

46th
annual

BANK & CAPITAL MARKETS TAX INSTITUTE

NOVEMBER 2-4, 2011

BUENA VISTA PALACE HOTEL & SPA | ORLANDO

**Tax & Financial Accounting
Aspects of Loan Workouts**

November 2011

WWW.BANKTAXINSTITUTE.COM

Tax & Financial Accounting Aspects of Loan Workouts – Speakers

- Bruce Kamins, Citigroup Corporate Tax Department, New York, NY (212) 559-1437, kaminsb@citigroup.com
- James Primus, Partner, Deloitte & Touche, LLP, Stamford, CT (203) 708-4018, japrimus@deloitte.com
- Joe Ferst, Director, Deloitte Tax, LLP, Atlanta, GA (404) 220-1313, jferst@deloitte.com
- Terry Meyers, Director, Deloitte Tax, LLP, Baltimore, MD (410) 576-7360, tmeyers@deloitte.com
- John Niemiec, Director, Deloitte Tax, LLP, Parsippany, NJ (973) 602-6741, jmiemiec@deloitte.com

Agenda

- Financial accounting treatment for non-performing loans and loan impairments
- Tax considerations in loan modifications
- Key issues in foreclosures and OREO
- Tax accounting for non-performing and sub-performing loans
- Bad debt issues for financial institutions

Financial accounting treatment for non-performing loans and loan impairments

Deloitte.

Loan Accounting Overview

Accounting Standards Codification 310 Receivables (“ASC 310”)

Four models of GAAP accounting apply to 2 general categories of loans

<i>Originated loans</i>	<i>Acquired loans</i>
Historical cost, based on contractual terms.	ASC 310-20 (FAS 91) – non-credit impaired
ASC 825-05-5 (“FAS 159”) Fair value- marked to market at each period end.	ASC 310-30 (SOP 03-3) – credit impaired
	ASC 825-05-5 (“FAS 159) Fair value- Marked to market at each period end.

- *Special topics*
 - Troubled debt restructurings-originated loans only.
 - Loans “put back” from Government Sponsored Entities (GSEs) and private label transactions.

Acquired loan accounting alternatives under U.S. GAAP

Accounting statement	ASC 310-30 ("SOP 03-3")	ASC 310-20 ("FAS 91")	ASC 825-05-5 Fair Value Option ("FAS 159")
Criteria		Applies to acquired loans where contractual amounts due are expected to be collected.	Can be elected for any financial instrument; election is instrument by instrument.
Financial statement recognition	Initially recorded at fair value. Accretion of the amount of expected future cash flows in excess of the carrying amount of the loans (non-contractual).	Initially recorded at fair value. Recognition of interest income based upon contractual terms. Accretion of the credit mark or premium over the term of the loan.	Initially recorded at fair value. Changes in the fair value of the individual loans are recorded in income.

Accounting for Acquired Loans

ASC 310-30

- Accounting model is based on *expected* cash flows, not contractual amounts.
- Applies the concept of accretable yield, which is the excess of future cash flows to be received in excess of acquired cost.
- Accretable yield is recognized over time based upon the determined yield
- Requires a continual reforecast of expected cash flows based upon evolving credit and non-credit related variables (i.e. defaults, loss severities, recovery rates, prepayment speeds, etc.).
- Allows for individual accounting or pooled treatment of acquired loans, where the acquired loans have “similar risk characteristics”. Typically results in multiple pools on large portfolio acquisitions.
- In pooled treatment, the pool becomes the unit of accounting and is in effect treated as one loan.

Accounting for Acquired Loans (cont.)

ASC 310-30 (cont.)

- Complexities arise on how to remove loan basis from a pool for what are termed “exit events”; pay-down, foreclosed real estate, loan sales, etc.
- Gains or losses for GAAP purposes on exit events are determined based upon arbitrary allocations of cost basis.
- Loan write-offs, troubled debt restructurings, loan modifications, do not typically result in a specific accounting treatment, rather impact expected cash collections of the pool.

ASC 310-20

- Pooling of loans is acceptable however, criteria is strict in terms of the loans which can be pooled.
- Impairments are determined based upon methodologies applicable to.

