examination report.

b. This year some agents have refused to review the examination report pages without the written approval of the federal bank examiners, which of course, is very difficult to obtain.

XII. Tax Accounting for TARP Funds.

A. C corporations - The TARP money is preferred stock.

1. The costs associated with obtaining the funds are stock issue costs and are nondeductible.

2. The dividends are nondeductible.

3. The warrants exercised by the government are additional stock and the premium to redeem them is nondeductible.

a. For book purposes, the warranto are being recorded as an allocation of earnings over the five years to expected redemption.

Debit	Retained earnings	$xxx.xxx	
Credit	Preferred Stock		$xxx,xxx

B. S corporations - The TARP money is debt.[38]

1. The costs associated with obtaining the funds are debt acquisition costs, and are capitalized and amortized over the **maturity** of the debt.

2. The interest is deductible.

a. If the TARP securities are issued by the bank, rather than the BHC, the interest expense is included in interest expense for purposes of the Section 265(b) and Section 291(e) TEFRA disallowances.

b. If the TARP securities are issued by the BHC, then the interest is not included in the

[38] This explains the higher interest rate.

265(b) and 291(e) disallowance calculations.

3. The Senior Warrant Subordinated Securities, equal to 5% of the TARP debt, cause the TARP debt to be OID obligations.

    a. OID is recognized over the **maturity** of the debt.[39] The unamortized balance is deducted when the TARP debt is prepaid.

    b. The issuer deducts OID over the same period as it is recognized by the holder.[40]

4. The material question is what is the maturity of the TARP debt?

    a. The conventional wisdom was that the term of the TARP debt for income tax purposes is its legal maturity, which is 30 years.[41]

        (1) If this is correct, the OID is *de minimis* because it is less than 0.25% multiplied by the years to maturity,[42] and the OID is deducted over 30 years on the straight-line method.

        (2) The debt acquisition costs are also amortized over 30 years using the straight line method.

        (3) If the securities are prepaid within five years as expected, then the unamortized balances of the OID and the debt acquisition costs are deducted in the year prepaid.

    b. Upon further review, Regulation 1.1272-1(c)(5) should apply.

        (1) Paragraph (c) of the Regulation addresses the yield and maturity of obligations which are subject to contingencies.

        "(c) Yield and maturity of certain debt instruments subject to contingencies.

            (1) Applicability. This paragraph (c) *provides rules to determine the*

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[39] See Section 1272, Regulation 1.1272-1 and Section 1273.

[40] Section 163(e).

[41] See Section 1272, Regulation 1.1272-1 and Section 1273.

[42] Regulation Section 1.1273-1(d). The discount is about 4.76% [0.05 divided by the stated principal at maturity of 1.05 = 4.76%]. This is easily less than 7.5% [0.25% per year times 30 years],

yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section." [italics added]

(2) The amounts of each payment during the entire 30 year life of the debt are known at issue and all of the payment dates are known at issue, so paragraph (c) appears to apply to the TARP debt.

(3) Paragraph (c) of the Regulation provides a "deemed" maturity date for obligations that are the subject of that paragraph. For those obligations, the Regulation overrides the more general language of Sections 1272 and 1273 and Regulation 1.1272-1, which refer to OID calculations to the "stated maturity" of the obligation.

(4) Subparagraph (c)(5) addresses the treatment of certain options.

""Treatment of certain options. Notwithstanding paragraphs (c)(2) and (3)[43] of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (e.g., an option to extend or an option to call a debt instrument at a fixed premium) . Under this paragraph (c)(5), *an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument*, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised." [italics added] [44]

(5) The issuer, in this case the Bank, has an unconditional option to call and prepay

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[43] Subparagraph (c)(2) is a payment schedule that is significantly more likely than not to occur and subparagraph (c)(3) is mandatory sinking fund provisions. Neither is applicable to the TARP obligations because (i) the thirty year payment schedule is unlikely to occur, and (ii) there are no sinking fund provisions.

[44] There are a number of examples in paragraph (j) of the Regulation. None of them are directly on point with the TARP securities, but the following scenario is consistent with the context of the examples.

the TARP obligation at any time.

(6) The holder, in this case the Treasury Department, has no put or call options.

(7) Accordingly, subparagraph (c)(5) should apply.

c. If paragraph (c) and subparagraph (c)(5) apply, then the *maturity* of the TARP obligation is the date that results in the minimum cost to the bank.

(1) As one would expect, the lowest yield to the holder of the TARP debt is for a call at the end of five years.

(2) The annual yields, compounded quarterly, if the TARP obligation is prepaid at the end of the following years are:

1st Year	13.15% [45]
4th Year	9.43%
5th Year	9.19%
6th Year	9.80%
30th Year	11.74%

(3) Accordingly, the maturity of the TARP securities should be five years.

(a) The TARP obligation is a five year debt instrument.
(b) The issue price is 100.
(c) The redemption price at maturity of 105.
(d) The 7.7% interest is qualified stated interest, and
(e) The OID is 1.49%. [46]

(4) The OID is not *di minimis*; 1.49% divided by 5 years is 0.298% per year, which is greater than 0.25%.

(5) Accordingly, the OID should be deducted over five years at the annual rate of 1.49% compounded quarterly.

(6) The debt acquisition costs would also be amortized over 5 years, but on the straight-line method.

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[45] The yield is so high at the end of the first year because the 5% warrant obligation would all be included in the first year's yield.

[46] 9.19% total yield, minus the 7.7% stated interest.

(7) Any unamortized balance would be deducted in the year that the securities are prepaid.

C. The other new issue that seems to have emerged this year involves the tax implications of a compromise of the TARP debt with the Treasury Department.

1. C corporations will have no tax gain or loss on compromise of the TARP obligation.

a. The TARP is preferred stock.

b. The corporation recognizes no gain or loss on a distribution in redemption of its stock. Section 311(a) reads in relevant part:

"(a) General rule. Except as provided in subsection (b) [i.e. distribution of appreciated property in redemption of shares], no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of (1) its stock (or rights to acquire its stock), or (2) property."

Property includes money.

(1) Accordingly, even though the preferred stock is "redeemed" from the Treasury Department for less than its original issue price, Section 311 protects the corporation from gain on the redemption.

2. S corporations will have discharge of debt income equal to the discount.

a. The S corporation TARP obligations are "debt."

b. Revoking the S election before the compromise will not solve the problem. The issue is not the S election, but the nature of the obligation as "debt."

XIII. Trust Preferred Securities - Deferred Interest Payments.

A. Trust preferred securities could have been OID obligations when issued, but the prospectuses which the author has reviewed have all treated the TPS as not having OID.

1. The issuer's ability to defer interest payments could have resulted in OID status.

2. The determining factor is whether the likelihood of deferring interest was "remote" or the

deferral of interest is not "significantly more likely than not to occur."[47] Regulation Section 11275-2(h) states in relevant part:

"(h) Remote and incidental contingencies. (1) In general. This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6)(ii) or (j) of this section or section 1.1272-1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e)[48] (other than sections 163(e)(5)[49]) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

"(2) Remote contingencies. A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur."

a. The prospectuses have concluded that deferral of the interest was "remote."

b. The significant due diligence done by the investment bankers who put together the trust preferred issues, and the financial standards imposed on the issuing banks, probably support the position that the publicly issued trust preferreds, whether single bank issues or pools, were not OID obligations.

c. Private issues used to raise capital for a bank that was incurring significant losses could be OID obligations from the date of issue.

B. When interest is first deferred, then the trust preferred security becomes an OID obligation. Regulation 1.1275-2((h)(6) states in relevant part:

""(6) Subsequent adjustments. (i) Applicability. This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if -

"(A) A remote contingency actually occurs or does not occur, contrary to the assumption

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47 Regulation Section 1.1272-1(c)(2).

48 As discussed again below, Section 163(e) allows the issuer a deduction for original issue discount parallel to the amount recognized by the holder.

49 Section 163(e)(5) relates to high yield obligations that are not an issue with trust preferred securities.

made in paragraph (h)(2) of this section;

"(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

"(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

"(ii) In general. If a change in circumstances occurs, *solely for purposes of sections 1272 and 1273*, *the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date*."

1. This is not a modification of the debt obligation under Regulation 1.1001-3. No gain or loss is recognized.

    a. The "reissued" language is limited solely to Section 1272 and 1273.

    b. Implementing a "remote" provision of the obligation is not a "modification" of the obligation because the deferral was in the original document.

C. The practical effect is that the accrued interest expense becomes OID rather than stated interest.

1. If the trust preferred security has become an OID obligation, then the OID is deductible by both an accrual basis issuer and a cash basis issuer as it accrues.

    a. Section 163(e) allows the issuer a deduction for OID equal to the aggregate daily portions of the original issue discount during the taxable year. This amount is equal to the amount included in the taxable income of the holders.

        (1) There is no restriction on the deduction based on the issuer's overall method of accounting.

        (2) Both accrual basis and cash basis issuers would deduct the same amount of OID as it accrues, even though it is not paid.

2. Similarly, the holders of trust preferred securities recognize OID income, whether on the accrual or cash method, for deferred interest that has not been received

3. What if the OID is uncollectible?

    a. The rulings on nonaccrual of interest do not apply because OID cannot be placed on "nonaccrual."

    b. Regulation Section 1.1272-1(g) states that OID is added to the income tax basis in the

obligation itself.

c. Uncollectible OID is not a separate asset like accrued interest receivable. Rather, it becomes part of the income tax basis in the obligation.

d. Accordingly, uncollectible OID should be "charged-off" and deducted as a bad debt under Section 166(a)(2) and (b).

(1) It is necessary for the holder to both recognize the OID on the books as income and an addition to the OID security, and charge the OID off to the reserve for loan and lease losses on the books.

(a) Recognition is the step that includes the OID in the basis of the obligation.

(b) The charge-off is the step that allows for a deduction for the partial worthlessness of a debt.

(2) If the holder has made the conformity election, this approach will create the"charge-off" to which its bad debt deduction can "conform."

(3) Even if the holder has not made the conformity election, the partial bad debt deduction is only allowed under Section 166(a)(2) to the extent of "the part charged off within the taxable year."

D. Does a Trust Preferred Security cease to be an OID obligation when the interest is brought current?

1. No. Once the Trust Preferred Security has become an OID obligation, it remains an OID obligation until it is retired.

a. The Trust Preferred did not become an OID obligation because the interest was deferred, but rather because the deferral was no longer a "remote contingency." Once the interest has been deferred, the likelihood of a deferral is no longer "remote."

b. The Trust Preferred changed from an non-OID obligation to an OID obligation because it is deemed by Regulation 1.1275-2((h)(6)(ii) to have been redeemed and reissued when there was a change in circumstances. Again, the "change in circumstances" was not the deferral of the interest, but rather the remote contingency actually occurring contrary to the assumption made when the obligation was issued. Paying the interest currently was not a remote contingency, so bringing the interest current is not a change of circumstances under Regulation 1.1275-2(h)(6)(ii).

E. What information reports are required?

1. The issuer should report the interest income to the holders on Form 1099-INT as long as interest payments have not been deferred.

2. Once interest has been deferred, then the issuer should switch for Form 1099-OID.

   a. Deferred interest would be reported in Box 1.

   b. Box 2 would not be used until the issuer has paid the interest current.

   c. Subsequent interest payments would be reported in Box 2.

      (1) Box 1 would be zero for as long as the interest continues to be paid currently as scheduled.

XIV. Tax Accounting for Purchases in FDIC Assisted Transactions.

A. The FDIC is asking the bidders to take all of the troubled loans, or at least substantially more than was the case in the past.

1. The buyer's bid is:

   a. The amount of cash that the buyer wants the FDIC to insert to close the sale.

      (1) The FDIC cash is federal financial assistance under Section 597, and is taxable to the failed bank.

   b. The assets that the FDIC/failed bank will retain.

   c. Whether there will be a loss sharing agreement.

   d. Beginning in September 2010, the percentage of losses that the FDIC will absorb.

2. Whether the buyer purchases all of the assets and assumes all of the liabilities is subject to some negotiation, especially if there are only one or two acceptable bidders. Assets not normally included in the closing.

   a. Bank premises are retained by the FDIC, appraised, and then offered to the successful bidder under the Purchase Agreement at appraised value.

   b. Federal Reserve stock is retained by the FDIC because it is not transferable. The FDIC will redeem it.

   c. Federal Home Loan Bank stock is treated differently, depending upon the bid. It may be acquired at the closing, or it may be retained by the FDIC and redeemed.

   d. The prepaid FDIC insurance premium of the failed bank is retained by the FDIC.

   e. The FDIC commonly retains bank owned life insurance policies.

f. Deferred tax assets cannot be acquired in an asset purchase.

g. In many cases there will be other assets peculiar to the failed bank that the bidder will exclude from its bid.