Loan Impairment Accounting Overview

Acquired loans with credit impairment

- ASC 310-30 (“SOP 03-3”)

Originated loans and acquired loans without credit impairment

- ASC 450 (“FAS 5”) Contingencies
- ASC 310-10-35 Subsequent measurements

Loan Impairment Accounting

Acquired distressed loans

ASC 310-30 Impairments

- Changes in cash flow expectations:
 - Resulting from non-credit related variables are accounted for by changing yield.
 - Result from an improvement in underlying credit risk factors are accounted for as an increase in yield.
 - Resulting from a worsening of underlying credit risk factors are accounted for as a reduction in basis (provision for loan losses). The provision can be reversed if credit risk factors improve and the cash flow expectations corresponding improve.
- Loan modifications, troubled debt restructurings, etc. typically result in changes in expected cash flows and, if material, would be accounted for as above when reforecasting expected cash collections.

Loan Impairment Accounting (cont.)

Originated Loans

Impairment ASC 450 (FAS 5) Contingencies

- Typically applied to homogenous loans. Could also apply to non-homogenous loans where specific ASC 310-10 impairment has not been identified (borrower still pays on loan but there has been a credit deterioration in the borrower).
- Contingent loss model, requires that loss is probable and estimable.
- Generally applied based upon FICO, LTV metrics and considers historical data internal or external (3rd party).
- An identified impairment event would require movement from ASC 450 to ASC 310-10.

Loan Impairment Accounting (cont.)

Originated Loans

ASC 450 ("FAS 5") Contingencies, continued

- Typically applied to homogenous loans. Could also apply to non-homogenous loans where specific ASC 310-10 impairment has not been identified (borrower still pays on loan but there has been a credit deterioration in the borrower).
- Contingent loss model, requires that loss is probable and estimable.
- Generally applied based upon FICO, LTV metrics and considers historical data internal or external (3rd party).
- An identified impairment event would require movement from ASC 450 to ASC 310-10.

Loan Impairment Accounting (cont.)

Originated Loans

ASC 310-10 (FAS 114)

- Applicable for all originated loans with specific impairment indicators.
- Impairment is calculated at the net present value of the contractual amounts to be received. Considers prepayments, defaults, and recovery no interest rate curve on variable rate loans.
- Discount rate is based upon effective rate at origination.
- Fair value practicability exception exists, consider costs to sell. Certain TDR loans which are collateral dependent could also be re-measured at fair value less costs to sell. Collateral dependent loans including TDR loans should be measured at fair value less cost to sell where it is probable that collateral will be taken in exchange.

Loan Impairment Accounting (cont.)

Originated Loan Write Offs

- Facts and circumstances based.
- GAAP requires consistent application consider regulatory requirements.
- As a principle, unlikely that collection will occur.

Loan Impairment Accounting (cont.)

Special Topics

Troubled Debt Restructurings

- Concession granted by creditor to debtor that is in financial difficulty.
- Typically takes the form of interest rate reductions, repayment extensions, principal reductions.
- Can also consider partial or full repayment through equity interest or other assets transferred in lieu of repayment.
- A debtor that can obtain funds at market rates for non-troubled debt from sources other than the creditor is not a TDR.
- Accounting Standards Update April 2011, amended Topic 310 to assist preparers of financial information in determining whether TDR accounting is applicable by clarifying whether a concession has been granted and if the debtor is in financial difficulty.

Tax Considerations in Loan Modifications

Deloitte.

Loan Modifications – The Basics

- Holder is treated as having exchanged the un-modified loan for a “new loan” issued by the same borrower
- Holder has **taxable gain or loss** if issue price of “new loan” is higher or lower than tax basis of un-modified loan
 - Potential for phantom income, especially on loans acquired at a discount

Steps:

1. Determine whether loan has been modified (Reg. §1.1001-3(c))
2. Determine whether modification is “significant” (Reg. §1.1001-3(e))
3. Calculate taxable gain or loss related to “significant” modification under (Reg. §1.1001-3(g))
4. Set up new loan for tax purposes (including possibility of original issue discount)

Loan Modifications – The Basics (cont.)

Has a modification occurred?

- A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise
 - Reg. §1.1001-3(c)(1)(i)
- A modification occurs at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective
 - Reg. §1.1001-3(c)(6)

Loan Modifications – The Basics (cont.)

Is the modification significant?

- Generally, a modification is considered “significant” where - based on all facts and circumstances the legal rights or obligations that are altered and the degree of alteration are economically significant
 - Reg. §1.1001-3(e)
- Forbearance would not be considered a modification provided:
 - There is no written or oral agreement
 - It does not exceed 2 years plus any period of good faith negotiations or borrower is in bankruptcy
 - Reg. §1.1001-3(c)(4)(ii)

Loan Modifications – The Basics (cont.)

Types of significant modifications:

- Change in annual yield that is more than the greater of 25bps or 5% of the original annual yield (Reg. §1.1001-3(e)(2))
- Change in timing of payments that results in a deferral period of more than the greater of 5 years or 50 percent of the original term of the instrument (without regard for options to extend) (Reg. §1.1001-3(e)(3))
- Change in obligor of a recourse obligation (Reg. §1.1001-3(e)(4)(i))
- Change in security and payment expectations (Reg. §1.1001-3(e)(4)(iv))
- Change in nature of a debt instrument from non-recourse to recourse (Reg. §1.1001-3(e)(5)(ii))

Loan Modifications – The Basics (cont.)

- Issue Price equals:
 - Stated principal amount of new debt if adequate stated interest (AFR)
 - IRC §1274(a)(1)
- Imputed principal amount if not adequate stated interest
 - IRC §1274(a)(2)
- FMV – if either old or new debt traded on an established market
 - IRC §1273(b)(3)
 - See also Prop. Reg. §1.1273 (b) (REG-131947-10)
- FMV in the case of “potentially abusive” transaction
 - IRC §1274(b)(3) (See also Prop. Reg. §1.1273 (b), which would preclude this treatment on loan modification)

Key Issues in Loan Modifications

- Gain may be mitigated by “deemed charge-off” when charge-off occurred in a prior tax year under Reg. §1.166-3
 - In distressed debt acquisition, instrument would have to be subsequently written down by purchasing bank
- Prop. Reg. §1.1273 (b) would liberalize “publicly traded” rules, but bank loans are not likely to qualify as “publicly traded”
 - Does the ability to utilize recent sales transaction under IRC §1274 apply?

Key Issues in Loan Modifications (cont.)

- In distressed debt acquisition use of MTM method of accounting under IRC §475 can avoid problem, as mark is to fair market value
 - MTM method could have unintended consequences (i.e. gain when conditions improve)
 - Make proper tax ID if MTM is not preferred for tax purposes or MTM may apply
 - Calculation of market discount (IRC §1276) on purchased debt still technically required
 - See proposed regulations under §475
- Potential permanent benefit if modified debt is a tax-exempt obligation; i.e., ordinary income tax loss followed by excluded OID

Key Issues in Foreclosures and OREO

Deloitte.

Income Tax Issues in Foreclosures

- Property fair market value (FMV) is used to determine foreclosure gain/loss (Reg. §1.166-6(b))
- Property FMV can be unclear
- Data may not be updated or available
- There are book/tax difference in valuing OREO

Income Tax Issues in Foreclosures (cont.)

Example:

- Bank has debt with unpaid principal balance of \$100, \$80 adjusted tax basis (due to write-downs), secured by collateral estimated to be worth \$60
 - At foreclosure auction, bank bids \$100 loan UPB in order to protect residual interest
 - Results based on FMV of property:
 - \$60 (FMV of property) = \$20 loss (bad debt)
 - Potential alternatives:
 - \$100 (bid price) = \$20 gain
 - \$50 (net realizable value) = \$30 loss
- Value used can produce significantly different results

Income Tax Issues in Foreclosures (cont.)

- Generally, bid price is presumed to be FMV unless clear evidence to contrary
 - Reg. §1.166-6(b)
- Appraisal may be enough evidence of current FMV, but must be recent in order to determine value
- Tax department may lack updated information for this purpose
- Net realizable value (NRV) as used by books generally cannot be used to determine FMV
- Using incorrect value may result in large overstatement of gain

Tax Information Reporting Issues in Foreclosures

- Lenders are required to report foreclosure or abandonment on Form 1099-A - *Acquisition or Abandonment of Secured Property* and provide a copy to borrower
 - § 6050J
- If \$600 or more of debt is discharged in foreclosure, lender must file Form 1099-C, *Cancellation of Debt*, and provide a copy to borrower
 - § 6050P
 - If both foreclosure/abandonment and debt discharge occur, only use Form 1099-C
- Risk associated with non-compliance or poor compliance
 - Penalties associated with failure to report
 - Under or over-reporting COD can create customer related problems
 - General reputational risks