3. Liabilities not normally included in the closing.

a. Uninsured deposits. Whether the buyer assumes the uninsured deposits is determined by the FDIC on a case by case basis.

(1) If the FDIC decides not to haircut the uninsured deposits, then the buyer assumes all of the deposits, including the uninsured deposits.

(2) If the FDIC does not support the uninsured deposits, then only the insured deposits are assumed.

b. Brokered deposits. The FDIC typically pays off the depositors directly.

c. FHLB term loans may or may not be assumed by the buyer, depending on whether the buyer wants the long term financing.

(1) The buyer's issue is commonly with the pre-payment penalty.

d. Current tax liabilities are usually not assumed.

e. As with deferred tax assets, deferred tax liabilities cannot be assumed.

4. Loss sharing agreements.

a. There is not always a loss sharing agreement, and lately, the FDIC has preferred bids without a loss sharing agreement, especially if the failing bank is small.

b. If there is a loss-sharing agreement, the assets that are covered tend to be determined by the FDIC, but the bidder has some flexibility to tailor the bid.

c. Initially, all acquired loans were subject to the loss sharing agreement, More recently, only the classified and nonperforming loans have been covered. The successful bidder has gone at risk for the unclassified and performing loans.

d. Accrued interest receivable on the loans subject to the loss-sharing agreement to the extent recorded on the books of the failed bank.

(1) Of course, much of the legally accrued interest is also likely to be nonaccrual interest from a book perspective.

(2) Nonaccrued interest is not supported by the loss sharing agreement, but it is not retained

by the FDIC. If the acquiring bank can collect it, it is the buyer's income.

e. Some limited post closing accrued interest income on covered loans may be covered by the loss sharing agreement.

f. Initially, publicly traded government securities and the related accrued interest were covered but not more recently.

(1) However, the FDIC will share in losses on investments in collateralized mortgage obligations, mortgage backed securities, and trust preferred securities.

g. Most OREO will be covered at book value on the closing date.

5. The loss sharing agreement is federal financial assistance, and to the extent that it generates a gain, it is taxable to the acquiring bank.

a. The original loss sharing agreements in 2008 and 2009 typically guaranteed 80% of the losses incurred by the acquirer up to a threshold established by the FDIC in the bid request, and 95 % of the loss over that threshold.

b. In April, 2010 the FDIC eliminated the 95% guarantee.

c. In September, 2010, the FDIC began asking the bidder to offer the percentage of loss guarantee. some transactions have occurred at less than 80% but that is still the standard percentage.

B. Of the 2011 bank closings that the author has “scheduled”:

1. Two thirds have reflected no deposit premium. The deposit premiums for the other one-third have ranged from 0.10% to 1.50%, with a weighted average of 0.70%.

2. The asset discounts for the closings where the bid summary has been posted on line range from 7% to 24% with a weighted average of 14%.

3. There were no loss-sharing agreements in about 27% of the transactions.

4. In the transactions with loss-sharing agreements, the agreements covered from 54% of the assets acquired to 89%, with a weighted average of 70%.

5. The estimated loss to the FDIC ranged from 3% to 40% of the book value of the assets at the previous call report date, with a weighted average of 24%.

C. Financial accounting - FAS 141R has introduced new accounting methods different from income tax reporting.

1. The major difference is the concept of negative goodwill.

   a. Under FAS 141R, if the fair market value of all the assets acquired [which includes the present value of the loss sharing agreement] exceeds the purchase price, the excess is "negative goodwill" and is recognized in income. at closing.

   b. Except for the effect of Regulation 1.597-5 on transactions with loss sharing agreements [see below], there is no tax concept of negative goodwill.

      (1) The purchase price is allocated to successive classes, and when it is fully allocated, no allocation is made to higher class assets.

2. Under FAS 141R, the FDIC's loan guarantee is recorded as a separate asset.

   a. The asset is credited when the FDIC performs on the guarantee.

   b. If the loan pays out better than predicted, the bank recognizes a gain on the pay-out net of the projected FDIC guarantee.

      (1) Example - Assume that the loan is $100, the projected collection is $50, and the FDIC loss share is 80% [i.e. $40 of the $50 projected loss].

      (2) If the loan pays $90, the entry is as follows:

Cash- Borrower	$90	
Cash - FDIC	8	
Loans		$50
Receivable from FDIC		40
Gain		8

      (3) If it pays out at $40 [i.e. less than the projected $50], then the entry is:

Cash - Borrower	$40	
Cash - FDIC	48	
Loss	2	
Loans		$50
Receivable from FDIC		40

   c. For tax purposes, the FDIC loss sharing agreement is included in the FMV of the Class II assets. It is not a separately stated asset.[50]

[50] Regulation Section 1.597-5(d)(2)(iii).

3. If the purchase agreement states that the buyer is paying the FDIC a premium for the intangible value of the core deposits, under FAS 141R that amount is recorded as an intangible, and may in fact create or increase negative goodwill.

    a. For tax purposes, when the purchase price is fully allocated, no allocation is made to the higher class assets regardless of the terms of the purchase agreement.

D. Tax allocation of the purchase price among the assets acquired.[51]

1. The "purchase price" is the sum of:

    a. Cash paid to the FDIC .

        (1) No cash is ever "paid" to the FDIC at closing.

        (2) However, it is the oral position of the IRS National Office that the step transaction doctrine applies to integrate the initial closing and any subsequent purchases of "retained assets" from the FDIC into a single purchase of assets transaction.

            (a) Suppose that the successful bidder later purchases some or all of the fixed assets for $1,000,000 pursuant to an option in the asset purchase agreement.

            (b) The step transaction doctrine would treat the $1 million as "cash paid to the FDIC" as part of the purchase price and include the fixed assets in the assets purchased.

            (c) Similar treatment may be given to certain loans that the successful bidder purchases after the closing.

    b. The buyer's capitalized transaction costs;[52] and

    c. The liabilities assumed.

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[51] Regulation section 1.597-5(d) cross-references the purchase price to Regulation section 1.1060-1T(c)(1).

[52] The Section 263(a) Regulations apply to determine the buyer's capitalized transaction costs. Because of the very short negotiation period, they are typically minimal. In house salaries and *di minimis* costs under $5,000 each are expensed pursuant to the Section 263(a) Regulations.

The costs of buying and installing new signs are capitalized fixed assets outside of the purchase transaction.

2. The "purchase price" is allocated among the assets acquired according to the Classes of assets in Regulation 1.338-6 [with the modifications in Reg. 1.597-2(d) if there is a loss sharing agreement], using the residual method.[53]

3. Purchase price is always allocated to Class I assets at par value, even if the par value of the Class I assets exceeds the purchase price.

   a. The cash and due from banks of the failed bank which is acquired by the acquirer.

   b. The cash provided by the FDIC to balance the closing transaction, and as subsequently adjusted to "actual" based upon the final purchase accounting.

      (1) This cash is federal financial assistance and is taxable income to the failed bank; not to the acquirer.[54]

      (2) Accordingly, the FDIC cash to balance the closing does not result in the application of Regulation 1.597-5(d)(2)(iii).

   c. Class I would also include any cash received from the FDIC subsequent to the closing if the successful bidder has the opportunity to "put" loans or other assets back to the FDIC at book value during some period of time.

      (1) The "put option" is treated as part of the original transaction, and the interim ownership of the "put" assets by the successful bidder is disregarded.

   d. Similarly, the successful bidder may have pre-sold some asset. For example, assume that the failed bank owns an airplane, and the successful bidder pre-arranged with a dealer to purchase the plane immediately after the closing.

      (1) The step transaction doctrine should also apply, and the momentary ownership of the plane by the successful bidder should be disregarded.

      (2) The failed bank is treated as having sold the plane to the dealer and the successful bidder should be treated as having received an additional amount of cash.

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[53] In those transactions without a loss sharing agreement or other "support" from the FDIC or other government agency to the buyer, Regulation 1.597-5 does not apply. The effect is to move all loans into Class III and to move OREO to Class IV.

[54] Regulation Section 1 .597-5(c)(1).

4. The purchase price is allocated to Class II assets at their respective fair market values, even if the sum of the Class I assets plus the fair market values of the Class II assets exceeds the purchase price.

   a. Certificates of deposit.

   b. Federal Funds Sold

   c. Publicly Traded Investment Securities; including U. S. government securities, state and local securities, and publicly traded corporate bonds.

   d. Accrued interest receivable on certificates, federal funds sold, and securities.[55]

   e. If the failed bank owned Federal Home Loan Bank stock, and if the successful bidder acquired that stock, there is no really clear place to classify it in the allocation.

      (1) On the one hand, it is not publicly traded, which is a trait of Class II.

      (2) On the other hand, it has a fixed value, supported by a government sponsored entity, which is not a trait of Class V.

      (3) On balance, the author suggests FHLB stock is more economically suited to Class II than Class V, and that it be included in Class II.

   f. If there is a loss sharing agreement, then all of the covered assets are also included in Class II, which is likely to include:

      (1) Loans;

      (2) Accrued interest receivable on covered loans; and

      (3) OREO.

5. The fair market values of the Class II assets are:

   a. Certificates of deposit and accrued interest - par value.

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[55] There is no written authority for including accrued interest receivable on securities and loans with the related assets in Classes II and III respectively, but during oral discussions with representatives of the IRS National Office, we agreed that it made no sense to separate the debt instruments into their separate principal and interest components.

b. Federal funds sold and accrued interest - par value.

c. Securities - market value on the closing date, plus accrued interest at par value.

d. Federal Home Loan Bank Stock - par value.

e. Assets covered by the loss sharing agreement - the minimum realizable value including the FDIC guarantee payments.

(1) If the loss-sharing agreement is 80% of book value, then the minimum realizable value is 80% of book value, assuming that the only collection is from the FDIC.

"The fair market value of an asset covered by a Loss Guarantee immediately after the Taxable Transfer is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put."[56]

(2) The 1.597-5 formula supercedes the "fair market value" standard for allocation of purchase price to Class II.

(3) However, notice that it does not limit the amount allocated to the covered assets to the 1.597-5 formula.

(4) It is clear from the wording that if some of the covered assets have a fair market value greater than the loss-sharing guarantee, the acquirer may allocate the fair market value to them.

(a) For example, the fair market value of covered but performing loans may be 100%. The acquirer may want to allocate 100% of fair market value to them to defer gain on the collection of those loans.

(b) Similarly for accrued interest receivable.

f. The acquirer's income tax basis in loans and OREO subject to FDIC or other agency guarantees is the amount allocated to them, even though some of the gain may be deferred over six years.

6. If the sum of the par value of the Class I assets and the fair market value of the Class II

[56] Regulation Section 1.597-5(c)(3)(ii).

assets equals or exceeds the purchase price, the excess is recognized by the Buyer in taxable income over six years on the straight-line method.[57]

a. No purchase price is allocated to any high class assets.

7. If there is no loss sharing agreement, then purchase price is allocated to Class II assets equal to the lesser of:

   a. Their respective fair market values, or

   b. The unallocated purchase price available after the allocation to the Class I assets.

      (1) It would be unlikely that the FMV of the Class II assets will exceed the purchase price because where there is no loss sharing agreement, the loans are moved to Class III and the OREO to Class IV.

      (2) If the purchase price remaining after the allocation to Class I assets were less than the fair market value, then the allocation to each Class II asset would be reduced pro-rata so that the sum equals the available purchase price.

8. The remaining unallocated purchase price after the allocations to the Class I and Class II assets is allocated to successive classes of assets to the extent of their respective fair market values until the purchase price is allocated in full.

   a. If the unallocated purchase price available to a class of assets is less than the sum of the fair market values of the assets in that class, then the available purchase price is allocated among that class of assets pro-rata to their respective fair market values.

   b. Once the purchase price is fully allocated, there is no allocation to higher classes, regardless of the terms of the purchase agreement.

9. Class III assets.

   a. Loans, and the related accrued interest receivable, that are not subject to agency guarantees.

      (1) Valued at fair market value.

         (a) Usually par value if not "impaired."

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[57] Regulation section 1.597-5(d)(2)(iii).

(b) At realizable value if impaired.

(2) One cannot "purchase" a reserve for loan and lease losses. To the extent that a reserve is reflected in the allocation of the purchase price of the loans, it is a FMV adjustment to the loans.

(a) The author usually suggests that the FAS 5 reserve for losses on unclassified loans be ignored in the tax allocation, and that the unclassified loans be valued at their outstanding balance.

(b) The buyer will then not be required to maintain separate accounting for the purchased loans, to forgo a deduction for actual charge-offs as incurred, or to recognize taxable income as each loan is collected in full.

10. Class IV.

a. Class IV is inventories, which banks typically do not have.

b. A securities trading account, which is typically accounted for as inventory, is included in Class II for this purpose.

c. In oral conversations with the IRS National Office, the author learned that they consider OREO that is not covered by a loss sharing agreement as a Class IV asset because it is "held for sale to customers in the ordinary course of business."

(1) This could be quite advantageous since it would rank the OREO above premises and other assets and has a better chance of having some purchase price allocated to it.

11. Class V.

a. All other assets that are neither included in Classes I through IV or Classes VI and VII.

b. Includes premises, depreciable personal property, prepaid expenses, etc.

c. Prepaid expenses are not allocated value except to the extent that they are available to benefit the buyer.

d. Deferred income tax assets and liabilities cannot be acquired by the buyer.

12. Class VI.

    a. Section 197 intangibles; typically the intangible value of core deposits.

    b. The purchase price allocated to Section 197 intangibles is usually the lesser of:

        (1) the available purchase price remaining after the allocations to Classes I through V, or

        (2) the amount allocated for financial reporting purposes.

13. Class VII is goodwill, which is whatever balance of the purchase price is still available after the allocation to Classes I through VI.

E. Post closing accounting for income and loss - The principal issues involve loans.

1. *Accrued Interest Receivable* - In many cases, the buyer will have income tax basis in the accrued interest receivable. Cash basis buyers in particular need to be careful to account separately for the collection of purchased accrued interest so that it is not included in the buyer's taxable income.

2. Performing loans, whether Class II or Class III assets.

    a. Should usually be treated as accrual assets. Interest income should be recognized at the contracted loan rates as accrued or received, depending on the buyer's method of accounting.

    b. If the buyer has allocated purchase price to the performing loans at par value, then there is no purchase discount to recognize in taxable income.

        (1) Charge-offs, net of FDIC loss sharing, equal the book amounts.

    c. If the buyer allocated less than par value to the performing loans, then it is the author's observation that the most common approach is to pool similar loans and recognize the discount on the principal reduction method.

3. Non-performing loans, whether Class II or Class III assets.[58]

    a. Interest income is recognized pursuant to the normal nonaccrual concepts.

[58] The only difference between Class II and Class III assets is the effect of the FDIC guarantees on the amount of gain or loss.

(1) In most cases, the non-performing loans have been allocated purchase price at realizable value; i.e. the cash expected to be paid by the borrowers plus the recovery from the FDIC under the loan guarantees.[59]

(a) Since full recovery of principal is not reasonably expected, these would be nonaccrual assets.

(2) One exception would be to the extent that post-acquisition interest might be guaranteed by the FDIC. In that case, the guaranteed interest would be accrued according to the guarantee agreement.

(3) Interest on nonaccrual assets would be recognized on a cost recovery basis similar to other nonperforming, nonaccrual loans.

b. Gains and losses on Class II loans.

(1) In most cases, the "discount" between the par value and guaranteed value of the loans is not "accreted" into income currently because there is no reasonable expectation of collecting the discount.

(2) Gain is recognized when collections reduce the income tax basis in the loan to zero; i.e. after principal collections exceed the basis.

(3) It is important to determine whether the FDIC loss sharing agreement "reimburses" the buyer for a percentage of the loss, or "guarantees" the buyer collection of a percentage of the book value of the loan [which may in fact be less than the outstanding balance if the failed bank had already recognized a charge-off].

(a) If the loss sharing agreement reimburses a percentage of the loss, resolution of the loan is likely to result in a tax gain.

(b) Example - Assume a $100 loan, and the FDIC will reimburse 80% of the loss.

i) Basis will be $80.

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[59] Note that this is likely to be different from the amount recorded for book purposes, which is discounted to the present value of the future cash flows. From the perspective of the tax allocation, the allocation of purchase price should be a cash analysis; "How much will be collected from the borrowers?".

ii) If the loan pays off at $60, there is a $40 loss, of which the FDIC will reimburse 80%, or $32.

iii) The Bank will have $12 gain on resolution of the loan, even though it pays out at less than the basis.

Cash from the borrower	$60
Cash from the FDIC	32
Proceeds	92
Income tax basis in loan	(80)
Taxable gain on loan	$12

c. Gains and losses on Class III loans.

(1) To the extent that the allocable purchase price available to the Class III loans is less than the reasonably collectible amount, that discount should be recognized in income on some appropriate method.

(a) The author's observation is that most banks recognize the discount on one of two methods.

i) The discount on material loans that were individually analyzed and valued is typically recognized on a loan-by-loan basis, using the principal reduction method.

ii) Where the bank has acquired a "pool" of like loans of smaller individual balances, the discount is typically recognized on the aggregate pool on the principal reduction method.

(2) Otherwise, Class III loans are not significantly different from the normal rules regarding loans.

(a) If the loan deteriorates to less than the income tax basis, the bank would make and deduct a partial charge-off.

(b) The only problem that may be encountered is if there is no book charge-off because partial charge-offs require book charge-offs. The author has not encountered that issue yet because book basis is more often greater than tax basis as a result of recognizing negative goodwill.

4. The buyer has purchased the assets of a trade or business, and Form 8594, Asset Allocation schedule is required to be included in the return.

a. The "other party" disclosed on the Form 8594 is the failed bank, not the FDIC.

XV. Taxation of a Failed Bank.

A. The "failure" of the Bank is not a bankruptcy. The FDIC takes possession, but not ownership, of the Bank's assets as the "receiver." Accordingly,

1. The failed Bank's tax year does not end.

2. The consolidated group is not terminated.

3. The Bank's tax return filing requirement is not terminated.

4. The common parent of the consolidated group may make an irrevocable election to disaffiliate the failed Bank and its subsidiaries from the consolidated return group.[60]

a. Disaffiliation removes the direct subsidiaries of the failed Bank from the consolidated group as well as the failed Bank itself.[61]

(1) The disaffiliated Bank and its subsidiaries become a new consolidated group.

(2) The tax year of the disaffiliated group terminates on the date of disaffiliation, and it begins a new consolidated tax year as a separate group.

(3) Disaffiliation does not terminate the tax year of the common parent, or its other subsidiaries that are not disaffiliated from it.

b. The election is made by sending a written statement by certified mail to the affected institution and to each of its subsidiaries.

(1) The statement must contain the following legend at the top of the page: "THIS IS AN ELECTION UNDER section 1.597-4(g) TO EXCLUDE THE BELOW-REFERENCED INSTITUTION AND CONSOLIDATED SUBSIDIARIES FROM THE AFFILIATED GROUP," and must include the names and taxpayer identification numbers of the common parent and of the Institution and Consolidated Subsidiaries to which the election applies, and the date on which the Institution was placed in Agency receivership.

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[60] Regulation section 1.597-4(g).

[61] There is no similar way to “disaffiliate” subsidiaries of the bank holding company. Accordingly, if there are subsidiaries which are not disaffiliated by the election, the former consolidated group continues unaffected.

(2) The statement is not sent separately to the Service, but the consolidated group must include a copy of each letter, and the accompanying certified mail receipt, as part of its first income tax return filed after rendering the disaffiliation notice.

(3) A statement must also be attached to this return certifying that the individual who signed the election was authorized to do so on behalf of the consolidated group.

5. The effect of "disaffiliation" on the final consolidated return of the former common parent.

   a. Income and deductions through the date of disaffiliation are included in the consolidated return of the former common parent.

      (1) Income and deductions after the date of disaffiliation are included in the separate return, or consolidated return, of the disaffiliated Bank.

   b. The federal financial assistance taxable to the disaffiliated Bank is included in the pre-disaffiliation consolidated return.

   c. The gain or loss on sale of the bank's assets by the FDIC is included in the pre-disaffiliation consolidated return.

   d. All of the disaffiliated companies' unrecognized Section 481(a) adjustments are accelerated into the pre-disaffiliation consolidated return.

   e. All deferred intercompany gains and losses between the continuing group and the disaffiliated companies are triggered.

   f. The members of the consolidated group owning the common stock of the disaffiliated Institution include in taxable income any excess loss accounts as of the disaffiliation date.

   g. If the Bank's liabilities exceed the aggregate fair market value of its assets on the date the Bank is placed in Agency receivership, the members of the consolidated group treat their stock in the Bank as worthless.

6. An S corporation may accomplish a similar result by revoking the QSub election.

   a. The S corporation is not under a 120 day deadline. The revocation may occur at any time after the failure.

b. Furthermore, the S corporation may revoke the QSub election before the failure, while a C corporation may not "disaffiliate" the Bank until the failure occurs.

c. Revoking the QSub election does not have as many "conditions" as disaffiliating a member of a C corporation consolidated return group.

(1) The most major potential issue would be "gain" recognized to the S corporation if the former Qsub's liabilities exceed its tax basis in assets.

(a) The former Qsub(s) are treated as newly organized corporations pursuant to Section 351.

(b) If liabilities assumed by the former QSub exceed the income tax basis in its assets, gain would be recognized under Section 357(c).

(2) The taxable federal financial assistance will be included in the S corporation's return depending upon whether the QSub election is revoked before or after the closing.

(3) Similarly, whether the gain or loss on sale of the bank's assets by the FDIC is included in the S corporation's return will depend upon whether the QSub election is revoked before or after the closing.

(4) Unrecognized Section 481(a) adjustments may be accelerated because the S corporation will have ceased the banking business.

(5) There would be no deferred intercompany gains and losses between the former QSub and the S corporation because of the deemed liquidation of the QSub.

B. Step 1 - The failed Bank is deemed to have received immediately before the sale of assets any "net worth assistance" which the FDIC provides in connection with the failure.[62] This federal financial assistance is taxable to the failed Bank, limited by a relatively complicated formula in subparagraph (c) of Regulation 1.597-2.

1. Begin with the gross federal financial assistance received.

2. The amount which a bank "without continuing equity," [the reference for a failed

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[62] Regulation section 1.597-5(c)(1) and 1.597-2(a)(1).

bank][63] must include in income is limited to the lesser of:

a. The financial assistance received from the FDIC, or

b. The sum of:

(1) The excess at the beginning of the taxable year of the institution's liabilities over the adjusted bases of assets; and

(2) The amount of the current net operating loss for the year (other than net operating and capital loss carryovers) is greater than the net tax basis in assets at the beginning of the taxable year.

c. Stated differently, the federal financial assistance included in current taxable income is limited to the amount needed to offset either:

(1) The net deficiency in the Bank's income tax basis in its assets at the beginning of the year plus the current year-to-date net operating loss, or

(2) If there was no deficiency at the beginning of the year, the deficiency caused by the current year net operating loss.

3. Any amount not included in current income is deferred, and is included in later income to the extent that the net operating loss for such future year exceeds the institution's remaining equity as of the beginning of the taxable year, if any.

4. In lieu of deferring the federal financial assistance, the Bank may elect to include all of the financial assistance in taxable income in the year received.

C. Step 2 - The FDIC "sells" the assets of the failed Bank on behalf of the Bank.

1. The cash assistance provided by the FDIC is treated as an asset of the failed Bank that is sold to the buyer.

2. To the extent that the FDIC conducts further transactions on behalf of the Bank after the initial closing, those also are included in the failed Bank's return.

a. There could be repeated sale transactions over more than one taxable year.

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[63] A bank with continuing equity is addressed in subparagraph (3) and applies to open bank assistance.

3. The "amount realized" from the sale of assets is cross referenced to Section 1001(b), which is essentially the liabilities assumed.

4. As with the buyer, the amount realized is allocated among the assets sold consistent with Regulation 1.338-6 with the following modifications.

   a. Stock of a consolidated subsidiary is a Class II asset to the extent the fair market value of the consolidated subsidiary's Class I and Class II assets exceeds the amount of its liabilities.

   b. The fair market value of an Agency obligation is deemed to equal its adjusted issue price immediately before the taxable transfer.

   c. The fair market value of an asset covered by a loss guarantee immediately after the taxable transfer is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put.

5. Gain or loss is the normal calculation of the difference between the income tax basis in the assets sold and the allocated proceeds.

   a. Having reported the assistance in taxable income, the failed Bank also has income tax basis in the FDIC assistance for purposes of the gain or loss.

   b. If the failed Bank is a cash basis taxpayer:

      (1) The accrued interest receivable acquired by the buyer is deemed to have been collected in the sale and is included in taxable income.

      (2) The accrued interest payable is deemed to have been paid to the extent that it was assumed by the buyer and are included in deductible interest expense.

      (3) Prepaid expenses which have benefit to the buyer are included in taxable income under the tax benefit rule.

      (4) Assuming that the prepaid FDIC insurance premium was not deducted in the year paid,[64] the unamortized balance would be a "loss" under Section 165 at the failure date.

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[64] The National Office of the Service told the American Bankers Association in 2009 that the prepaid FDIC insurance premiums were not deductible in the year paid by either cash or accrual method taxpayers because the prepayment period exceeded one year. There was also an issue whether for income tax purposes the prepayment was really a prepaid expense or a loan to the FDIC.

(5) To the extent that other prepaid expenses are not transferable to the buyer, they are either (i) not recaptured, or (ii) a "loss" under Section 165 as appropriate.

D. Tax return issues that arise in connection with compliance by a failed bank.

1. When is the return due?

a. The return is due on the normal date two and one-half months after the end of the tax year.

2. When does the company file a final return?

a. If there is a bank holding company, when the holding company liquidates and dissolves. That might be anywhere from a few months to a year or more after the bank fails.

(1) In most cases, the bank holding company will file for bankruptcy. However, a corporate bankruptcy does not terminate the taxpayer or create a separate taxpayer. The BHC must continue to file returns until the bankruptcy is complete and the corporation dissolves.

(2) If the bank is not "disaffiliated" and the bank holding company dissolves, then the consolidated group is terminated [there is no longer a common parent], and the bank begins filing a stand alone return until the receivership is finalized and the bank dissolves and liquidates.

b. For a stand alone bank, when the Receivership is finalized and the company dissolves and liquidates, which may also be several years.

3. Who signs the tax returns after the FDIC closes a bank?

a. It appears relatively clear that an officer of the company should sign the returns. The Company has not disappeared as a taxpayer; the FDIC has merely taken custody of the assets as Receiver.

b. This would be particularly true for bank holding company consolidated return groups, whether S or C. The holding company is the "agent" for the consolidated group, and it is not under the jurisdiction of the FDIC. A FSA implies that the FDIC

doesn't even have authority to sign for the holding company.[65]

c. In the case of a stand alone bank, the FDIC is authorized to sign as Receiver of the bank, but it would not appear improper for an officer of the bank to sign.

(1) The author understands that the FDIC receiver will sign if the officers of the Company refuse to do so.

4. Who pays any post-closing tax liabilities?

a. Section 7507 exempts insolvent banks from tax to the extent that the tax would reduce the amount available to pay depositors. Section 7507 reads in relevant part:

"Whenever and after any bank has ceased to do business by reason of insolvency or bankruptcy, no tax shall be assessed or collected, or paid into the Treasury of the United States, on account of such bank or trust company, which shall diminish the assets thereof necessary for the full payment of all its depositors; and such tax shall be abated from such national banks as are found by the Comptroller of the Currency to be insolvent; and the Secretary, when the facts shall appear to him, is authorized to remit so much of the said tax against any such insolvent banks and trust companies organized under State law as shall be found to affect the claims of their depositors."

b. The immunity only extends to a bank that is "insolvent" when the FDIC is appointed Receiver. This is illustrated in Field Service Advice 1999-568, in which the Service states:

"For section 7507(a) to apply, it is required that the bank cease to do business by reason of insolvency. The "mere allegation of insolvency" is not sufficient. Treas. Reg. section 301.7507-7(a). "It must be affirmatively established to the satisfaction of the district director that collection of tax will be contrary to section 7507." Id. Moreover, "insolvency" within the context of section 7507(a) means asset insolvency (i.e., liabilities in excess of assets) since it obviously contemplates a situation where there are not sufficient assets to pay depositors and other creditors.

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[65] Field Service Advice 1999-568 deals with executing a consent to the assessment of tax rather than signing a return, but the context is analogous. In the FSA, the Service states, "Generally speaking, the FDIC is authorized to execute a consent to assessment for a bank for which it is receiver. However, since the tax liability at issue is a liability of the consolidated group of which the bank is a member, and since the Service has not chosen to deal with each member separately, only the parent of the group is authorized and required to execute a consent to assessment of the consolidated group's tax liability."

"In the case under examination, the FDIC has totally failed to show that the Bank was insolvent for purposes of section 7507. To the contrary, it seems clear from the Assistance Agreement and reported accounts of the transaction that the Bank's assets exceeded its liabilities. Because of this, and since payment of taxes would not diminish assets necessary for payment of depositors, section 7507(a) does not prevent assessment and collection of taxes owed to the Service"

(1) Accordingly, an FDIC receivership that occurs when the bank's capital has fallen below the minimum level and the bank became subject to "prompt corrective action" does not make the bank immune from taxes.

c. A C corporation, stand alone bank that is insolvent should not owe any income tax to the IRS.

(1) However, not all states follow the federal immunity. Nebraska is an example.

d. If the C corporation stand alone bank is not insolvent, the tax liability will be paid from assets left over, if any, after the FDIC is finished with its Receivership. The tax liabilities will have the same priority as in any ordinary bankruptcy.

e. The situation is not so clear if the failed bank is controlled by a C corporation bank holding company that files a consolidated return.

(1) The immunity is from the collection of tax, not from recognizing the taxable income. This is key in the consolidated return context because under Regulation 1.1502-6(a), "the *common parent corporation and each subsidiary which was a member of the group* during any part of the consolidated return year *shall be severally liable for the tax* for such year computed in accordance with the regulations under section 1502 prescribed on or before the due date (not including extensions of time) for the filing of the consolidated return for such year." [italics added]

(2) In three technical advice memoranda, the Service held that an insolvent industrial loan company was immune from collection of the consolidated tax liability, but pointedly avoided mention of whether the parent was immune from collection of the consolidated liability.

"The immunity from collection under section 7507 also applies to an institution's tax liabilities that arose from its inclusion in a consolidated group. Section 1.1502-6(a) of the regulations provides that each member of an affiliated group of corporations filing a consolidated return is severally liable for the taxes due from the group. Each member of the consolidated

group is directly liable for the total tax liability of the group. Thus, assessment and collection of this tax, including interest and penalties related thereto, are prohibited from a financial institution entitled to protection under section 7507." [66]

The FDIC will certainly take the position that a C corporation bank subsidiary does not owe any tax to its parent holding company under the tax sharing agreement because of Section 7507. Such an intercompany payment would be contrary to the intent of the Code not to reduce the assets available to pay depositors by taxes.

(3) The C corporation parent is probably liable for the full tax liability of the consolidated group, including any net taxable income of the immune bank subsidiary.

f. An S corporation bank would not pay built-in gain tax on the sale of its assets if the bank fails during the built-in gain recognition period.

g. However, a QSub bank is not the "taxpayer." The bank has been liquidated for tax purposes, and it appears that the S corporation bank holding company would not have immunity under Section 7507 and would owe the tax.

h. The S corporation shareholders clearly do not have immunity and would owe tax on the taxable income of either a failed S corporation bank or a QSub bank.

(1) For this reason, counsel and tax advisers to a failing bank need to consider together whether the shareholders should either (a) revoke the S corporation election, or (b) have the S corporation revoke the bank's QSub election before the bank fails.

(2) If the S corporation election is revoked, it is also necessary to obtain the shareholder consents to the cut-off election to achieve the objective of shielding the shareholders from gain on the sale of the bank's assets or discharge of debt income.

5. Who benefits from any tax refunds from net operating loss carrybacks?

a. If the taxpayer is a stand alone C corporation bank, the refund is a bank asset which the FDIC will use to pay depositors.

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[66] Private Letter Ruling 9436056.

b. If the taxpayer is a consolidated C corporation group, the parent holding company will literally receive the refund.

(1) The FDIC should claim the bank's share of the refund under either (a) the tax sharing agreement, or (b) the regulatory policy on intercompany tax sharing.

(2) Whether the holding company will be able to keep the refund resulting from its separate losses is a legal question.

(3) The Wall Street Journal had an interesting article discussing litigation between the FDIC and Corus Bankshares Inc., the parent of the failed Corus Bank over "more than $257 million" in tax refunds stemming from the bank's failure. The litigation was filed in U. S. Bankruptcy Court because Corus Bankshares had filed for Chapter 11 protection.[67]

c. If the taxpayer is an S corporation, the shareholders are the taxpayers, the losses will be reported in their individual returns, they will file the refund claims,.and they will receive the refunds directly.

(1) Whether the FDIC has an enforceable claim on the shareholders is a legal question. Such a claim would not seem to flow from tax law, but may flow from either banking law, the FDIC insurance act, or state law.

XVI. Tax Exempt Interest

A. The 20% interest disallowance in the American Recovery and Investment Act will be with us for many years, even though the period for issue of eligible tax exempt bonds expired December 31, 2010.

1. The Act reduced from 100% to 20% the disallowance of interest expense to carry bonds that were (i) *issued* during calendar years 2009 and 2010 and (ii) were not "bank qualified small issues."

a. Because of the way the amendment was drafted, the ARRA bonds are included in the same provisions as Qualified Small Issues for purposes of the 20% disallowance.

b. Accordingly, if the S corporation has a zero disallowance rate on Qualified Small Issues under the *Vainisi* decision, the disallowance rate on the ARRA bonds is also

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[67] August 18, 2010.

zero.

2. Bonds issued during 2009 and 2010 will be eligible for the 20% disallowance until the bond is called or matures, not just for two years.

3. The bonds are not required to be purchased in 2009 and 2010; just that they be issued during those two years. These bonds might be quite liquid in the secondary market after 2010 if they are viewed as desirable investments by banks trying to maintain their pool of 2009 and 2010 bonds at two percent of average assets.

4. There are three exceptions to the 20% disallowance.

   a. The reduced rate only applies up to 2% of the bank's income tax basis in total assets. 2009 and 2010 bonds in excess of the 2% limit continue to be subject to the 100% disallowance.[68]

      (1) The 2% limit is based on average assets for the year [i.e. the amount calculated under Section 265(b)(2)(B)].

   b. The reduced rate does not apply to *refunding bonds*.[69]

      (1) "Refunding Bonds" is not defined in the Act or in the Committee Report, despite having been used repeatedly in both.

      (2) The only definition in the Code or Regulations is in Regulation 1.150-1(d), which might not technically apply to all tax exempt bonds purchased by banks. That section states in relevant part:

      "Regulation 1.150-1(d) Definition of refunding issue and related definitions. (1) General definition of refunding issue. Refunding Issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a prior issue, as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue. ..."

      "(5) Prior issue. Prior Issue means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for

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[68] Section 265(b)(7)(B).

[69] Section 265(b)(7)(C).

with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue."

(3) Technical Advice Memorandum 9831003 also discusses whether a bond is a "refunding bond", but it too is not entirely clear in its holding. A University paid for construction projects with short-term taxable loans. The local government then "fronted" a 501(c)(3) tax exempt bond for the University. The facts state that "$a" of the proceeds were used to pay off the loans. It is not said in the TAM that "$a" was only part of the bond proceeds, but that is clearly implied. The IRS National Office held that the bond was a "refunding bond", stating in relevant part:

"The [short term] Loan, a taxable obligation, was retired with $a of the proceeds of the Bonds. The Loan is a valid evidence of indebtedness and thus does constitute an "obligation" within the meaning of section 1.150-1(b). The Loan is therefore a "prior issue" for purposes of section 1.150-1(d)(5). Because proceeds of the Bonds were used to redeem the Loan, the Bonds are a refunding issue within the meaning of section 1.150-1(d)(1)."

(a) The TAM is not entirely satisfactory because it does not specifically state whether the whole bond is a refunding bond or just the part used to repay the loan. It does, however, refer to the "issue" in the singular, suggesting that it cannot be divided.

(4) Absent authority to split a bond in two parts, counsel with whom the author has discussed the issue suggest to the author that if any part of the proceeds of a bond is used to repay a prior obligation, except for the one year's interest exception in the Section 150 Regulation, then the whole bond is a refunding bond.

c. The reduced rate does not apply to bank qualified small issues.

(1) This is logical because these bonds are already subject to a 20% disallowance. The bank should not use up its 2% pool by purchasing bank qualified small issues issued in 2009 and 2010.

5. The ARRA bonds are best illustrated by an example. Assume the following facts:

Income tax basis in average total assets	$100,000,000
The 2% of average assets limitation in Section 265(b)(2)(B)	2,000,000

Purchases of 2009 issued bonds that *are not* bank qualified small issues	2,100,000
Purchases of 2009 issued bonds that *are* bank qualified small issues	800,000

Interest to carry the $2.9 million in 2009 bonds is calculated as follows:

Subject to the 100% disallowance	$100,000 - i.e. the bonds that are not bank qualified small issues in excess of $2 million
Subject to the 20% disallowance	$2,800,000 - i.e. the bank qualified small issues plus the $2 million excluded from the 100% disallowance

6. *Decision Tree* - The following is a decision tree regarding the reduced interest disallowance.

   a. Was the bond issued during 2009 or 2010? If yes, go to "b." If no, stop, the bond is not eligible.

   b. Is the bond a refunding of a bond issued prior to 2009. If yes, stop, the bond is not eligible. If no, go to "c."

   c. Is the bond a designated "qualified small issue?' If yes, stop, the bond already has a 20% disallowance and it does not "use" any of the bank's 2% of total assets pool. If no, go to "d."

   d. Has the bank exceeded its 2% of assets limit. If yes, stop, the bond will be subject to the 100% disallowance. If no, exclude the bond from the numerator of the 100% interest disallowance calculation and include it in the numerator of the formula for the 20% disallowance.

B. Tax exempt loans and leases. There are two requirements in Section 149 for an obligation to be tax exempt under Section 103(a).

   1. Registration [Section 149(a)]

      "(a) Bonds must be registered to be tax exempt. (1) General rule. Nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required bond

unless such bond is in registered form.

"(2) Registration-required bond. For purposes of paragraph (1), the term 'registration-required bond' means any bond *other than a bond* which-

(A) is not of a type offered to the public,
(B) has a maturity (at issue) of not more than 1 year, or
(C) is described in section 1 63(f)(2)(B)" [italics added]

a. If the asset is not registered, and does not qualify for an exemption, the interest is simply not tax exempt.

b. Fortunately, the exemptions in Section 149(a)(2) cover most small dollar and short term obligations.

2. An information report to the IRS under Section 149(e).

a. Information reporting and registration are separate requirements.

b. The information report is made on Form 8038 or 8038-GC.

c. If the Form 8038 or 8038-GC is not filed, the interest is not exempt regardless of whether the issuer is an exempt issuer.

(1) There is no exception in Section 149(e) for small issues, or less formal loan agreements.

"(e) Information reporting. (1) In general. Nothing in section 103(a) or any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond unless such bond satisfies the requirements of paragraph (2).

"(2) Information reporting requirements. A bond satisfies the requirements of this paragraph if the issuer submits to the Secretary, not later than the 15th day of the 2d calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement), a statement concerning the issue of which the bond is a part which contains [and there follows a list of the required information that is reflected on Form 8038-G or -GC as applicable]."

d. There is a special form, with its own instructions [Form 803 8-GC] for issuers to use to report the information on small issues. There is even a special rule for small

issues that allows a single report at the end of the year for all small issues by the same issuer, rather than filing the form with each issue.

(1) Form 803 8-GC includes leases and installment sales.

3. Revenue Procedure 2002-48 provides the procedures for a government issuer to apply for an extension of time to file the information report.[70]

   a. If the extension is granted, the tax exemption for the interest is salvaged.

   b. File the appropriate form as promptly as is reasonably practical after discovery of the failure.

   c. Type or print "Request for Relief under Section 3 of Rev. Proc. 2002-48" in the top margin.

   d. The extension is deemed accepted if the Service does not notify the issuer to the contrary within 90 days after the Service's receipt of the request.

C. In addition, Section 265(b) provides that to be a bank qualified small issue tax exempt obligation, the bond, loan, lease, etc., the issuer must:

1. Represent that it will not issue more than $10 million in tax exempt obligations during the year, and

2. Formally "designate" the borrowing as a small issue tax exempt obligation.

   a. If the designation is not made, then the asset is a Section 265(b) asset, not a Section 29 1(e) asset, and the disallowance is 100%, not 20%.

3. The designation is commonly included in the bond indenture itself.

4. However, the designation is often overlooked in loans and leases that are done without the benefit of bond counsel.

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[70] The instructions to Form 8038-G and-GC both still refer to revenue Procedure 88-10. However, Revenue Procedure 2002-48 states that it supercedes Revenue Procedure 88.10

Both Revenue Procedures 88-10 and 2002-48 reiterate the absence of any exception from information reporting. Section 2.04 states in relevant part, "Section 149(e)(1) of the 1968 Code provides that interest on a state or local bond will not be excludable from gross income unless certain information reporting requirements are satisfied. The issuer must submit a statement that contains the information required under Section 149(e)(2)."

a. The author has searched unsuccessfully for guidance on the deadline for making the designation.

(1) It is generally thought to be contemporaneously with the loan.

(2) The author has heard of examining agents being willing to accept “missing” designations obtained during the examination.

XVII. Losses on FNMA and FHLMC Preferred Stocks

A. This is an "old" issue that surfaced when both the FNMA and FHLMC went into receivership.

B. Section 301 of the Emergency Economic Stabilization Act of 2008 [the first "Stimulus" act] changed the losses from capital to ordinary. Section 301 applies:

1. Only to FNMA and FHLMC preferred shares. Common shares of FNMA and FHLMC which the bank may still hold from the public offering are not "ordinary" under the Act.

2. Owned by a bank or thrift, a bank or thrift holding company, or a nonbank subsidiary of a bank or thrift [but not a nonbank subsidiary of a bank or thrift holding company].

3. Held on September 6, 2008 [the day before both companies were placed in government receivership]; or sold or exchanged between January 1 and September 6, 2008 inclusive.

4. If the financial institution is a partner in a tax partnership [the so-called "auction rate preferred investments], and the tax partnership:

   a. Held the shares on September 6, 2008 and sold them after that date; or

   b. Sold the shares between January 1 and September 6, 2008, inclusive, or

   c. The partnership distributed the shares to the partners after that date to the financial institution in liquidation of the partnership.

Then the financial institution's losses are ordinary.[71]

5. Section 301 also applies to sales by a financial institution of an interest in a partnership if at least 95 percent in value of the partnership’s assets consisted of FNMA and

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[71] Note that the ordinary treatment of the financial institution’s loss is determined at the partner level, not the partnership level. Nonbanks invested in teh auction rate preferred partnerships still have capital losses.

FHLMC preferred shares and cash or cash equivalents.

C. Rev. Proc. 2008-64 provides guidance on the ordinary loss provisions.

1. Section 3 implements the intent of Congress to allow banks that had invested in the FNMA and FHLMC stocks indirectly through auction rate "partnerships" to have an ordinary deduction. Many people believed that the statute itself extended the ordinary deduction to auction rate preferred partnerships, but that was not the case. The statute authorized the Service to do so, and it has.

2. Section 4 grants ordinary treatment to losses on the sale by the bank of the auction rate preferred partnership interests during 2008 or thereafter (i.e. the sale of the interest in the auction rate preferred trust by the bank directly, rather than the sale of the underlying shares by the trust).

3. Section 5 grants ordinary treatment on losses incurred by the bank on FNMA and FHLMC shares distributed by the auction rate preferred partnerships in liquidation.

4. Section 6 extends ordinary treatment to sale of the stock by non-bank subsidiaries of the bank or thrift.

5. Section 7 extends ordinary treatment to shares received from a bank or thrift in a "tax free" exchange in which basis carries over from the transferor. In addition to facilitating the acquisition of banks holding the FNMA or FHLMC preferreds in type A or C reorganizations.

6. Section 7 also eliminates a concern that ordinary treatment might be lost by the deemed liquidation of the bank in an S and QSub election.

D. Section 301 does not apply to:

1. Common shares of FNMA or FHLMC.

2. Any other equity securities. FNMA and FHLMC are referred to by name.

3. "Partial worthlessness" of the FNMA and FHLMC preferred shares.

   a. They either must be sold and the loss incurred in that manner, or must become wholly worthless.

4. Losses on FNMA or FHLMC preferred shares held by nonbank subsidiaries of a bank or thrift holding company remain capital.

XVIII. Bank Owned Life Insurance

A. Surrender of BOLI Policy

1. All gain or loss is ordinary (Rev. Rul. Rev. Rul. 2009-13, citing Rev. Rul. 64-5 1; Rev. Rul. 61-201). – Surrender of the policy yields payment of the cash surrender value which is comprised of the residual investment and earnings thereon. All interest in the death benefit is forfeited.

2. Gain on surrender of the policy equals the excess of the proceeds received over the "investment in the contract" (Sec. 72(e)(5)).

   a. Investment in the contract equals the aggregate of premiums paid less the aggregate of amounts previously received which were Excludable from gross income under the rules of Section 72 (Sec. 72(e)(6)).

3. Loss on surrender of the policy equals the excess of the adjusted basis in the policy less the proceeds received.

   a. The adjusted basis of the policy equals the aggregate premium payments less the net cost of life insurance protection and any amounts previously received and treated as a recovery of investment. (Rev. Rul. 61-201; PLR 200945032)

B. Sale of BOLI Policy.

1. Gain on sale of policy is ordinary to the extent it does not exceed the excess of cash surrender value over aggregate premiums paid and not recovered previously via payments treated as return of investment as of the date of sale.

2. Gain is capital to the extent it exceeds the amount described in the preceding sentence. (Rev. Rul. 2009-13).

3. Gain on sale of policy equals the excess of the proceeds received over the adjusted basis of the policy.

   a. The adjusted basis of the policy equals the aggregate premium payments less the net cost of life insurance protection and any amounts previously received and treated as a recovery of investment. (Rev. Rul. 2009-13).

4. Loss on sale of policy *should* equal the excess of the adjusted basis of the property over the proceeds received.

a. The adjusted basis of the policy equals the aggregate premium payments less the net cost of life insurance protection and any amounts previously received and treated as a recovery of investment. (Based on the reasoning of Rev. Rul. 2009-13).

5. Fundamentally the policy is a capital asset. (Rev. Rul. 2009-13).

a. The Service has fairly consistently asserted the "substitute-for ordinary-income-doctrine" that "property" does not include claims for or rights to ordinary income.

b. Thus IRS have held that the portion of any gain attributable to the "inside build-up" is to be treated as ordinary income. But there appears to be an absence of published authority on the question of what is the character of a loss on sale?

C. BOLI, S Corporation Stock Basis and AAA

1. Premium expense is not deductible (Section 264(a)). It reduces basis but is not charged against AAA. (Rev. Rul. 2008-42).

2. Death benefit payments under a BOLI policy increase basis, but do not increase AAA. (Rev. Rul. 2008-42).

3. Premium expense and benefit payments adjust "Other Adjustments Account" as tax exempt income and related expenses. (Form 1120S Instructions)

XIX. Change in Control Issues

A. Section 382 change of ownership issues.

1. The current percentage Section 382 limitation on using net operating losses carried forward assures that substantial pre-change NOLs will never be used.

a. The November Section 382 rate is 3.41%.

(1) 3.41% multiplied by the 20 year carryforward period is only 68.2% even if the NOLs are "brand new" when the ownership change occurs.

2. The American Recovery and Reinvestment Act [the 2009 stimulus bill] repealed Internal Revenue Service Notice 2008-83 regarding the determination of built-in losses

subject to the limitations of Section 382 after a change of control.[72]

a. The repeal is effective for changes of control which closed (i) after January 9, 2009 or (ii) were not subject to a binding contract on January 9, 2009.

(1) The Act specifically exempted the TARP program as a change of control under Section 382.

(2) Essentially a codification of Notice 2008-100.

3. It is instructive to analyze IRS Notice 2003-65 to understand the importance of Notice 2008-83 to the banking industry. Notice 2003-65 provides two ways to determine the built-in gains and losses at the change date.

a. The Section 1374 Approach - Built-in gains and losses are the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change.

(1) This determination generally relies on the accrual method of accounting to identify built-in gains and losses. If a taxpayer using an accrual method of accounting would have included the item in income or been allowed a deduction for the item before the change date.

(2) However, there is a special exception to this general rule for bad debt deductions. Any bad debt deduction properly allowed during the first 12 months after the change date is treated as built-in loss if the loss is on a debt owned by the loss corporation on the change date.

b. The 338 approach identifies built-in gains and losses generally based on the gains and losses that would have been recognized by the loss corporation in a sale of assets under Section 338.

(1) Built-in gains and losses are calculated in the same manner as under the 1374 approach, except that:

(a) The loss corporation’s actual accounting methods are used rather than the accrual method; and

(b) Most importantly for banks, there is no special rule for bad debts incurred

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[72] Section 1261 and 1262 of the Act.

in the first twelve months.

c. Notice 2003-65 materially impairs the value of troubled banks because whichever approach is used, there will be significant built-in losses subject to the Section 382 limitation in addition to the existing net operating loss carried forward.

(1) In most cases, the acquirer will not be able to defer the charge-offs for a year [in fact purchase accounting is likely to push many of the charge-offs effectively to the closing date] for the Section 1374 approach to work.

(2) Purchase accounting is likely to establish even greater built-in loss under the Section 338 approach because the buyer's discount in valuing the loss becomes a built-in loss.

d. In an effort to maximize the value of the large, troubled banks that the Treasury wanted to "sell" without a "failure," Notice 2008-83 attempted to (i) "void" the special rule in the Section 1374 approach and (ii) avoid the purchase accounting issue in the Section 338 approach by simply excluding from built-in losses "any *deduction properly allowed* after an ownership change ...with respect to losses on loans or bad debts ... ."

(1) As noted in the Committee Report, a bad debt is not "properly allowed" until it is charged-off in accordance with regulatory standards.

e. Congress' voiding Notice 2008-83 materially reduces the value of a troubled bank to a profitable acquirer by making the entire "purchase discount" in loans a built-in loss.

(1) This is as much of an issue for community banks trying to make an acquisition before the target bank fails as for the large banks that were the focus of Congress' ire over Notice 2008-63.

B. Purchase of branch facilities

1. A purchase price allocation will generally include a fixed amount allocated to the cost of acquiring existing branch buildings, if taken as part of the deal.

a. Such allocations generally do not establish detailed fair market values for individual assets within the branch.

b. Absent a specific purchase price allocation, the practitioner will be required to depreciate real estate branch purchases over 39 years, not including land price

allocations

2. Cost segregation studies can perform a "purchase study" which utilizes a "replacement cost" approach to provide substantially faster depreciable lives for bank branch purchases.

   a. Most studies average 30% to 40% of the total cost being allocated to shorter lives.

   b. Note that even if the bank has a current tax loss, such a reclassification to shorter lives may be advisable, if the bank returns to profitability in the near future.

XX. Maintaining a Valid S or QSub Election

A. There is no self-help way to make a technically invalid election valid except to obtain a waiver from the IRS.

1. Bankers seem to believe that if they eliminate the problem and the statute of limitations closes, then the election is valid again. Not so. Once the election becomes invalid, it remains invalid until a new election is made or the IRS waives the termination.

2. What happens if an invalid election is discovered years later:

   a. The S returns are not invalid. There is ample case law that filing the wrong return in good faith is not a nonfiling that keeps the statute open forever.

   b. The three year statute normally applies.

      (1) Unless there are other issues in the company's return that omit more than 20% of gross revenue, the three year statute would apply to the company.

      (2) Similarly, the three year statute will normally apply to the shareholders because, absent a loss, they will have usually included more than the correct income.

   c. The "killer" is that the shareholders' basis adjustments to the shares is lost retroactive to the date of the invalidity of the election.

      (1) The statute of limitations on the tax basis in the shares does not start to run until the shares are sold.

B. Automatic waivers of invalid elections.

1. Revenue Procedure 2003-43.

a. Applies to late S elections, QSub elections, QSST elections, and ESBT elections.

b. Must be less than 24 months late.

c. No returns have been filed, or returns have been filed consistent with a valid election.

d. Procedure:

(1) Late S election.

(a) File a completed Form 2553 with the Service Center.

(b) All shareholders during the entire S corporation period must sign.

(c) Attach a declaration signed by every shareholder that the income was reported consistent with an effective S election.

(d) Attach a statement providing the "reasonable cause" for being late.

(e) Attach a penalties of perjury statement signed by an officer of the Company.

(2) Late QSub election.

(a) File a completed Form 8869 with the Service Center.

(b) Attach a statement that the company qualifies as a QSub and that returns have been filed consistently with a valid QSub election.

(c) Attach the "reasonable cause" statement.

(d) Attach the penalties of perjury statement.

(3) Late QSST election.

(a) File a completed election with the Service Center.

(b) Attach a statement that the trust qualifies as a QSST and that returns have been filed consistently with a valid QSub election.

(c) Attach the "reasonable cause" statement.

(d) Attach the penalties of perjury statement,signed by the *beneficiary* of the QSST.

(4) Late ESBT election.

(a) File a completed election with the Service Center.

(b) Attach a statement that the trust qualifies as a QSST and that returns have been filed consistently with a valid QSub election.

(c) Attach the "reasonable cause" statement.

(d) Attach the penalties of perjury statement signed by the *trustee* of the ESBT.

2. Revenue Procedure 2004-35

a. Applies solely to elections that are invalid because one or more spouses with community property interests in the S corporation shares did not sign the Form 2553.

b. Both spouses with a community property interest in the shares must sign the Form 2553. The Community Property states are:

Arizona	Idaho	Nevada	Texas	Wisconsin
California	Louisiana	New Mexico	Washington	

c. Procedure - File a Statement with the Service Center saying that it is filed under Revenue Procedure 2004-35.

(1) Include the names , addresses, and tax identification numbers of the corporation and of all the community property spouses.

(2) That each community property spouse reported the income consistently with the S election.

(3) Each spouse signs the penalties of perjury statement.

3. Revenue Procedures 2004-48 and 2007-62.

a. Applies only to relief for *both* a late classification election and a late S election. Will not normally have much application to banks because of the scarcity of LLC banks.

(1) An unincorporated entity intended to be classified as an S corporation but filed neither Form 2553 nor Form 8832, or Form 8832 was not deemed to have been filed under Regulation 301.7701 -3T(c)(1)(v)(C).

b. If no returns have been filed, Rev. Proc. 2007-62 applies.

(1) Attach a completed Form 2553 with all required signatures to the first timely filed Form 1 120S, including extensions.

(2) Indicate however it can be done electronically “Filed Pursuant to Rev. Proc. 2007-62."

(3) Attach a reasonable cause statement.

c. If returns have been filed, Rev. Proc. 2004-48 applies.

(1) Due within six months of the original due date of the first intended S corporation return.

(2) File a completed Form 2553 with the Service Center.

(3) Write in the top margin, “Filed Pursuant to Rev. Proc. 2004-48.”

(4) Attach a reasonable cause statement.

4. No user fee applies to any of the automatic waivers.

C. Nonautomatic waivers.

1. If none of the above Revenue Procedures apply, then must file with the National Office for a private letter ruling.

2. The user fee during 2011 is $14,000.

D. Suggested due diligence steps.

1. Have the beneficiary of every IRA account shareholder sign a disclosure statement regarding the application and scope of the BIT tax when the Form 2553 signatures are obtained.

2. Confirm ownership annually.

a. Send a positive confirmation with the Schedules K-1 that the shareholder still owns the stated number of shares, has no co-owners, has not transferred any shares during the year, and that the tax identification number on the Schedule K-1 is correct.

b. The author has been told by preparers who use this confirmation procedure that confirmations sent with the Schedules K-1 are usually returned, often by the preparer of the shareholder's return.

XXI. Miscellaneous Accounting Methods

A. What if a cash method C corporation with consolidated average annual gross receipts over $5 million misses its Section 448 year of change? Is the change to the accrual an automatic change.

1. Yes.

2. If the change is being made for a year *other* than the first Section 448 year, then the automatic change number is "122."

> "Designated automatic accounting method change number. The designated automatic accounting method change number for a change under section 14.1 of this APPENDIX for (a) a taxpayer not subject to § 448, or (b) a taxpayer subject to § 448 that is not making the change for its first § 448 year is "122."[73]

3. Other than the first Section 448 year may be either before or after the Section 448 year. Accordingly, even if the change is late, it is automatic.

B. Change of accounting methods by S electing banks from the accrual to the cash method pursuant to Rev. Proc. 2011-14, Appendix Section 14.12.

1. The change is automatic if average gross revenues are under $50 million.[74]

2. Section 14. 12(5)(a) has an unusual description of average annual gross receipts that many people have not observed.

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[73] Revenue Procedure 2011-14, Appendix section 14.01(7). Phrase (a) would apply to an S corporation bank voluntarily changing to the accrual method. Phrase (b) applies to a C corporation bank that is either voluntarily making the change before the first Section 448 year or that missed the Section 448 year and is making the change late.

[74] This is a change in rev. Proc. 2008-52. The previous threshold was $10 million.

"(a) Average annual gross receipts. A bank has average annual gross receipts not in excess of $50,000,000 if, for *each prior taxable year ending on or after December 31, 2006,* the bank's average annual gross receipts for the three prior taxable-year period ending with the applicable prior taxable year do not exceed $50,000,000. If a bank has not been in existence for three prior taxable years, the bank must determine its average annual gross receipts for the number of years (including short taxable years) that the bank has been in existence. See in existence. See Section 448(c)(3)(A)." [italics added]

a. If average gross receipts for 2006 or any year since were over $50 million, then the bank is not eligible for the automatic change even though average gross receipts for the year of change are less than $50 million.

3. Appendix Section 14.12(4) also includes the following "additional requirement" for an automatic change to the cash method.

"In addition to complying with all other applicable requirements, the Form 3115 must describe each specific item of the bank's income or expense that is affected by the change under this Section 14.12 of the APPENDIX and, for each such item, identify the following: the accounting method under which the bank reports that item for federal income tax purposes immediately before the change; and the amount of the §481(a) adjustment associated with changing that item to the cash method under this section 14.12 of the APPENDIX." [caps in the original][75]

a. Instead of simply calculating the accrual to cash transition adjustment as of the beginning of the year of change, the Form 3115 requires a schedule that would appear something as follows:

Income or expense affected by the change to the cash method	Method of reporting this item for federal income tax purposes before the change	Sec. 481(a) transition adjustment
Accrued interest receivable on investment securities	Accrual	$(xxx,xxx)
Accrued interest receivable on loans	Accrual	(xxx,xxx)
List the remaining accrued income accounts		

[75] This requirement that the Section 481(a) adjustment be identified by "item of income or expense" appears to be new in Rev. Proc. 2008-52.

Accrued interest payable on deposits	Accrual[76]	xxx,xxx
List the remaining accrued expense accounts		
Prepaid expenses	Accrual	(xxx,xxx)
Total Sec 481(a) Adjustment		$xxx,xxx

4. *De novo* banks:

   a. A *de novo* bank which is also making the S election is allowed to adopt the cash method regardless of its gross receipts.

   b. An independent, C corporation *de novo* bank is automatically allowed to use the cash method its first year. If the *de novo* bank is part of an affiliated group, then whether it can use the cash method is determined on the basis of the affiliated group's gross receipts.

      (1) If its first year gross receipts exceed $5 million, it must change to the accrual method the second year.

      (2) If its first year gross receipts are less than $5 million, and its second year receipts are over $5 million, but the average for the two years is less than $5 million, it may continue to use the cash method for the third year.

C. Prepaid Interest - Accrual method banks do not need to recognize prepaid interest when the payment is received. The claim of right doctrine does not apply. [Reg. 1.1273-2(g)]

D. Deferred loan fees.

1. This accounting method has been around since the first final Original Issue Discount Regulations were issued on February 2, 1994.

2. Loan fees and points reduce the issue price of the loan and create OID. [Reg. 1.1273-2(g)]

3. It is not important whether the borrower finances the fees (i.e. the bank disburses the loan net of the fees) or pays the fees from separate funds. The result is the same.

   "(g) Treatment of certain cash payments incident to lending transactions –

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[76] Accrued expenses may already effectively be on the cash method under Regulation Section 1.263(a)-4.

"(1) Applicability. The provisions of this paragraph (g) apply to cash payments made incident to private lending transactions (including seller financing).

"(2) Payments from borrower to lender - (i) Money lending transaction. In a lending transaction to which Section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. However, solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under Section 461(g)(2)."[77]

See also Example 1 in Reg. 1.1273-2(g)(5).

4. It is not important whether the bank is an accrual or a cash method taxpayer, the result is the same.

5. There is no financial statement consistency requirement.

   a. A small bank which is still on current recognition for book purposes may use the deferral method for tax purposes.

6. Only fees that are "interest" for the use or forbearance of money can be included in the deferral as OID.

   a. The easy example is points measured by the size of the loan.

   b. Charges to reimburse the lender for loan expenses (i.e. credit reports, appraisals, surveys, filing fees, taxes, etc) are offsets to the expense and are not included in the deferred fees.

   c. Nonrefundable loan application fees are a fee for services and are not included in the deferred fees.

7. Loan fees are recognized as OID over the life of the loan.

8. Deferred loan fees are not built-in gain when the bank makes the S election.

   a. They are not accrued income.

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[77] Sec 461(g)(2) related to pints paid on a loan secured by a principal residence which are deductible by the borrower in the year paid. Note that this exception applies only to the borrower, not the lender. It is consistent with the borrower's deduction for the points in the year paid.

b. They do not represent fair market value of the loan in excess of the income tax basis.

XXII. Calculating the Gross Receipts of a Bank.

The calculation of gross receipts of a bank is far more obtuse than one is likely to expect.

A. Method of Accounting - Gross receipts are determined under the taxpayer's existing tax accounting methods. The Regulation states in relevant part:

> "The term 'gross receipts' means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method *used in that taxable year* ... for federal income tax purposes."[78][italics added]

1. Accordingly, if there has been a change in accounting for any item of revenue during the three year period, the methods are not "conformed" to average gross receipts.

B. Schedule M-3 items that affect revenues, both positive and negative, are included in gross receipts.[79]

C. Calculating Gross Receipts from the Tax Return - Gross receipts are "gross income" on page 1 of the income tax return with the following adjustments, among others:

1. Tax exempt income must be added.[80]

2. Original issue discount, whether on taxable or tax exempt assets, is included in gross receipts.[81]

3. If the taxpayer uses the cash method of accounting, gross receipts are increased or reduced by the change in only the income items of the accrual to cash adjustment.

   a. This is important because the accrual to cash adjustment is often reflected as a single "net" item miscellaneous income or expense.

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[78] Regulation Section 1.448-1T(f)(2(iv)(A).

[79] This is not usually the source of an error because the related income lines on page 1 of the return are customarily adjusted to reflect the effect of the M-3 adjustments. However, the preparer needs to confirm that this is the case.

[80] Regulation Section 1.448-1T(f)(2)(iv).

[81] Regulation Section 1 .448-1T(f)(2)(iv). However, except for OID on tax exempt bonds, OID is usually already included in interest income on page 1 of the return.

(1) If the accrual to cash adjustment increases taxable, the net increase is included in miscellaneous income.

(2) If it decreases taxable income, the net adjustment is included in miscellaneous expense.

b. The accrued expense part of the accrual to cash adjustment does not affect "receipts."

c. Similarly, the change in prepaid expenses does not affect "receipts."

4. Gross receipts are reduced by returns and allowances made during such year,[82] but **not** by the cost of goods sold.[83]

a. This rule is not likely to have a significant effect on a bank, unless there is an affiliated business that has cost of goods sold, but it will have a major effect on other companies that sell products, such as manufacturers, retailers, restaurants, etc.

b. However, see below regarding sales of foreclosed collateral. OREO is considered by the Service to be held for sale to customers in the ordinary course of business, and it is likely that if the issue ever becomes important, the Service's position would be that gross receipts are the gross proceeds of sale of OREO.

5. Gross receipts do not include the repayment of a loan or similar instrument.[84]

a. "Loan" for this purpose would include investment securities which are paid at maturity or called by the issuer. If the issuer makes the payment, that is the "repayment of a loan."

6. Gross receipts do not include the adjusted income tax bases of depreciable assets or assets used in its business described in Section 1221(a)(2) which are sold.[85]

7. "... gross receipts do not include amounts received by the taxpayer with respect to sales

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[82] Section 448(c)(3)(C).

[83] Reg. Section 1.448-1T(f)(2)(iv)(A).

[84] Regulation Section 1.448-1T(f)(2)(iv).

[85] Regulation Section 1.448-1T(f)(2)(iv).

tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax."[86]

This statement probably has a number of analogous effects for banks

a. The amounts received by bank trust departments "in trust" should not be gross receipts.

b. The amounts received by the bank for escrows for property taxes and insurance should not be gross receipts.

c. The interest received by the originating bank that is servicing a loan for the participating bank(s) should not be gross receipts.

d. Similarly, the amounts received by a mortgage servicer on behalf of investors who own the mortgages should not be gross receipts.

e. The insurance premiums collected by insurance agencies on behalf of the insurance underwriters should not be gross receipts.

There are undoubtedly other examples of this principal in banks and other companies

8. Gross receipts should not include intercompany dividends or other intercompany payments.

a. In a C corporation consolidated group, intercompany dividends, rents, interest, et. al. are not received from "outside sources." Regulation Section 1.488-1 T(f)(2)(iv)(A) includes the following statement:

"For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources."

(1) This is important because in a proper consolidated return, intercompany dividends are eliminated in consolidation, but intercompany income and expense is not.

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[86] Regulation Section 1.448-1T(f)(2)(iv).

b. In an S corporation, in addition to not being from "outside sources," intercompany dividends and income and expenses between the S corporation and the QSub are disregarded transactions.

9. In a C corporation, gross receipts are not reduced by the dividend received deduction.

D. Asset Transactions - The most difficult issues involve asset transactions by banks and their holding companies.

1. Temporary Regulation 1.448-1T(f)(2)(iv) states in relevant part:

"Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property."[87]

2. It is the reference to "capital assets" that is so very troublesome for banks. If a debt security is sold in the market before maturity, are gross receipts reduced by the income tax basis in the security?

a. Regulation Section 1.448-1T(f)(2)(iv)(A) states in relevant part:

"With respect to sales of *capital assets as defined in section 1221,* or sales of property described in 1221 (2), ... gross receipts shall be reduced by the taxpayer's adjusted basis in such property." [italics added]

b. The relevant question is the proper relationship between the words "capital asset" and "as defined in section 1221."

c. Code Section 5 82(c)(1) states in relevant part:

"For purposes of this subtitle, in the case of a financial institution referred to in paragraph (2), the sale or exchange of a bond, debenture, note, or certificate or

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[87] The Temporary Regulation dates from 1991, before the Tax Relief Extension Act of 1999 divided Section 1221 into subsections (a) and (b). All of the cited sections are now part of Section 1221(a).

The citations to Section 1221(a)(1), (3), (4) and D(5) are not likely to apply to most banks. Sentence (1) is inventory. Sentence (3 is copyrights, literary, musical, or artistic compositions and letters or memoranda. Sentence (4) is accounts or notes receivable acquired in the ordinary course of business for services rendered or from the sale of property. Finally, Sentence (5) is publications of the U.S. Government

other evidence of indebtedness *shall not be considered a sale or exchange of a capital asset.*"[88] [italics added]

d. The conventional interpretation is that Section 582(c)(1) adds a ninth exception to the definition of capital assets in Section 1221(a) that applies specifically to banks. Accordingly, the debt securities are not "capital assets" and therefore, gross receipts are not reduced by the income tax basis in the securities sold.

e. Alternatively, Regulation 1.448-1T refers specifically to "capital assets as defined in section 1221 ... ." Investment securities, and loans discussed below, are not excluded from the definition of capital assets by any exception in Section 1221. Rather, the exclusion from capital assets is in Section 582. This reading of the Regulation would conclude that investment securities are capital assets as defined in Section 1221, are not any of the assets referred to in Subsections (1), (3), (4) or (5) of Section 1221, and therefore, gross receipts are reduced by the income tax basis in investment securities sold.[89]

3. The very same issue exists on the sales of loans, sales of originated mortgage loans, sales of loan participations, et. al. in the normal course of business. Again, the loans are not capital assets pursuant to Section 582(c)(1), and the sale proceeds are not "repayments" received from the borrower.

   a. Whether gross receipts are reduced by the principal amount of loans sold is controlled by the same analysis discussed above for investment securities.

4. Other Real Estate Owned and Other Foreclosed Collateral - The gross receipts from sales of "other real estate owned" is even more uncertain that investment securities and loans. There is no Code section defining the character of OREO.

   a. The Service steadfastly insists that foreclosed collateral, primarily real estate, is held for sale to customers in the ordinary course of business. The Audit Examination Guide for Commercial Banking states in Chapter 6, paragraph 5:

      "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 122 1(1) gains or losses are ordinary deductions."

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[88] "This subtitle" is subtitle A of the code, which includes Sections 448, 582, and 1221.

[89] From an economic and business operations perspective, this is certainly the more logical of the two interpretations.

b. If the Audit Guide is correct, then OREO and other foreclosed collateral which is held for sale is an asset referred to in Section 1221 (a)(1), and gross receipts are not reduced by the income tax basis in the OREO sold.

5. Operating OREO that is income producing is referred to in Section 1221(a)(2), so gross receipts should be reduced by the income tax basis in that OREO sold.

E. Aggregation - Gross receipts are aggregated for all businesses under common control as described in either Section 52(a) or (b) or in Section 414(m) or (o).

1. The 80% threshold for the parent-subsidiary controlled group is changed to 50%.

2. Section 52(b) brings commonly controlled LLCs, proprietorships, partnerships, or indeed any other form of business organization such as a Delaware Business Trust.

F. Attribution - The parameters of the family attribution for purposes of determining whether "related" businesses must be aggregated under the "gross receipts" test are not the common Section 318 rules. Section 448(c)(2) provides that all entities treated as a single employer under subsections (a) or (b) of Section 52 or subsections (m) or (o) of Section 414 are aggregated. The cross references lead eventually to 1563(e), which is a complete and stand-alone set of attribution rules, separate and apart from Code Section 318.

1. There are a number of differences between the attribution rules in Section 1563(e) and the attribution rules in Section 318. A few of the more notable differences are:

a. Stock owned by children *over* age 21 is not constructively owned by a parent who owns directly less than 50% of the stock.

b. Stock is not constructively owned by the spouse of the direct owner unless one of the following applies:

(1) The spouse owns stock directly, or

(2) The spouse is an employee, officer, or director of the business, or

(3) More than 50% of the gross income of the business is passive, or

(4) There are substantial restrictions on the disposition of the stock by the direct owner [spouse].

c. Attribution within the family is limited to two generations.

d. Options to acquire stock are considered exercised.[90]

e. Many of the attributions from entities to individuals are limited by a 5% *de minimis* rule.

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[90] Section 1563(e).

As of __________________[Date of Closing]

	Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis
Cost of Assets Purchased					
Cash paid at closing, if any					$0
Cash paid post-closing for purchase of assets:					
Premises					0
Personal propery					0
Loans					0
Other assets					0
Total Cash					0
Buyer's Capitalized Transaction Costs:					
Legal Fees					5,000
Accounting Fees					25,000
Due Diligence Expenses					0
Appraisal Fees					0
Other Capitalized Transaction Costs					0
Total Capitalized Transaction Costs					30,000
Liabilities Assumed:					
Deposits					
Insurred Deposits	$65,000,000	$0	$65,000,000		65,000,000
Uninsured Deposits	0	0	0		0
Brokered Deposits	10,000,000	(10,000,000)	0		0
Any Other Deposits NOT Assumed	0	0	0		
Total deposits	75,000,000	(10,000,000)	65,000,000		65,000,000
Fed Funds Purchased	0	0	0		0
Accrued Interest Payable					
Assumed	100,000	0	100,000		100,000
NOT Assumed	40,000	(40,000)	0		
Accrued Expenses & Other Liabilities					
Accrued Salary	0	0	0		0
Accrued Vacation Pay and/or Sick Leave	95,000	(95,000)	0		0
Accrued Deferred Compensation:					
Assumed	0	0	0		0
Not Assumed	0	0	0		
Federal Home Loan Bank Loans	0	0	0		0
Accrued Interest Payable	0	0	0		0
Federal Reserve Bank Loans	0	0	0		0
Accrued Interest Payable	0	0	0		0
Subordinated Notes Payable	0	0	0		0
Accrued Interest Payable	0	0	0		0
Subordinate Notes Payable	0	0	0		0
Accrued Interest Payable	0	0	0		0
Trust Preferred Notes	0	0	0		0
Accrued Interest Payable	0	0	0		0
Other Liabilities	0	0	0		0
Accrued Interest Payable	0	0	0		0
Deferred Income Tax Liabilities	0	0	0		

As of ________________[Date of Closing]

	Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis
Other Liabilities	30,000	(30,000)	0		0
[enter description]	0	0	0		0
[enter description]	0	0	0		0
Total liabilities	75,265,000	(10,165,000)	65,100,000		65,100,000
Shareholders' equity:	500,000	(500,000)	0		
Total liabilities and shareholders' equity	$75,765,000	($10,665,000)	$65,100,000		
Total Cost of Assets Acquired					$65,130,000
Assets Purchased:					
Class I Assets:					
Cash and Due from Banks	$6,400,000	$0	$6,400,000		$6,400,000
Cash from the FDIC at Closing		1,500,000	1,500,000		1,500,000
Cash proceeds of pre-arranged asset sales		0	0		0
Class II Assets:					
Certificates of Deposit	0	0	0		0
Federal Funds Sold	0	0	0		0
Publicly Traded Investment Securities					
US Government and Agencies	13,800,000	0	13,800,000	0	13,800,000
State and Local	0	0	0	0	0
Corporate	0	0	0	0	0
Other Securities	2,800,000	(2,800,000)	0	0	0
Accrued Interest Receivable - Securities					
US Government and Agencies	0	0	0	0	0
State and Local	0	0	0	0	0
Corporate	0	0	0	0	0
Other Securities	0	0	0	0	0
Federal Home Loan Bank Stock	0	0	0	0	0
Loans Covered by Loss Sharing Agreements or Other Agency Guarantees [@ minimum realizable value, including agency guarantees]	24,700,000	0	24,700,000	(4,940,000)	19,760,000
Accrued Interest Covered by Guarantee Agmts	105,000	0	105,000	(21,000)	84,000
Other Real Estate Owned and Other Assets Covered by Loss Sharing or Guarantee Agmts	1,300,000	0	1,300,000	(260,000)	1,040,000
Purchase Price Minus the Sum of the Class I and Class II Assets (If positive, continue the allocation)					**22,546,000**
(If negative, stop, and include the negative amount in taxable income over six years}					
Class III Assets:					
Loans NOT Covered by Any Agency Assistance:					
Unclassified Loans Purchased	24,600,000	0	24,600,000	(300,000)	22,536,726
Accrued Interest Receivable on Performing Loans	10,000	0	10,000	0	9,274
Material Classified Loans Individually Valued	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0

As of ________________[Date of Closing]

	Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis
Pools of Substandard Loans Purchased					
Real Estate Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Farm Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Commercial and Industrial Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Loans to Individuals	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Pools of Doubtful Loans Purchased					
Real Estate Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Farm Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Commercial and Industrial Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Loans to Individuals	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Other Loans	0	0	0	0	0
Accrued Interest Receivable	0	0	0	0	0
Nonperforming Loans NOT Purchased	1,400,000	(1,400,000)	0		
Accrued Interest Receivable NOT Purchased	30,000	(30,000)	0		
Reserve for Loan & Lease Losses	(1,800,000)	1,800,000	0		
Class IV Assets					
Inventory; usually none in a bank	0	0	0	0	0
OREO, not covered by the loss-sharing agreement	0	0	0	0	0
Class V Assets:					
Fixed Assets					
Land	0	0	0	0	0
Buildings	700,000	0	700,000	0	0
Accumulated Building Depreciation	0	0	0	0	
Personal Property	0	0	0	0	0
Accumulated Depreciation	0	0	0	0	
Other Assets					
Prepaid Expenses	100,000	0	100,000	(20,000)	0
Misc other assets	70,000	0	70,000	0	0
Tax receivables ets	750,000	(750,000)	0	0	0
Deferred Income Tax Assets	450,000	(450,000)	0		
Net Purchase Price Available for Class VI & VII Assets					0
Class VI Asssets					
Section 197 Intangibles					
Core Deposit Intangible Assets	350,000	(350,000)	0	0	0
Accumulated Amortization	0	0	0	0	
Class VII Assets					
Goodwill	0	0	0	0	0
Accumulated Amortization	0	0	0	0	
Total Assets	$75,765,000	($2,480,000)	$73,285,000	($5,541,000)	$65,130,000
	0		0		0

As of ___________________[Date of Closing]

	Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis

Instructions

Cells shaded in green are intended to be input cells. Cells in white with numbers are formulas and should not have to be changed unless I have an error in the formulas. White cells without numbers are intended to be blank, such as Column D and E for deferred taxes because the buyer never reflects any of the failed bank's deferred taxes in the tax allocations. Similarly, Column F for accumulated depreciatioin and amortization.

If the buyer pays any cash to the FDIC, that is entered in Column F, Line 10 and becomes part of the purchase price for the assets.

It is the position of the IRS National Office that any subsequent purchases and sales betweeen the successful bidder and the FDIC is part of a single transaction pursuant to the step transaction doctrine. Accordingly, if the successful bidder purchases the premises, fixed assets, loans, or other assets after the closing pursuant to options in the purchase agreement, this is treated as additional purchase price and the subsequently acquired assets are included in the allocation schedule.

The buyer's capitalized transaction costs are also entered in Column F and become part of the purchase price for the assets.

The total purchase price for the acquired assets appears in Column F, Line 62.

Column B is the book value of assets and liabilities of the failed bank..

Line 59 should total to the liabilities of the failed bank.

Line 162 should equal the total book value of the assets of the failed bank immediately before the closing.

Lines 61 and 162 should be equal. That is the purpose of the check total in line 164.

Column C is the liabilities and assets that are not acquired by the acquiring bank; i.e. any liabilities or assets retained by the failed bank or by the FDIC. Amounts should be entered as negative amounts.

If there are unrecorded liabilities that the buyer assumes, they should be entered as a positive amount in Column C.

Similarly, if there are book liabilities for which the buyer is not obligated to make any payment, they should be entered as negative amounts in Column C..

Column D is the sum of Columns B and C.

Column E is the fair market value adjustments in the transaction.

The liability section is all blank because from a tax perspective, one does not adjust any liabilities to fair value. The purchase price includes all liabilities at the amounts owed.

Allocation of the purchase price on Line 62 among the assets [Regulation 1.597-5]

The purchase price is allocated among the assets according to the classes provided in the Section 338 Regulations with a few adjustments.

Class I is the cash and due from banks of the failed bank which is acquired by the acquirer.

Class I also includes the cash provided by the FDIC to balance the closing transaction. [Note, this cash is federal financial assistance and is taxable income to the failed bank; not to the acquirer. Reg 1.597-5(c)(1)].

On occasion, the successful bidder will have arranged during the bid preparation for the immediate resale of some asset. The resale price is, of course, reflected in the bid. Under the step transaction doctrine, the purchase and resale of that asset by the successful bidder is disregarded, and the cash proceeds from the resale are reflected as "purchased cash" in the asset allocation.

The fair market value allocated to the Class I assets is their par value.

Class II assets are certificates of deposit held by the failed bank as investment assets, publicly traded securities and related accrued interest.

Class II assets also include any assets (principally loans, accrued interest receivable, and OREO) which are acquired subject to any form of loss sharing agreement, yield maintenance agreement, cost to carry or cost of funds reimbursement agreement, etc.

FDIC guarantees to the buyer against losses on loans are not separate assets. Rather they are part of the fair market value of the loans. Reg. 1.597-5(d)(2)(ii)..

The fair market value of the Class II assets is:

With respect to certificates of deposit, their face value.

With respect to traded investment securities, their fair market value as of the transfer date.

With respect to assets subject to FDIC or other agency guarantees, the MINIMUM REALIZABLE VALUE, INCLUDING THE MAXIMUM AGENCY GUARANTEE PAYMENTS.

Federal Home Loan Bank stock is sometimes retained by the FDIC and redeemed by the FHLB. However, it is also sometimes acquired by the successful bidder. In this case, the FHLB stock does not fit well within any of the Class descriptions. It looks like a government security because it has a fixed value and cannot be traded except to the FHLB. On the other hand it is not a publicly traded security. On balance, the author suggests including it in Class II as more similar economically to Class II assets than Class V assets.

As of ____________________[Date of Closing]

Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis

Note - IF THE FAIR MARKET VALUE OF THE CLASS I AND CLASS II ASSETS EXCEEDS THE PURCHASE PRICE, THE EXCESS IS INCLUDED BY THE BUYER IN TAXABLE INCOME RATABLY OVER SIX YEARS. Reg. 1.597-5(d)(2)(iii).

Class III assets are loans, and the related accrued interest receivable, that are not subject to agency guarantees.
One cannot "purchase" a reserve for loan and lease losses. To the extent that a reserve is reflected in the allocation of the purchase price of the loans, it is a FMV adjustment to the loans. Accordingly, I usually suggest that the FAS 5 reserve for losses be ignored in the tax allocation, and that the unclassified loans be valued at their outstanding balance. The buyer will then not be required to maintain separate accounting for the purchased loans, to forgo a deduction for actual charge-offs as incurred, or to recognize taxable income as each loan is collected in full.
Purchase price is allocated to the Class III assets equal to either the lesser of (i) the balance after the allocation to the Class I and Class II assets or (ii) the fair market value of the loans as reflected in the buyer's analysis of the transaction. If the amount available to allocate to the Class III assets is less than the sum of their fair values, the available purchase price is allocated among the Class III assets pro-rata to the total fair values.

Class IV assets are inventories, which banks typically do not have.
Note - A securities trading account, which is typically accounted for as inventory, is included in Class II for this purpose.
Note - The IRS National Office also believes that OREO which is not covered by the loss-sharing agreement is a Class IV asset because it is held for sale to customers in the ordinary course of business.

Class V are all other assets, including premises, depreciable personal property, prepaid expenses, etc.
Prepaid expenses are not allocated value except to the extent that they are available to benefit the buyer.
Note, deferred income tax assets cannot be acquired by the buyer. Similarly, income tax liabilities are never included in the pruchase price except to the extent of current liabilities assumed by the buyer.

Class VI assets are Section 197 intangibles; typically the intangible value of core deposits.
The purchase price allocated to Section 197 intangibles is usually the lesser of (i) the available purchase price remaining after the allocations to Classes I through V or (ii) the amount allocated for financial reporting purposes.

Class VII assets are goodwill, which is whatever balance of the purchase price is still available after the allocation to Classes I through VI.

Note - Unlike FAS 141R, the income tax basis in the assets acquired cannot exceed the purchase price.
Tax allocations are done by the "residual method", meaning that when one exhausts the purchase price, no more basis is allocated to assets of any higher class. Note that in the illustration, no allocation is made to Class V assets, even though they appear to have value.
If gain must be recognized because the sum of the Class I and II assets exceeds the purchase price, then no allocation is made to any other assets in higher classes.
If the purchase price is all allocated to tangible assets, no allocation is made to intangibles regardless of whether the purchase agreement reflects an amount for core deposit value or other intangibles.

Column F is the income tax basis in assets.

Line 164 is check totals. Column B should be zero [i.e. liabilities plus equity = assets]
Column D should equal zero [i.e. Column B minus assets not purchased in Column C minus D - zero]
Column F should equal zero [i.e. total purchase price equals the total amount allocated among the acquired assets]

As of ___________________ [Date of Closing]	Target Pre-Failure Stmt of Cond	Retained by the FDIC	Target's Liabilities Assumed / Assets Purchased	FMV Adj Reflected in the Purchase	Tax Basis

Post acquisition tax accounting for loans subject to FDIC or other agency guarantees:

The income tax basis in loans subject to FDIC or other agency guarantees is the amount allocated to them, even though some of the gain may be deferred over six years.

In most cases, there should be no lossess because basis is the maximum realizable from the FDIC even if collections are zero.

Gains are recognized to the extent that the amount actually realized, including any FDIC payment, exceeds the sum of basis and any reimbursement due the FDIC pursuant to "net loss" calculations or "recapture" provisions, if any, in the loss sharing agreement.

In many cases, performing loans with no ascertainable impairment are subject to the loss sharing agreements, and the sum of the Class I and Class II assets does not equal to the pruchase price. In this event, it is likely that the bank will allocate the full par value to those loans, and there will be no gain on the subsequent collections. In this case, if there is a loss, the charge-off will be net of the FDIC loss guarantee reimbursement.

If performing loans are recorded at a discount, whether the maximum loss which the buyer might recognize under the loss sharing agreement or a lesser amount based on management's analysis of the fair market value of the loans (including the loss sharing guarantees), it is our observation that the most common approach is to pool similar loans and recognize the discount on the principal reduction method, similar to the method discussed below for performing loans with no agency guarantees.

It is our observations that most banks recognize the discount on nonperforming loans and classified loans on one of two methods.
The discount, net of the agency guarantee, on material loans that were individually analyzed and valued is typically recognized on a loan-by-loan basis, using the cost recovery method if collection of more than the guaranteed amount is doubtfel, or on the principal reduction method if collection of more than the guarantee is probable.

Where the bank has acquired a "pool" of like loans of smaller individual balances, banks commonly recognize the discount similarly to the approach for individual nonperforming loans, except on the pool in the aggregate rather than on a loan-by-loan basis.

Interest is recognized pursuant to the normal nonaccrual concepts.
Accrued interest on performing loans must be recognized in income currently.
Accrued interest on nonperforming loans must be recognized in income currently to the extent that the FDIC loss sharing agreement. guarantees its collection.
Accrued interest on nonperforming loans that is not guaranteed is not recognized if the facts support nonaccrual status and the collection is not guaranteed.

Post acquisition tax accounting for loans not subject to FDIC or other agency guarantees:

If unclassified loans are recorded at par value, then the buyer deducts actual charge-offs as incurred.

If unclassified loans are recorded net of a provision for losses, it is my observation that most banks adopt the principal reduction method of recognizing gain on the collection of the loans.
Charge-offs for losses must be reduced to the net income tax basis in the loan at the time of the loss; i.e. the outstanding balance minus the unamortized discount.

Gain on material classified loans that are separately valued may be recognized for income tax purposes differently based on the facts.
If the loan is performing, income is most commonly recognized on the principal reduction method as collected.
If the loan is not performing, banks more commonly use the cost recovery method.

Gain on pools of substandard loans is most commonly recognized on the principal reduction method. For example, if the loans in the pool are valued at 85% of the pool's outstanding balance, the buyer will deduct 85% of actual losses incurred and will recognize taxable income to the extent of 15% of the principal amounts collected. If the math is done correctly, the tax basis will be zero when the outstanding balance in the loan pool is zero.

The purpose of separating substandard loans from doubtful loans is that in most cases, the doubtful loans are so speculative in nature that the buyer is likely to be justified pursuant to case law to use the cost recovery basis of recognizing income or loss on them; i.e. all collections reduce income tax basis in the pool until basis reaches zero, and any further collections are recognized in taxable income. Similarly, no loss is deducted until the collections from the pool of loans is exhausted and the remaining income tax basis in the loans is worthless, when the remaining income tax basis would be deducted as a bad debt loss.