Foreclosure Expenses

- Expenses to acquire property and to protect title are added to the basis of the foreclosed property
 - Expense prior to foreclosure, generally added to loan basis
 - See *Schieffelin Est. v. Comr.*, 44 B.T.A. 137 (1941), acq., 1941-1 C.B. 9
- Expenses once a foreclosure has been initiated, generally added to property basis
 - See *Hadley Falls Trust Co. v. U.S.*, 110 F.2d 887 (1st Cir. 1940)
 - See also §164(d) and Rev. Rul. 72-237, 1972-1 C.B. 51

OREO – Key Issues

- Proper characterization of OREO expenses – current deductibility v. capitalization
 - Capitalization required if two tests under IRC §263A are met :
 - Property must be acquired for resale (OREO generally not deemed to be acquired for resale)
 - Property must either be inventory or held for sale to customers in ordinary course of business under IRC §1221(a)(1)
 - OREO obtained through foreclosure may not pass the first test above. The second test is likely a facts and circumstances determination.
- Other issues:
 - Need to reverse book write-down of OREO, as deduction not allowed for tax purposes
 - Potential for capital treatment for non-bank entities on OREO if held for investment

Tax accounting considerations for non-performing/sub-performing loans

Deloitte.

Cease Accrual of Interest

- Cease accrual when determined to be uncollectible
 - When charge-off occurs
 - There exists no reasonable expectation at the time of accrual that the items of income will be collected (Rev. Rul. 80-361 also see Rev. Rul. 2007-32)
 - For example, where it can be demonstrated that the borrower was insolvent at the time the right to accrue the interest arose
- IRS position that this rule does not apply to OID (TAM 9538007)

Market Discount

- Debt acquired in the secondary market at a price less than its AIP¹ (IRC §1276)
- Gain recognized as ordinary income (IRC §1276(a)(1)) :
 - To the extent of gain on sale/disposition or to the extent of principal payments received, or
 - By election of the taxpayer, currently as it accrues
- Potential deferral of interest expense
 - See special rule for banks IRC §1277(c)(2))
- Applicable to distressed or “highly speculative” debt?
 - Loan past stated maturity
 - Debtor insolvent, in bankruptcy, in default?
 - Debt acquired at a deep discount (e.g. 20% of principal or very high yield)?
 - Application of cost recovery method?
 - See e.g. *Phillips v. Frank*, 295 F. 2d 629 (C.A. 9, 1961) and *Willhoit v. Commissioner*, 308 F. 2d 259 (C.A. 9, 1962)

¹ Subject to de minimis rule

Tax Accounting Methods for Market Discount

- Ratable (Market Discount) – IRC §1276(b)(1)
 - Generally only available for loans with a single principal payment
 - See legislative history
- Constant Yield
 - Standard Method - IRC §1272(a)(3)
 - “PAC” Method – IRC §1272(a)(6)
- Market Discount Ratios
 - Stated Interest Ratio
 - OID Ratio
- Election to recognize market discount currently (IRC §1278(b))

The Standard Method

- IRC §1272(a)(3)
- Applies to individually held loans
- Yield determined based upon a zero loss and zero prepayment assumption
- Amortization equals
 - The product of the amortized cost of the loan at the beginning of the accrual period (i.e., monthly) and its tax yield less the amount of QSI

The PAC Method

- IRC §1272(a)(6)
- Applies to pools of loans
- Yield determined based upon a zero loss assumption and the prepayment assumption used to establish the purchase price of the pool (for OID)
- Amortization generally equals:
 - The sum of (a) the present value of cashflows remaining at the end of the accrual period and (b) the principal and non-QSI received during the accrual period minus (c) the present value of the loan at the beginning of the accrual period (a + b – c)

Market Discount Ratio Methods

- Equals the ratio of current Stated Interest/OID to the remaining Interest/OID as of the beginning of the accrual period
- Amortization equals the product of Market Discount/Premium Remaining at the beginning of the accrual period and the Market Discount Ratio for the accrual period

“Wrap-election” Reg. §1.1272-3

- Simplifies tax accounting by aggregating the debt’s various discount/premium components
- All interest, discount/premium recognized based on single constant yield
- May cause deemed election to recognize market discount currently (IRC §1278(b)) for all subsequently acquired market discount bonds
- May want to revoke election prior to acquiring distressed debt instruments
- Revocation requires IRS consent

Bad Debt Rules for Financial Institutions

Deloitte.

Bad Debt Rules for Financial Institutions

- If bank under IRC Sec. 581:
 - Partial bad debt
 - Bad debt conformity election (Reg. 1.166-2(d)(3))
 - Rev. Rul. 2007-32
 - Safe harbor method of nonaccrual interest (Rev. Proc. 2007-33)
- General rules apply in absence of these special elections (Reg. 1.166-2(a))
 - Based on all “pertinent evidence”
 - Legal action not required
 - Bankruptcy generally indication of worthlessness

Partial Bad Debt

- Two advantages:
 1. Accelerates deduction – current deduction rather than waiting until particular debt becomes completely worthless
 2. Provides ordinary deduction – ordinary loss rather than capital loss treatment if the indebtedness is partially repaid or later sold
- Not available for corporate and government debt evidenced by a security as defined in §165(g)(2)(C)

Bad debt conformity (Reg. § 1.166-2(d)(3))

- Presumption that a charge-off for regulatory purposes is correct
- Loan must be classified as a loss asset for regulatory purposes
- Provides IRS audit protection of charge-offs
- Must obtain determination letter from federal regulator (see Rev. Proc. 92-84)

Bad debt conformity (Reg. § 1.166-2(d)(3)) (cont.)

- Election made bank-by-bank
- Treated as an adoption or change in method of accounting
 - For new banks – automatic change (as opposed to manual) for first election
 - Cut-off approach, so no Sec. 481(a) adjustment

Revenue Ruling 2007-32 – Non-accrual interest

- Deals with accrued but uncollected interest when bank has made conformity election under Reg. § 1.166-2(d)(3)
- Extends conformity election to nonaccrual interest
- Holds that without a conformity election:
 - Accrued but unpaid interest must be recognized for tax purposes, even when loan is charged-off, when some expectation of payment
 - Remedy is bad debt deduction for accrued but unpaid interest in year of charge-off
 - Subsequent payment goes to interest first
 - Reg. § 1.446-2(e)

Revenue Ruling 2007-32 – Non-accrual interest (cont.)

Facts

- Bank with bad debt conformity election in place
- \$8,000 of accrued, unpaid interest in 2006
- \$24,000 of accrued, unpaid interest in 2007
- Loan charged-off for regulatory purposes and classified as a loss asset in 2007
- \$31,000 payment in 2008

Revenue Ruling 2007-32 – Non-accrual interest (cont.)

- GAAP Result
 - \$8,000 of interest income for 2006
 - No interest income in 2007
 - \$31,000 in 2008 treated as recovery of principal

- Tax Result
 - 2006: \$8,000 of interest income (likely recognized in 2007)
 - 2007:
 - \$24,000 of interest income
 - \$32,000 bad debt deduction
 - 2008: \$31,000 interest income

Revenue Ruling 2007-33 – Safe Harbor Method

Rev. Proc. 2007-33 provides safe harbor method for determining interest accrual

- Does not require bad debt conformity election
- Interest income for tax is based on ratio of collections for last 5 years history
- Recovery Percentage equals

Accrued but uncollected interest for the year multiplied by:

Total 5 taxable year payments (P&I)

Total 5 year payments (P&I DUE)

Revenue Ruling 2007-33 – Safe Harbor Method (cont.)

- All loans (accrual and nonaccrual) are included in ratio
- Recovery percentage must be calculated to at least four decimal places
- If bank acquires portfolio, must include in calculation of recovery percentage
- If bank disposes of portfolio, cannot include in recovery percentage
- Provides a temporary, permanent benefit

Revenue Ruling 2007-33 – Safe Harbor Method (cont.)

- Bank may not know five year history
- Might be issue with reconciling to interest received
- Are payments that become delinquent included in recovery percentage every year?
- Unclear how to reverse in subsequent years

Any tax advice included in this written communication was not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency.

This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation.

Deloitte.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2011 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited