0400 INCOME AND EXPENSE ISSUES COMMON FOR BOTH STATE AND FEDERAL PURPOSES

The issues addressed in the following discussion are applicable for both state and federal purposes. Accordingly, it is important to determine if any federal audits are currently being conducted on years covered by the audit or if a federal audit is scheduled. If so, the audit should be restricted to state issues. Further, the audit file should contain information as to the expected completion date of the federal audit. Do not assume that, because the taxpayer is a large case, a federal audit will necessarily be conducted. If the taxpayer cannot provide any information as to a pending or completed federal audit, the auditor should include in the audit a review of income and expenses. Some of the issues addressed in this section may in certain instances result in only a shift of income within a year or between consecutive years and should only be pursued when material.

The general theme of most of the subjects discussed in this section relates to the deferring of income or treatment of capital costs as current expenses. It is extremely important that a thorough review be made of all Schedule M adjustments. The auditor should obtain detailed and complete explanations as to all adjustments and understand the effect of such adjustments. Auditor should also also determine whether the adjustments are consistent with the taxpayer's elections (e.g., accounting method, water's-edge election). As a rule, be wary of all income deferrals.

0401 Tax Accounting for Banks and Financials—In General

Banks and financial corporations typically provide one of three descriptions for their method of accounting elected: CASH, ACCRUAL, or HYBRID. Institutions describing their accounting method as cash are often on a hybrid method. This is because while they generally account for their transactions on cash basis, they use a reserve for bad debts to establish their bad debt provision. It is important to note that some of issues described below are directly affected by the accounting method elected.

With respect to accrual method lenders:

> Income is included in gross income when all the events have incurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

With respect to cash basis lenders:

> "All items which constitute gross income are to be included for the taxable year in which the income is actually or constructively received."

0402 Accounting Principles

0402.1 Differences Between Generally Accepted Accounting Principles (GAAP), Regulatory Accounting Principles (RAP), and Tax Accounting

It is important to recognize the fact that there are differences in how income, expenses, assets, and liabilities are reflected in the various types of financial statements that will be encountered in audits. For information on RAP accounting principles review the instruction booklets for the bank call reports entitled Federal Financial Institutions Examination Council "INSTRUCTIONS - CONSOLIDATED REPORTS OF CONDITION AND INCOME."

0403 Accounting Methods for Income Recognition

Many banks and financial corporations use different accounting methods of income recognition for book purposes, regulatory agency purposes, and tax purposes. Income may be understated by the improper deferral or omission of income. Auditors should familiarize themselves with the method of accounting for book purposes and for tax purposes. Sections below describe some of the methods of recognizing interest and discount income.

0403.1 Accounting Methods for Income Recognition—In General

Interest income shall be recognized as income when received by cash basis taxpayers and when earned by accrual basis taxpayers.

The Tax Reform Act of 1986 placed most banks and financial corporations on the accrual method of accounting. The state conformed to the federal limitations on use of the cash method of accounting effective for taxable years beginning on or after 1/1/1987.

0403.2 Accounting Methods for Income Recognition—Loans or Mortgages Made or Acquired at a Discount

Generally, the discount on both interest and non-interest bearing loans and mortgages is reportable as income when earned by a taxpayer on the accrual basis or when note payments are received by a taxpayer on the cash basis. The reporting of the discount may be deferred until the full loan is paid only under the following exceptional circumstances:

- Realizable discount is uncertain.
- Full collection of the loan appears doubtful.
- The loan contract has no ascertainable market value.

For a discussion related to the treatment of the discount income deferral, see Bank & Financial Handbook Section 0404, METHODS OF TREATMENT OF ORIGINAL ISSUE DISCOUNT (OID). .

0403.3 Accounting Methods for Income Recognition—Principal Reduction Method

Pursuant to Rev. Proc. 94-29taxpayers can use the principal-reduction method of accounting, i.e., an aggregate method of accounting for de minimis OID on certain loans originated by the taxpayer.

Rev. Proc. 94-29 also describes how eligible taxpayers may change their method to the principal-reduction method for loans acquired on or after a “cut-off date.” The principal-reduction method applies only to loans that:

(1) are acquired by the taxpayer at origination;

(2) do not have OID or, because the OID is de minimis under reg section 1.1273-1(d), are treated as not having OID;

(3) are not issued at a premium;

(4) are not subject to the election under IRC section 1.1272-3; and

(5) produce ordinary gain or loss when sold or exchanged by the taxpayer.

And, if the principal reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans.

The standard categories of loans are:

(1) loans secured by a 1 to 4-family residential real property and are not home equity lines of credit or construction loans;

(2) construction loans with original terms not greater than three years;

(3) loans secured by real property, and which are not contained in categories (1) or (2), and are not home equity lines of credit; and

(4) consumer loans with original terms not greater than 7 years, and which are not secured by real property and are not revolving credit loans.

Although Rev. Proc. 94-29 provides the procedures for obtaining IRS's consent to an automatic change to the principal reduction method, the Rev. Proc. does not provide “audit protection” with respect to the taxpayer's method of accounting for discount on loans acquired before the cut-off date.

Pursuant Rev. Proc. 97-39, IRS is allowing taxpayers to adopt or change to principal reduction method of accounting for de minimis original issue discount on certain loans. To qualify, loans must be acquired by taxpayer at origination, not have OID (or be treated as not having OID due to OID being de minimis), not be issued at premium, not be subject to Treas. Reg. §1.1272-3 election, and produce ordinary gain or loss for taxpayer when sold or exchanged. Rev. Proc. 94-29, 1994-1 CB 616, is modified and superseded by Rev. Proc. 97-37. IRS cautioned that the method is identical to the method described in Rev. Proc. 94-29, and taxpayer who adopted the method based on the earlier ruling isn't required to change based on the new Revenue Procedures.

The formula, calculated on a monthly basis for <u>each</u> of the standard categories of loans, is as follows:

Discount (points) included in Income =

$$[\text{Starting Discount} + \text{Current Discount}] \; X \; \frac{(\text{Starting Principal} + \text{Current Principal} - \text{Ending Principal})}{\text{Starting principal} + \text{Current principal}}$$

0404 Methods of Treatment of Original Issue Discount (OID)

0404.1 SUMMARY OF THE PROPER REPORTING OF DISCOUNT INCOME
0402.2 YEARS ENDING ON OR AFTER 1/1/87—USE IRC §1271
0402.3 LONG TERM OBLIGATIONS ISSUED AFTER 7/1/82 (IRC §1272(a))

IRC Section 1271 through IRC Section 1275 provide rules for the inclusion of OID. Effective for years beginning on or after 1/1/87, R&TC Section 24990 conformed to the treatment of OID set forth in IRC Section 1271 through IRC Section 1288. OID is the excess of the stated redemption price at maturity over the issue price. For example, assume ABC Inc. acquired a non-interest bond for $80,000 that was redeemable in 5 years for $100,000. The stated redemption price at maturity of $100,000 less the issue price of $80,000 results in $20,000 of OID.

The "Constant Interest Rate Basis Method" is generally used in computing the reportable discount on interest bearing loans, bonds and mortgages issued under an OID.

IRC Section 1273(a)(3) provides for a de minimis rule. If the excess of the stated redemption price over the issue price is less than 1/4 of 1% of the stated redemption price times the number of years to maturity, then the OID is zero.

See also Bank & Financial Handbook Section 0548.4, ORIGINAL ISSUE DISCOUNT.

0404.1 Summary of the Proper Reporting of Discount Income

A. Interest Bearing Loans

Discount under the cash basis method:

- Interest bearing loans purchased at a discount. The discount is income earned ratably as the obligation is collected. The interest is income as received.

- Interest bearing installment loans purchased at a discount. The balance of the installment payment after being reduced by the applicable portion of interest income is then ratably apportioned between discount income and a reduction of the cost basis.

Discount under the accrual method:

- Interest bearing loan purchased at a discount. The discount is income earned ratably as the obligation is collected. The interest is income as earned.

- Interest bearing installment loans are purchased at a discount. The interest is income as earned. The balance of the installment payment after being reduced by the applicable portion of interest income is then ratably apportioned between discount income and a reduction of the cost basis.

B. Non-Interest Bearing Loans

Discount under the cash basis method:

- Non-interest bearing loan made directly to the borrower. The discount and commissions are income earned when the loan is paid in full.

- Non-interest bearing installment loan made directly to borrower. The discount and commissions are income earned ratably as each installment is received.

- Non-interest bearing loan purchased at a discount from a third party. The discount is income earned when the note is paid in full. In the case of an installment loan, discount and commissions are income ratably as each installment is received.

Discount under the accrual method:

- Non-interest bearing loan made to borrower. The discount is income earned over the period of the loan. The commission is income when the loan is made. If the loan is subsequently extended, any additional commission charge is income when the loan is extended.

- Non-interest bearing loan purchased at a discount. The discount is income earned over the remaining period of the loan.

0404.2 Methods of Treatment Of Original Issue Discount (OID)–Years Ending On or After 1/1/87—Use IRC Section 1271

Effective for years beginning on or after 1/1/87, R&TC Section 24990 conformed to the treatment of OID set forth in IRC Section 1271 through IRC Section 1288., which collectively provide complex set of rules that require current exclusion and deduction of discounts and treatment of gain on the sale or retirement of debt instruments. Among the factors to be considered by the auditor are the types of debt instruments-being-held, when they were issued, and whether the issuer had an intention to call the debt instrument before maturity.

0404.3 Methods of Treatment of Original Issue Discount (OID)—Long Term Obligations Issued After 7/1/82 (IRC Section 1272(a))

The "Constant Interest Rate Basis Method."

Pursuant IRC Section 1272(a), there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

Per Treas. Reg. Section 1.1272-1(b)(1), the amount of OID includible in the income of a holder of a debt instrument for any taxable year is determined using the constant yield method as such:

> Step one: determine the debt instrument's yield to maturity. The yield to maturity or yield of a debt instrument is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument.
>
> Step two: determine the accrual periods. An accrual period is an interval of time over which the accrual of OID is measured.
>
> Step three: determine the OID allocable to each accrual period. The OID allocable to an accrual period equals the product of the adjusted issue price of the debt instrument (as defined in §1.1275-1(b)) at the beginning of the accrual period and the yield of the debt instrument, less the amount of any qualified stated interest allocable to the accrual period.
>
> Step four: determine the daily portions of OID. The daily portions of OID are determined by allocating to each day in an accrual period the ratable portion of the OID allocable to the accrual period. The holder of the debt instrument includes in income the daily portions of OID for each day during the taxable year on which the holder held the debt instrument.
>
> See examples provided in Treas. Reg. Section 1.1272-1(j).

0405 Change of Accounting Method

The consent of the IRS or Franchise Tax Board is required before a taxpayer changes its method of accounting for tax purposes.

Rev. Proc. 94-29 allows a taxpayer to use the principal-reduction method of accounting, precludes use of the loan liquidation method of accounting for loans acquired after a certain date, and grants consent for a taxpayer to use the principal-reduction method of accounting. See also Bank & Financial Handbook Section 0403.3, PRINCIPAL REDUCTION METHOD.

Rev. Proc. 94-30, 1994-1 C.B. 621, provides procedures for accounting method changes for loans acquired before the cut-off dates specified in 94-29.

0406 Alternative Mortgage Instruments

The conventional mortgage is characterized by fixed payments, set interest rates, and long maturities. Due to volatile interest rates in the late 1970's and early 1980's banks and thrifts wanted to shift some of the risk to the customer. Alternative mortgage instruments (AMIs) offer possible relief from liquidity problems by providing yields that are comparable to current rates paid on deposits.

AMIs do not have one or more of the characteristics listed above for a conventional mortgage. The most common types of AMIs are the:

- Variable rate mortgage (VRM)—Characterized by an interest rate that will fluctuate based on the terms of the loan agreement. The rate is linked to a specific index, and the payments are periodically adjusted upward or downward. This can result in a larger or smaller monthly mortgage payment or a longer or shorter length of time to pay off the mortgage.

- Graduated payment mortgage (GPM)—Intended to allow prospective home buyers who anticipate increasing incomes to acquire mortgages which more clearly reflect their ability to pay. For example, a new accounting graduate may be hired by the FTB. After one year he or she will hopefully be promoted and will most likely receive step increases for the next four years. The mortgage agreement may provide for a lower payment in year one. The monthly payment will increase each year for 5 years, and will then have level payments for 25 years.

The VRM and the GPM may result in negative amortization. That is the monthly payment is not enough to cover the total interest, thus the unpaid interest is added to the principal. In the above example of a GPM, negative amortization would result in the first five years.

Since a greater portion of loans are written for the purchase of real property, the savings & loan industry was one of the leaders in the AMIs market.

On February 6, 1975, the Federal Home Loan Bank Board issued regulations authorizing AMIs. Criticism by Congress resulted in the Board not pursuing the regulations. In 1978, the Bank Board authorized AMIs by allowing variable rate mortgages to some degree. The regulations were amended in 1980.

On April 23, 1981, the FHLBB issued new regulations providing broad authority of federal chartered savings & loan associations to deal in a variety of adjustable mortgage loan instruments. The regulation also preempted all state laws concerning loan instruments on federal chartered savings & loan associations and mutual banks thus establishing a uniform national standard.

On March 27, 1981, the Office of Comptroller of the Currency issued rules governing the authority of national banks to make or purchase adjustable rate mortgage (ARM) loans. The rules were similar to the FHLBB regulations.

Liquidity is of great importance for all financial institutions. Many financial institutions sell mortgages in secondary markets to generate cash. Much of a financial institution's income may come from loan fees and servicing the loan rather than collecting periodic interest payments.

The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) are two federal agencies that purchase home loans. Their guidelines are normally more restrictive than the FHLBB and the Comptroller of the Currency, creating a potation for more restrictive AMIs offered by financial institutions.

The mortgage loan industry has developed a wide range of AMIs, although each loan is basically a variable rate mortgage or a graduated payment mortgage. The primary difference between AMIs and conventional loans is the manner, timing, and amount of interest and principal payments.

The tax treatment of AMIs is substantially the same as conventional loans with the following exceptions:

- AMIs may result in negative amortization where the payments do not cover all the interest due, thus resulting in capitalization of the unpaid interest.

  Prior to the Tax Reform Act of 1984, a cash basis lender would not record the income until paid in cash. A cash basis borrower would not deduct the interest until paid in cash.

  The Tax Reform Act of 1984, expanded application of the original issue discount (OID) rules to apply to home mortgages. The OID rules (IRC Section 1272; R&TC Section 24990 through R&TC Section 24994) in regards to negative amortization may result in a cash basis lender recognizing income without receiving cash.

  For additional information on OID, see Bank & Financial Handbook Section 0403, ACCOUNTING METHODS FOR INCOME RECOGNITION.

- The amortization of loan fees is more difficult as the length of the loan may change if the loan provides for negative amortization.

- If the interest rate fluctuates, the mortgage may result in prepaid or deferred interest. If the rate change is based on an objective standard such as the prime interest rate, then all interest should be included in current income. Also see Bank & Financial Handbook Section 0419, INTEREST RECEIVED IN EXCESS OF A MAXIMUM AMOUNT (CAP).

0407 Branch Application Costs

Sections 6550-6553 of the Financial Code require an additional license for a branch facility. The Legislature has effectively characterized each branch as a separate enterprise with an unlimited useful life.

All expenses attributable to the acquisition of the branch office (e.g. related executive salaries, feasibility studies, attorney fees) should be capitalized. The license costs are not amortizable as they have an unlimited life. The costs incurred for the branch application would be deductible if the application is denied.

The auditor should review the annual report or regulatory agency report, if provided, to determine the existence of any new branches. The taxpayer may have handbooks that have general information about the taxpayer, including a list of branches.

Once the auditor has established that the taxpayer has a new branch, the auditor should inquire about the amount of branch application costs to be capitalized. Accounting Principles Board (APB) opinion #17 provides that for book purposes, intangibles are capitalized and amortized over the period benefited, not to exceed 40 years. A review of the costs capitalized for book purposes and an inquiry of the types of expenses incurred in establishing the new branch may be a sufficient tax audit procedure, depending on how material the item is.

In Private Letter Ruling 8135031, the IRS ruled that a mutual savings bank could currently deduct promotional expenses such as advertising and gifts for new depositors involved in opening a new branch.

In *NCNB Corp. v. U.S.*, (4th Cir. 1982) 684 F2d 285, expenditures for long-range planning reports, feasibility studies and applications to the Office of the Comptroller of the Currency were held as the current year expenses.

The Fifth Circuit in *Central Texas Savings & Loan Association v. U.S.* (5th Cir. 1982) 731 F2d. 1181 held that costs incurred to investigate and establish new branches of a savings and loan association were not deductible under IRC Section 162(a). The expenses "procure benefits that endure for the life of the branch" and thus must be capitalized.

FTB follows the decision in *Central Texas Savings & Loan Association v. U.S., supra.*

The Tax Reform Act of 1984 revised IRC Section 195 relating to start-up expenditures. Beginning after June 30, 1984, no deduction is allowed for start-up costs although the taxpayer may elect to amortize the costs over 60 months. R&TC Section 24414 has the same provisions (except for effective dates) as IRC Section 195.

Treasury Regulation Section 1.195-1 regarding election to amortize start-up expenditures applies to expenditures paid or incurred after August 16 ,2011. .

0408 Buy-Downs

A buy-down is a subsidy paid by a real property seller for a portion of the interest that the real estate buyer would normally pay. A buy-down normally will cover the first year's interest but can also cover up to the first five years of interest. The sellers arrange buy-downs to facilitate the sale of their property. This type of transaction is arranged when the buyer/borrower is either unable or unwilling to buy the property at the prevailing interest rate but would buy at a reduced rate. When this happens, the seller can negotiate with a financial institution for a "buy-down" of the interest rate. To accomplish this, the seller deposits into a savings account a sum of money sufficient, after considering the interest to be earned on the account, to cover the difference in the monthly payments between the prevailing rate and the buy-down rate for the period of time agreed to in the buy-down arrangement. This may range anywhere from 12 to 60 months. This deposit is non-refundable to the seller at any time, including the loan's early payoff or refinancing. Each month an amount equal to the difference between the two interest rates is transferred out of the savings account and added to the buyer's monthly payment; the resulting payment yielding the required interest rate.

When the institution receives this non-refundable deposit, it immediately establishes a deposit liability for the full amount. The normal procedure is then to amortize the buy-down into income on a monthly basis. Since the institution receives this front-end fee without any real restrictions, it should be included in income in the year of receipt. See Treas. Reg. Section 1.446-1(c)(1)(i) & Treas. Reg. Section 1.446-1(c)(1)(ii) and Treas. Reg. Section 1.451-2, and IRC Section 451.

In the industry buy-down loans are also known as "teaser" or "seller assisted" loans. The liability account might also be classified as mortgagor funds.

0409 Capital Costs

Some of the costs that are often written off as current expenses are as follows:

- Foreclosure costs—these include such items as back taxes, insurance, and legal expenses as well as substantial repairs and improvements.
- Mortgage expenses—these are expenses incurred in connection with mortgage money.
- Legal expenses—these are expenses incurred in acquiring leases or formulating loans.
- Merger, acquisition, and consolidation expenses.

Capitalization of any of the above costs may be required. Some of the costs will be amortized over the life of the mortgage or loan. Foreclosure costs are taken as part of the cost of the property when it is disposed of. Merger, acquisition, or consolidation costs become part of the cost of the survivor. Before proposing the above or similar adjustments, be sure to consider the ultimate tax effect.

All of the above expenses are considered capital and are covered under the capital expenditures section of IRC Section 263 (R&TC Section 24422 and R&TC Section 24423).

0410 Change of Accounting Adjustments (IRC Section 481 & R&TC Sections 24721)

Issues that arise in this area are primarily due to acquisitions/mergers. If one savings & loan company (S&L) acquires another, and they are on different accounting methods, an issue may arise whereby the taxpayer may attempt to recalculate the income of the acquired S&L using the taxpayer's method of accounting. This is to obtain the benefit of its accounting method (for instance the liquidation method) in computing the income of the acquired S&L.

The operative sections in regard to acquisitions/mergers for federal and state purposes are IRC Section 381 and R&TC Section 24471. Taxpayers may attempt to apply IRC Section 481, which would permit the re-computation of income using the acquiring or surviving corporation's accounting method. IRC Section 381 requires that dollar balances be brought over from the acquired corporation. The adjustment made under IRC Section 481 may surface in one of the following ways:

- The taxpayer may file a separate claim for refund based on this adjustment.
- The taxpayer may reduce its loan fee income via a journal entry on the tax spreadsheet. Therefore the tax return does not reflect the change in accounting method adjustment, it having been made prior to bringing income into the schedule M.
- The taxpayer may net the adjustment with other schedule M adjustments.
- The taxpayer may report the change in accounting method adjustment as a separate schedule M adjustment.

The situation will normally arise in an acquisition where different methods of accounting have been used in reporting loan fee income or escrow interest income (e.g., the acquiring corporation uses the liquidation method and the acquired corporation uses either the straight cash or accrual method). When this occurs, the taxpayer will re-compute the income of the acquired corporation on a historical basis as if they should have been using the other method (e.g. the liquidation method) all along. The difference in income between this re-computation and the income actually reported over the years in question equals the adjustment claimed by either the acquired or acquiring corporation. IRC Section 381 is the controlling over IRC Section 481, with . IRC Section 481 applicable only where adjustments are necessary to prevent amounts from being duplicated or omitted. Adjustments for a change in accounting method are frequently made pursuant to a revenue procedure (Rev. Proc.). A Rev.Proc. would identify the conditions for approval of the accounting change including the number of years to spread the IRC Section 481 adjustments. If IRC Section 381 applies, dollar balances would be brought forward and no duplication or omission of income would result.

0411 Commitment Fees

Commitment or standby fees are charges for making funds available on a standby basis and not for the use of funds. They do not represent interest. These fees may relate to business loans, letters of credit, construction loans or mortgage loans. There are no special rules for reporting income on commitments or standby fees.

Rev. Rul. 56-136 states that since commitment fees are current charges for making business funds available on a standby basis rather than for the use of funds, they do not represent interest expense to the borrower. However, commitment fees are deductible as ordinary and necessary business expenses, and thus would constitute gross income to the bank payee.

Rev. Rul. 56-136 is revoked by Rev. Rul. 81-160, 1981-1 CB312, which states that a loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of the money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee become a cost of acquiring the loan and is to be deducted ratably over the term of the loan.

The two most common types of commitment fees are for unsecured business loans and mortgage commitments. The business loan commitment is a fee charged monthly on the unused portion of the commitment or line of credit. The fee is billed monthly and usually collected within a few days. The auditor is not likely to find much difference between tax and financial reporting of this item. The mortgage commitment is by nature like an option. The fee is earned and collected at the time the commitment is given. However, the auditor may find that for financial reporting the income is spread over the life of the commitment, thus the auditor should look for a related schedule M adjustment. If a schedule M adjustment indicates that commitment fees are being deferred, the auditor should determine the type of commitment fees and how each was reported.

0412 Core Deposits

On December 29, 1981, the Office of the Comptroller of the Currency (OCC) issued Circular #164, which provides that banks, under appropriate circumstances could capitalize the value of customer deposit relationships. The FDIC adopted a similar policy on March 5, 1982. Banks intending to record such assets must obtain prior approval from the OCC and the SEC.

The OCC defines core deposits as the deposit base. The deposit base, while usually not restricted, is generally based on stable customer relationships the bank can expect to maintain for an extensive period of time.

The core deposit issue arises in the acquisition of another bank. The purchaser allocates the purchase price based on fair market value to the tangible assets acquired. Any purchase price over fair market value of tangible assets is generally assigned to goodwill. This is not an issue for book purposes as goodwill is amortized.

For tax purposes, prior to adoption of IRC Section 197, goodwill could not be amortized. Thus, the taxpayer received no benefit from the amount allocated to goodwill until the asset is sold or otherwise disposed of.

The taxpayer may allege that the reason for the excess purchase price over the fair market value of tangible assets is due to the amount of deposits and that past business practice shows that the deposits will not be withdrawn for some time. Thus, the taxpayer is also purchasing a source of stable money, the core deposits.

IRC Section 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or election-back date, where applicable) of IRC Section 197. IRC Section 167 provides for a depreciation or amortization deduction for the exhaustion of property used in a trade or business. Although IRC Section 167(a) does not specifically refer to intangible property, Treas. Reg. Section 1.167(a)-3 recognizes that an intangible asset may be amortizable under certain circumstances. Treas. Reg. Section 1.167(a)-3 permits amortization of an intangible asset if the asset is known from experience or other factors to be of use in the business or in the production of income for a limited period, the length of which can be estimated with reasonable accuracy. The regulation denies amortization for intangible assets that do not have limited useful lives, and states specifically that no depreciation is allowable for goodwill.

During 1993, several major changes occurred in the tax law that impact the amortization of intangibles. First, the United States Supreme Court rendered a decision holding that, if a taxpayer could prove that an intangible asset had a limited useful life and a value that could be determined with reasonable accuracy, the taxpayer could amortize (or depreciate) the intangible despite how closely the intangible resembled goodwill. (*Newark Morning Ledger v. United States* (1993) 113 S. Ct. 1670.) Although the court did not overturn the mass asset rule, it did hold that, if the taxpayer could meet its burden of proof, the mass asset rule would not apply. The mass asset rule prohibits the amortization of certain intangibles on the grounds that these assets are self-regenerating. Although the assets may change, they never waste. Thus, we can no longer argue that core deposits are so related to goodwill as to be nondeductible per se. Instead, we must determine whether the taxpayer has met its burden of proof, which is a question that depends upon the facts of each case. The IRS will allow amortization for a customer-based intangible where the taxpayer's appraisal meets the test of *Newark Morning Ledger*.

The second major tax change that occurred was the enactment of IRC Section 197. IRC Section 197 permits the amortization of all intangible assets, including, for the first time in tax history, goodwill. All intangibles that are covered under Section 197 must be amortized on a straight-line basis over a 15-year life. IRC Section 197 generally applies to the purchase of businesses as of August 2, 1993, with special elections available that can make it retroactive to July of 1991. California's conformity to IRC Section 197 will be discussed at the end of this section.

The IRS has stated that the amortizability and useful lives of customer based intangibles will no longer be issues under Section 197. However, the valuation issues will continue to present problems notwithstanding the enactment of this code section.

The third major tax law event is that the IRS announced a national settlement policy for all those cases that involved the amortization of intangibles acquired prior to the effective date of IRC Section 197. The IRS estimated that there were 8,100 different issues relating to the amortization of intangibles, totaling $14 billion of adjustments, in its inventory. The settlement procedures consist of a one-time offer by the IRS to taxpayers. The offer makes an adjustment to the basis of the amortized intangibles (with a corresponding offsetting adjustment to goodwill) based upon the greater of 15% of the basis of the amortized intangibles or a 50% cost recovery amount. Closing agreements and offers were to be mailed to taxpayers on April 1, 1994. The taxpayer could accept the offer, counter the offer to extend the useful life rather than change the basis of the assets, or reject the offer, and then argue facts and circumstances. California's conformity to this program will be discussed at the end of this section.

Taxpayer's Burden of Proof

The primary question to be answered in a case involving the amortization of intangibles is whether the taxpayer has met its burden of proof.

On February 19, 1996, the IRS issued a revised ISP paper discussing the amortization of customer-based intangibles, including core deposits, prior to the enactment date of IRC Section 197. Relevant portions of the paper are cited throughout this section of the handbook. The entire paper may be obtained through Tax Notes Today, 96 TNT 49-26.

With regard to the taxpayer's burden of proof, the IRS issue paper states:

> “It is also clear from the majority opinion [in Newark Morning Ledger], however, that a taxpayer claiming amortization of a customer based intangible has a substantial burden to establish (1) that the taxpayer has accurately determined the duration of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value. The Supreme Court acknowledged that ‘although we now hold that a taxpayer able to provide that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage, we do not mean to imply that the taxpayer's burden is insignificant. On the contrary, that burden will often prove too great to bear.' 113 S. Ct. at 1681. The Court cited several core deposits cases as examples where the Tax Court and appellate courts had concluded that certain core deposit intangibles could be amortized because those taxpayers had met their burden.”
>
> “In Newark Morning Ledger, the government did not attempt to challenge the taxpayer's valuation methodology, nor did it challenge the useful life attributed to the ‘paid subscribers.' Instead, the entirety of the government's case was its argument that amortization of the asset should be disallowed as a matter of law. Because the government had not developed the case factually, the government lost the case once the Supreme Court held that depreciability of an intangible asset is a question of fact. The lesson of Newark Morning Ledger is that the Service has to factually develop cases involving intangible assets, or else expect to lose these cases.”
>
> “The Service has been relatively successful in those cases where it challenged taxpayers' valuation methods and useful life assertions. Where taxpayers have inappropriately valued and lifed their intangible assets, the government has been relatively successful in challenging

> the taxpayers' claims and has generally prevailed with respect to the dollar amounts of the deficiencies. Thus, Newark Morning Ledger should not be taken as a signal that the Service is reluctant to litigate valuation and useful life issues if the factual development demonstrates that the taxpayer has not proven these elements."
>
> "The taxpayer must be able to (1) identify the claimed asset, and demonstrate that it does not overlap with other putative intangibles claimed on the return; (2) demonstrate that the customer based intangible has a useful life of limited duration, and the useful life can be established with reasonable certainty; (3) demonstrate the asset's value with reasonable accuracy, with substantiation in the form of a proper appraisal; and (4) establish that its method of amortization is a reasonable one."
>
> "Because a case involving a customer based intangible requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's appraisals or assertions are erroneous. General guidance on critiquing taxpayers' appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N."

In order to prove the value and useful life, most taxpayers that have acquired businesses with intangible assets of any significant value obtain an appraisal or valuation of the assets acquired. The mere fact that the taxpayer obtained an appraisal report from an independent company that is in the business of valuing assets does not mean that the taxpayer has met its burden of proof. The auditors must determine whether the report was properly prepared, i.e., that its assumptions are correct under the facts.

The appraisal report should contain sufficient detail for the auditors to have a full understanding of how the value was determined (the methodology), the assumptions that were used, and the source of the data utilized. The auditor should be able to trace the raw data numbers into the report and verify the information presented. If the auditors are not able to do this, then chances are i information is insufficient to determine the adequacy of the appraisal. The auditors must, then, request additional information from the taxpayer or have the taxpayer provide a detailed explanation about the appraisal process that took place.

- <u>Nature of the Appraised Asset</u>

Auditors must begin by identifying the intangible assets that are at issue in the case, ensuring complete understanding of the nature of the asset. Sometimes a taxpayer will place a creative label on an intangible asset; still the auditors need to understand what each asset represents.

Once auditors understand the nature of the asset that the taxpayer is claiming, auditors need to determine whether the individual elements that the taxpayer valued are actually components of that asset. For example, since a core deposit is to represent the cost savings of using the core deposit as a source of funds rather than alternative sources, if the deposit is interest sensitive, i.e., it bears a market rate of interest, then it cannot be part of the core deposit base. Additional information will follow with an explanation of relevant decisions.

- <u>Statistical Sampling</u>

Most reports do not examine 100% of the components of the intangible assets, but instead will statistically sample the elements. For core deposits, reports will not trace the history of all bank accounts ever opened at each branch but will select only a portion. The sample size must be sufficiently large enough to produce reliable results. For example, in *Newark Morning Ledger*, 460,000 accounts were included in the sample size and this was considered large enough. In *Ithaca Industries, Inc. v. Comm.* (4th Cir. 1993) 17 F.3d 684, a case that involved the amortization of an assembled workforce, the court stated that a sample size of only 5,000 different people was not sufficient to identify pertinent variables and reliable patterns of attrition.

The taxpayer must stratify the components of the asset into groupings if very different decay or runoff rates are expected for different groups. If the purchased intangible's components have not been properly broken down, then the appraisal is subject to inaccuracies that may be unreasonably acceptable. Auditors must make sure that the percentage of each category sampled is high and that the overall dollar value that was sampled is also high (90% range).

- Assumptions Used

Auditors must make sure that the assumptions used are reasonable under the circumstances by looking at the discount rate, alternative costs of funds, etc. If the auditors do not understand why an adjustment was made or why a particular figure was used, auditors should request the taxpayer to provide a detailed explanation.

- Methodology

For core deposits, the U.S. Tax Court has approved the use of the cost savings methodology for the measure of the value of the core deposit base. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184 and *Citizens & Southern Corp. v. Comm.* (1988) 91 T.C. 463.) Under this approach, the value of the core deposit is equal to the present value of the difference between the asset's ongoing cost and the cost of the next most favorable market alternative.

With regard to valuations, the IRS issue paper states:

> In Newark Morning Ledger, the Supreme Court sanctioned the INCOME APPROACH for valuing customer-based intangibles. This approach is an appraisal methodology that measures the present value of future net income to be received from the customers existing on the date of acquisition, over the useful life of the asset. The income stream attributable to a customer based intangible:

- Must be determined based on the actual full term of the income stream, not its average life.
- Must be NET.
- Must not include the return on any other asset (no double counting).
- Must be consistent with all other valuation assumptions made by the taxpayer.
- Should consider future income from only those customers of the acquired concern on the acquisition date. THE INCOME STREAM SHOULD NOT REFLECT INCOME FROM FUTURE OR REPLACEMENT CUSTOMERS.
- Should include an after-tax discount rate that reflects the speculative nature of the asset (i.e., should reflect a higher discount rate for more speculative assets), and should use a higher discount rate for the specific asset as compared to the discount rate appropriate in valuing the business as a whole. If the rate used is not at least as high as the taxpayer's actual return on equity, further inquiry will be necessary.
- Should NOT be increased by an inflation factor.

- Should identify the costs (both direct and indirect) identifiable with the asset being valued.

  Net after cash flow may include a 'tax shield,' i.e., the present value of the tax savings attributable to the amortization deduction. See *IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. 496 (1991), and *Peoples Bancorporation v. Commissioner,* T.C. Memo, 1992-285, where the court sanctioned the use of a tax shield. The after-tax cost savings may be computed in either of two ways. In *Citizens & Southern and Colorado National Bankshares*, for example, an effective tax rate of 20% was applied to cost savings unreduced by the amortization deductions. Alternatively, the statutory tax rate can be applied to the cost savings reduced by the amortization deductions. However, be alert to a flawed computation which applies an effective tax rate to cost savings reduced by the amortization deductions because the tax benefit of amortization is already included in the effective tax rate. *IT&S of Iowa, Inc. v. Commissioner*, supra, 97 T.C. at 532-533. See, e.g., *Trustmark Corp. v. Commissioner*, T.C. Memo, 1994-184.

  If the taxpayer is using a COST METHOD, this is acceptable. This method is based on the cost to replace or recreate the property or property of equivalent utility. Preferably, costs used should be the actual cost figures experienced by the taxpayer, as these are most indicative of the replacement cost. However, if these are unavailable, cost data of the industry is acceptable. Note that in applying the cost approach, accumulated obsolescence from all sources must be taken into account.

Useful Life

The taxpayer must perform a lifing study or lifing analysis to determine the useful life of the asset. A lifing study typically considers three factors: (1) the number of open accounts at or near the date of acquisition; (2) the age of the accounts at the time; and (3) the rate at which the accounts were expected to terminate as a function of their current age. The rate at which accounts will close is usually assumed to be the same as the rates at which past accounts closed. These rates are determined by observing prior account closures over a certain period of time. The Tax Court has deemed as reasonable periods ranging from three months to three years. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184.)

Often the lifing study will be part of the appraisal report. The life of the asset will determine its value if the income method is used because income is projected over the estimated life of the asset, then discounted back to the date of purchase. The terms discussed above under Appraisal Reports apply with regards to the determination of the life as well as the value of the assets.

The IRS issue paper states:

> The fact that the customer based intangible has a limited useful life must be demonstrated by the taxpayer. Additionally, the duration of the useful life must be established. THE LIFE WHICH IS RELEVANT FOR AMORTIZATION PURPOSES IS THE ACTUAL, ENTIRE LIFE OF THE COMPOSITE WHOLE, AND NOT THE AVERAGE LIFE OF THE UNITS COMPRISING THE CUSTOMER BASED ASSET. Where statistical methods have been used to project the life of an intangible asset, the statistical projection should be compared with the taxpayer's actual post-acquisition experience. Lifing studies should, where possible, be reviewed by a statistician to identify lifing methodologies that are inconsistent with general statistical principles.
>
> The taxpayer may not ignore the above-normal life of certain stable customer relationships, such as commercial accounts or long-term supplier relationships.

Wasting Nature

Goodwill and going-concern value have not been subject to amortization (prior to the enactment of IRC Section 197) because they are not wasting in nature (there is no exhaustion of the asset). In *Newark Morning Ledger*, supra the U.S. Supreme Court defined goodwill as "the expectancy of continued patronage." It is composed of all of the qualities that attract customers to the business. In order to separate an asset from goodwill, the taxpayer must show that public taste or other socioeconomic forces will cause the intangible asset to be retired from service. The mass asset rule prohibits the amortization of certain customer-based intangibles on the grounds that those assets are self-regenerating. Although the assets may change, they never waste.

Amortization Method

Generally, intangible assets are to be amortized over their useful lives on a straight-line basis. If, however, the taxpayer is able to prove that an accelerated method results in a more reasonable depreciation allowance, an accelerated method can be used. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184; *IT&S of Iowa, Inc. v. Comm.* (1991) 97 T.C. 496; and *Citizens & Southern Corp. v. Comm.* (1988) 91 T.C. 463.)

The IRS issue paper notes:

> The STRAIGHT LINE METHOD is generally acceptable. If an accelerated method is used, it must be consistent with the rate that the customer based asset (not its present value) is projected to waste for valuation purposes.

Definition of Core Deposit

The IRS in its issue paper defines core deposits as:

> stable deposits which a bank or savings & loan association expects to retain for an extensive period of time, but which the depositors may terminate at will. The intangible is associated with the present value of the future cost savings from acquiring low cost core deposits to fund a bank's earning assets, instead of more expensive sources of investible funds. The core deposit intangible is also referred to as deposit base.

Assembled workforce represents the value inherent in having a trained staff of employees in place and is limited to employees who do not have employment contracts.

The Tax Court in *Citizens and Southern Corp. v. Comm.*, (1988) 91 T.C. 463 defined core deposits as "a relatively low-cost source of funds, reasonably stable over time, and relatively insensitive to interest rate changes."

Citizens and Southern Corp. included regular savings accounts, NOW accounts and certificates of deposit (CD) in their definition of core deposits. The taxpayer did not include money market accounts in core deposits.

The IRS took the position that the core deposits were an element of goodwill. The IRS did not take issue with the make up of the accounts *Citizens and Southern Corp.* included in their core deposits.

In *IT&S of Iowa, Inc. v. Comm.,* 97 TC 496, the IRS took issue with the definition of core deposits. The Tax Court noted that in *Citizens and Southern* the taxpayer defined core deposits to include CDs. The inclusion of CDs in *Citizens and Southern* was not relevant to other taxpayers as "we did not consider the breadth of the core deposit definition because it was not contested by respondent."

In *IT&S of Iowa, Inc.*, supra, the taxpayerincluded all deposits except certificates of deposit over $100,000, internal accounts and government funds. The taxpayer's definition of core deposits included demand accounts, savings accounts, super NOW accounts, money market accounts, and CDs under $100,000. However,the Tax Court rejected the taxpayer's definition of core deposits as being overly broad and defined core deposits as "a relatively low-cost source of funds, reasonably stable over time, and relatively insensitive to interest rate changes." The court further provided:

> If deposits bear a market rate of interest and are sensitive to market rate fluctuations, they offer no potential for extra-normal profitability and there is no potential for cost savings associated with them. If, however, deposits are insensitive to interest rate changes, they do offer the possibility of providing above normal profits, and, accordingly, will command a premium in a sale transaction.

The Tax Court in *IT&S of Iowa, Inc.* also noted:

> adjustable rate deposit accounts, such as certificates of deposit, money market accounts, and super NOW accounts, were expressly created in order to allow banks to compete successfully for deposits against financial intermediaries not bound by interest rate ceilings applicable to banks.... inasmuch as such accounts were designed to be interest rate sensitive and rate competitive products of banking, it is illogical to include them automatically in core deposits, a term defined to mean deposits which are not sensitive to interest rate changes.

While such accounts are not automatically excluded from core deposits, there must be a showing that the accounts are insensitive to interest rate changes. The court looked at such indications as market competition and the relationship between the taxpayer's interest rate and market rates. The *IT&S of Iowa, Inc.* court excluded CD's and money market accounts from the definition of core deposits. A similar conclusion was reached in *Peoples Bancorporation and Subsidiaries v. Comm.* (1992) T.C. Memo 1992-285.

In *Colorado National Bankshares, Inc. v. Comm.*, (1990) T.C. Memo 1990-495, the taxpayer only included interest free checking accounts, NOW accounts and savings accounts. It appears that the Tax Court took a common sense approach to the idea of core deposits. While the IRS was correct in that many aspects of core deposit valuation relate to goodwill (what are the odds that the depositor will leave their account at that branch), it makes common sense that a source of funds at 5.5% is more valuable when replacement funds costs 8%. Someone would pay a premium to acquire a lower cost source of funds.

At the same time, the Tax Court found that it was illogical to say that funds which are at or near the market interest rate qualify as core deposits as they do not have the ability to earn above normal profits.

In *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184, the Tax Court relied heavily upon the definition of core deposit that it set forth in IT&S of Iowa. The court stated that it did not foreclose the possibility of including money market accounts and Super NOW accounts in the deposit core in situations where the taxpayer could show that such deposits were in fact insensitive to interest rate changes.

Once the core deposit has been defined, the cost to the bank, both in terms of explicit interest and the cost of services provided to depositors, called implicit interest, must be ascertained.

Cost of Alternative Funds

The cost savings methodology measures the present value of the difference between the cost of an asset and the cost of the next most favorable market alternative. In *Trustmark Corp., Inc., et al.,* the taxpayer used insured certificates of deposit as the alternative source of funds because of their similarity to core deposits in terms of insurability, average balance size, and maturity or remaining life. The court accepted this as a reasonable basis for comparison. In *IT&S of Iowa,* the court suggested that the best sources of comparison are the rates paid by the taxpayer on interest rate sensitive deposits. In *Trustmark,* the court found that competitor's CD interest rates are a reasonable cost of alternative funds to the taxpayer.

After-Tax Cost Savings

In computing the after-tax cost savings, the taxpayer may either apply an effective tax rate (i.e. a rate that is lower than the actual tax rate) or it may reduce the pre-tax cost savings by the amortization deduction, but it cannot do both. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184; *Citizens and Southern Corp. v. Comm.* (1988) 91 T.C. 463.

Discount Rate

The discount rate to be applied usually consists of the weighted cost of debt and equity capital. The specific facts of the case, however, can impact the discount rate. (See *Trustmark Corp., et al. v. Comm.* (1994) T.C. Memo 1994-184.)

Audit steps should cover the following analysis:

1. Has the IRS audited this issue? Did the IRS make a settlement offer pursuant to the IRC Section 197 settlement program? Did the taxpayer accept the offer or make a counter-offer that the IRS accepted? If the answer to all of these questions is yes, then we will follow the federal agreement.

2. Determine how the taxpayer is treating the transaction for book purposes. Did they place a separate value on the core deposit intangible and amortize it over the same period and method as for tax purposes or is it included in goodwill? Ask the taxpayer to reconcile any difference in treatment between the tax return and the books. There should only be one set of facts that should result in the same value for books and tax. In addition, the facts that support accelerated amortization for tax purposes should also support accelerated amortization for book purposes.

3. If a national bank, did they obtain permission of the Comptroller of the Currency? Obtain a copy of the request for approval and the approval.

4. If publicly traded, did they receive permission of the SEC? Obtain a copy of the request for approval and the approval.

5. Ask for a copy of the appraisal. The entire copy of the appraisal for each acquired branch should be in the audit working papers.

California Conformity to IRC Section 197 and IRS Settlement Initiative

SB 1880 was signed by Governor Wilson on September 30, 1994, enacting R&TC Section 24355, R&TC Section 24355.5, and amending R&TC Section 24353 and R&TC Section 24916. This bill, among other changes, results in conformity of our law to IRC Section 197 pertaining to the amortization of intangible assets. Under Section 197, intangibles acquired after August 10, 1993 can be amortized over 15 years (180 months) on a straight-line basis. Goodwill and customer-based intangibles are among the assets that are subject to Section 197 treatment. There are many exceptions and special rules that apply, including elections to have Section 197 apply retroactively to acquisitions made after July 25, 1991 and to elect out of Section 197 treatment if there was a binding contract in effect prior to August 10, 1993.

By conforming to federal law, our law piggybacks off the federal definition of a Section 197 asset, however, the date with which a taxpayer may begin amortizing the asset is delayed. For federal purposes, a taxpayer may begin amortizing Section 197 asset the month after the acquisition. If a taxpayer acquired a core deposit on August 25, 1993 for $150,000, then for federal tax purposes, the taxpayer could amortize the core deposit on a straight-line basis for 15 years beginning in September of 1993. Assuming that the taxpayer had a calendar year end, the taxpayer would claim $3,333 ($150,000 divided by 180 months times 4 months) of amortization on that asset in 1993, $10,000 for each of the following 14 taxable years, and $6,667 in 2008.

For California purposes, a corporate taxpayer cannot claim an amortization deduction until the first taxable year beginning on or after January 1, 1994. If the intangible asset was acquired prior to January 1, 1994, the basis of the asset is its adjusted basis as of the first day of the first taxable year beginning on or after January 1, 1994. The amortization period for California purposes begins with the first month of the first taxable year beginning on or after January 1, 1994, and ending 15 years after the month in which the intangible was acquired. Thus, where the acquisition took place prior to January 1, 1994, the California amortization period will be less than 15 years. The amortization is taken ratably over this period.

Under the example above, the taxpayer would begin the amortization period on January 1, 1994, and would end it in August of 2008 (14 years, 8 months or 176 months). Rather than claiming an amortization deduction of $10,000 for 1994 (the federally computed amount), the taxpayer would be entitled to $10,227 ($150,000 divided by 176 months times 12 months).

R&TC Section 24355.5 provides that any election made at the federal level under IRC Section 197 is binding for state purposes. Thus there is no ability to make a different election for state and federal purposes concerning purchased intangibles.

We have also decided to follow the IRS settlement initiative with regards to the amortization of intangibles acquired prior to the enactment of IRC Section 197. We will follow whatever determination the IRS made, if there has been an audit by the IRS on the intangible issue. If the IRS decided to apply the settlement initiative, including adjustment of the useful life in lieu of the basis adjustment, we will do the same. If the IRS refused to settle the issue, then we will likewise go forward with the factual development of the issue. Hopefully, the taxpayer would agree in that case to wait until there is a final federal determination so that we do not have to duplicate audit efforts. If the IRS has not audited this issue, then we can apply the IRS settlement process rules to the case. Once the basis adjustment has been determined, a closing agreement is entered into with the taxpayer setting forth the basis of the assets, the useful life, and the method of amortization. The closing agreement must be prepared by legal. If the taxpayer wants to settle the issue in a manner that is outside the guidelines set forth by the IRS, then the matter must go through the regular settlement process and meet all of the guidelines for that process.

0413 Credit Card Fees

Most commercial banks that provide customers with credit card services charge an annual fee for those services. In situations where the banks, financials, or savings & loans are accrual basis taxpayers, the IRS has questioned whether the entire annual fee for the credit card contracts should be included in income in the taxable year in which the contract begins. Or should the fee be included in income on a straight-line ratable basis over the one-year time period of the contract agreement. The IRS has taken the position that the annual fee should be reported when received or when it is due and payable under the accrual basis (whichever is earlier). Before approaching this type of adjustment, be sure that any potential tax change is material.

0414 Dividends from FNMA Stock

The dividends paid on the common stock of the Federal National Mortgage Association are eligible for the deduction provided under section 243 of the Internal Revenue Code of 1954 per Rev. Rul. 56-510.

0415 Early Withdrawal Penalties

Many financial institutions offer fixed term certificates with early withdrawal penalties. For example on July 1, year 1 you may purchase a $10,000 one-year certificate of deposit which pays 10% interest. Assuming the financial institution is on a calendar year end and the account including interest is withdrawable on demand, the financial institution would deduct interest expense of $500 ($10,000 x 10% x 1/2 year) during year 1.

Assume you withdraw your deposit on 1/1/year 2. Also assume that the financial institution has an early withdrawal penalty of the difference between the interest rate paid and the passbook rate. If the passbook rate is 5%, the penalty would be $250 [($10,000 x (10% - 5%) x 1/2 year]. Thus you would receive $9,750 from the financial institution. The question for tax purposes is if the early withdrawal penalty is current income.

A series of court cases has established the tax benefit doctrine, which requires inclusion taxable income of the recovered but previously deducted amounts. IRC Section 61(a)(12) also provides that forgiveness of indebtedness is taxable income. IRC Section 108 limits the application of Section 61(a)(12) and the tax benefit rule in certain cases involving discharge of indebtedness income.

Prior to the enactment of the Tax Reform Act of 1986, the taxpayer could reduce the basis in assets for income from discharge of indebtedness if the discharge is from qualified business indebtedness (IRC Section 108).

Many banks and financial corporations, especially savings & loan associations, have taken the position that the early withdrawal penalty is a discharge of indebtedness within IRC Section 108 and as provided by Section 1017 elect to reduce the basis in assets, deferring the recognition of income. Before June 2, 1980, penalties charged on early withdrawal of depositors' account were calculated based upon the number of days the certificates were held. Generally, interest is accrued throughout the year and credited to the depositor's account. The interest portion was subject to withdrawal by the depositor. The penalty was based on the interest paid to time of withdrawal of principal.

The 1980 Financial Institutions Deregulation and Monetary Control Act required the FHLBB, the Comptroller of the Currency, and the FDIC to issue new regulations.

Effective June 2, 1980, the following minimum penalties are imposed on early withdrawal:

- 90 days interest for certificates of deposit with a term of less than one year.
- 180 days interest for certificates of deposit with a term over one year.
- The regulations provide that the depositor's principal may be reduced if the penalty exceeds the interest remaining in the account.

Rev. Rul. 83-60 states that early withdrawal penalties do not qualify for forgiveness of indebtedness and thus cannot be excluded from income under IRC Section 108. Rev. Rul. 83-60 also provides a copy of part of the regulation on the new early withdrawal penalties.

Although Rev. Rul. 83-60 applies to all banks and financial corporations the ruling specifically refers to IRC Section 591 and Treas. Reg. Section 1.591-(b) in regards to domestic building and loan associations and certain other thrifts. The regulation states that these financial institutions may deduct the full amount of interest credited and available to the customer even if it is subject to an early withdrawal penalty. If the penalty is later imposed, the penalty must be included in taxable income. R&TC Section 24370 is similar to IRC Section 591.

The U.S. Supreme Court in *U.S. v. Centennial Savings Bank FSB,* (1991) 499 U.S. 573, affirmed the IRS position in Rev. Rul. 83-60 that early withdrawal penalties are not a discharge of indebtedness and must be included in taxable income.

This should not be an audit issue for withdrawal penalties generated after 1986 by a solvent bank or thrift given the Tax Reform Act of 1986 amendments to IRC Section 108.

0416 Foreign Exchange

Generally Accepted Accounting Principles (GAAP) for the translation of foreign currency for financial accounting developed in response to changes in the international monetary system. Prior to 1920, foreign currency translation was not a material issue. Although commodities were exchanged over international boundaries, few U.S. corporations had foreign subsidiaries or branches, thus most transactions were translated at spot rates.

The accounting profession first addressed the issue in 1931 in a report called "Foreign Exchange Losses," which recommended basing foreign exchange gain or loss on classification of assets and liabilities as current or non-current. In 1939, the AICPA published Accounting Research Bulletin (ARB) No. 4 "Foreign Operations and Foreign Exchange Gains," which used the current/non-current method of foreign exchange. The current/non-current method provides that current assets and liabilities are translated at year-end exchange rates. Non-current assets and liabilities are translated at historical cost and exchange rates on date of acquisition.

During 1944 - 1971 exchange rates were stable. The international monetary system was controlled by the Articles of Agreement of the International Monetary Fund. It was adopted by most major countries in 1944 and was commonly referred to as the "Bretton Woods Agreement." The monetary system was based on having most currencies valued by reference to the U.S. dollar. The value of the U.S. dollar was based on the supply of gold. The currency of all member countries was based on a pegged rate with the U.S. dollar. The pegged system was dependent on a number of items, including uniformity in Central Bank policies of member countries, balance of payments, health of individual member economies, and politics among member nations.

Exchange rates were stable until the late 1960's. Member countries refused to devalue their currency due to inflation worries, unbalance of payments of member countries, the demand for the U.S. dollar exceeded the supply, and finally by 1968 the United States had developed significant payment deficits which resulted in fluctuation of exchange rates.

In 1971, the U.S. dollar was devalued and a new set of pegged rates were established in the "Smithsonian Agreement." The United States then went off the gold standard and, in 1973, the U.S. devalued the dollar again. As a result of these events a modified floating system was developed which is still in use today.

The currency of the 12 major countries is theoretically set by supply and demand. Central Banks of the various countries are free to purchase and sell foreign currencies to affect exchange rates. Other currencies are valued under a modified version of the floating rate or under a pegged system.

In 1953, ARB 4 was replaced with ARB 43, "Foreign Operations and Foreign Exchange" which substantially continued with prior methods of current vs. non-current exchange translation.

Due to exchange rate fluctuations of the early 1970's, the Financial Accounting Standards Board (FASB) was forced to study the issue. The study eventually became FASB Statement No. 8. This was a significant departure from prior methods. FASB Statement No. 8 provided that:

- Cash, receivables and payables (both current and non-current) are translated at current exchange rates.

- Assets and liabilities carried at past exchange rates, for example fixed assets, are translated at historical rates.

- Assets and liabilities carried at current purchase or sale exchange rate or future exchange rate, for example inventory valued at market as provided by the lower of cost or market method, are translated at current exchange rates.

- Income and expenses are translated at average rates, except for depreciation and inventory for cost of goods sold, which are translated at historical rates. An exception to the use of the historical rate is, if the inventory is valued at market as provided by the lower of cost or market method, then the average rate should be used.

- Unrealized foreign currency gains or losses will be included in income.

Under prior GAAP pronouncements, current assets and liabilities were translated at current rates. Under FASB #8, certain current assets and liabilities (e.g., cash) are translated at current rates, while other current assets valued at other than market (e.g., inventory) are subject to historical rates.

FASB #8 resulted in broad criticism, which prompted another study, resulting in FASB #52 "Foreign Currency Translation." The two major areas covered by this statement are:

- The accounting and reporting of foreign currency transactions, including forward exchange contracts.

- The translation of foreign currency financial statements for purposes of consolidation, combination or reporting on the equity method.

The difference between foreign currency transactions and translation is that a foreign currency transaction is a transaction that requires a settlement in other than the functional currency of the reporting entity. Translation is the restating of foreign financial statements in the reporting currency of the parent (usually U.S. dollars).

FASB #52 requires a determination of what is the functional currency of the foreign operations. Functional currency is defined as the "currency of the primary economic environment in which the entity generates and expends cash." The following two examples help define functional currency:

- The functional currency of a self-contained foreign operation, located in a particular country, whose daily operations are not dependent on the parent's functional currency would use the currency of the country where they are located as the functional currency. This type of entity generates and expends funds in the foreign currency and net cash flows are reinvested in the foreign country, or distributed to its parent. This may be a manufacturing entity whose cost of goods sold is from the foreign economy.

- The second example is that of a foreign entity which is a direct and integral component or extension of the parent's operation. The purchase and sale of assets are made in U.S. dollars and changes in individual assets and liabilities of the subsidiary effect the cash flow to the parent. The functional currency of the foreign operation would be the reporting currency of the parent, most likely U.S. dollars. This type of operation may be a marketing or sales entity.

Basically, FASB #52 provides for the following:

- Foreign currency statements must be in conformity with U.S. GAAP prior to translation.

- Assets, liabilities, and operations of the entity are translated in the functional currency of the entity.

- The current rate of exchange shall be used to translate the foreign assets and liabilities to reporting currency.

- The weighted-average exchange shall be used to translate revenue, expenses, gains, and losses from the functional currency to the reporting currency.

- The current rate of exchange shall be used to translate changes in financial position other than accounts that effect the income statement which use weighted average exchange rates.

- If a foreign entity's books are not kept in the functional currency, then the books must be re-measured into the functional currency prior to translation. For example, a U.S. parent may have a self-contained foreign subsidiary located in Germany. The German subsidiary may have a branch located in France. The functional currency is most likely German marks. The branch operation's books kept in French francs must be re-measured in German marks (the functional currency) before translation into the reporting currency of the parent.

- Unrealized foreign currency gains or losses are not reflected in the parent's current income except:

a. Where the foreign books are re-measured, such as in the example above.

b. Where foreign operations are located in a highly inflationary economy. FASB #52 defines a highly inflationary economy as one that has experienced inflation over three consecutive years of 100% or more, i.e., an inflation rate averaging 35% per year. Under FASB #52, operations in highly inflationary economies do not have a functional currency. The functional currency of the parent is used as the functional currency of the foreign operations.

- Unrealized foreign currency gains or losses, except from re-measurement, are separately stated as a component of owner's equity. The accumulated translation adjustments are taken into account in measuring the gain or loss on sale of the investment of the foreign operations. If 50% of the stock in the subsidiary is sold, then 50% of the accumulated translation adjustments are included in determining the gain or loss.

- Gains and losses from foreign currency transactions are recognized in current income, except for:

a) Gain or loss from a currency hedge to protect the investment in the foreign operations.

b) Gain or loss from certain long-term inter-company transactions.

c) Gain or loss on a hedge transaction to protect a foreign currency commitment.

- Deferred income tax treatment and disclosure provisions are also discussed in the FASB.

Prior to the Tax Reform Act of 1986, there was no comprehensive body of law explaining the tax treatment of foreign currency gains and losses in a coordinated manner. Instead, there were general guidelines provided by various court decisions, IRS rulings, and regulations. For example:

- Where a loan received in foreign currency is repaid in foreign currency, taxable income results if the dollar value of the loan received, converted at the rate of exchange at the time of the loan, exceeds the dollar value of the foreign currency repaid, converted at the date of repayment. (William Helburn Inc. v. Comm. (1st Cir 1954) 214 F2d 815).

- Basis of property purchased with foreign currency is translated to U.S. dollars at the exchange rate on the purchase date. (Rev. Rul. 78-281).

- If the foreign loan is qualified business indebtedness described in IRC Section 108, the taxpayer may elect under IRC Section 108(c) to reduce the basis of depreciable property as provided by IRC Section 1017 for foreign exchange gains. *Kentucky & Indiana Terminal Railroad Co. v. Comm.* (6th Cir. 1964) 330 F2nd 520.

Except for some Subpart F instances, federal tax law did not include unrealized gains or losses in current income.

The Tax Reform Act of 1986 added Subpart J (IRC Section 985 through IRC Section 989). The purpose of Subpart J is to provide comprehensive rules for the taxation of foreign currency gains and losses, as well as their source and characterization.

Federal corporate income tax law is similar to California personal income tax in that both subject all income to tax. The problem of double taxed income is handled by the foreign tax credit (federal law) and credit for taxes paid to another state (California law).

Branch income of a U.S. corporation would be included in the federal Form 1120. The auditor should carefully review the Form 1120 when the taxpayer has foreign branch operations to ensure the correct income and factors are being used for California tax purposes, if this is a material issue.

CCR Section 25106.5-10 provides rules for inclusion of foreign country operations in a combined report. Whenever combination with foreign country operations will result, the regulation should be read carefully.

FTB's policy is that exceptions to the application of CCR Section 25106.5-10 must be fully supported in the audit file. It is recognized that full taxpayer cooperation is required to follow the regulation. The auditor should, through letters and information requests, document that FTB requested the information necessary to apply the regulation.

CCR Section 25106.5-10 provisions include:

- Unrealized foreign currency gains or losses are not included in income.
- Depreciation, depletion, and amortization shall be translated at the date of asset acquisition.
- Fixed assets and inventory shall be included in the property factor at the historical cost and the exchange rate at the date of acquisition.

Problems immediately arise if we use the annual report for foreign income and total factors including:

- Under FASB #8, unrealized gains and losses are included in current income.
- Under FASB #52:
    - Unrealized gains or losses may be included in current income if the foreign financial statements are subject to re-statement, for example, if the foreign operation is in a highly inflationary country.
    - Depreciation and inventory for cost-of-goods sold are translated at weighted-average rates.
    - Assets are stated at current exchange rates for balance sheet presentation.

The auditor needs to thoroughly study the related FASB in order to determine which questions to ask the taxpayer so that CCR Section 25106.5-10 can be correctly applied.

0417 FSLIC & RTC Payments Received Pursuant to a Supervisory Merger

Prior to August 1989, the Federal Savings and Loan Corporation (FSLIC) was responsible for insuring deposits in savings & loan institutions, rescuing failing savings & loan associations, and protecting deposits in failing S&Ls. Because of massive losses in the S&L industry during the 1980s, FSLIC had a large number of S&Ls in serious financial difficulty. FSLIC could either allow the savings & loans to fail and then pay off depositors, or it could provide large infusions of capital to those institutions, making them attractive to new management groups to acquire the failing institutions and attempt to manage them profitably. FSLIC preferred the latter choice. The infusions of capital went directly to the acquiring institution to protect the acquiring institution against future losses, because the value of the liabilities, primarily deposits, were greater than the value of the assets available in the failing institution.

Generally, a taxpayer may claim a deduction for a loss on the sale or other disposition of property to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition, and the loss is not compensated for by insurance or otherwise (IRC Section 165). There were, however, some special provisions for troubled savings & loan associations during the 1980s.

Federal Law

For Federal purposes, the acquisitions of a failing S&L by a new management group was considered to be a tax-free reorganization under IRC Section 368(a)(1)(G). Additionally, based on IRC Section 597, financial assistance received by the acquiring group from FSLIC was not considered income and did not require an adjustment to the basis of assets received in the acquisition.

IRC Section 597 (effective for FSLIC payments made after December 31, 1980, and repealed for transactions occurring after May 10, 1989) excluded from gross income of a domestic savings & loan association, money or other property received from FSLIC. It also prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. The combination of the tax-free reorganization treatment and the exclusion of FSLIC payments from income, or as an adjustment to basis, resulted in the acquiring institutions obtaining large tax benefits from their acquisitions of failing savings & loan institutions.

The Technical and Miscellaneous Revenue Act of 1988 reduced this favorable treatment. Taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988.

Section 13324 of the Revenue Reconciliation Act of 1993 further modified the treatment of FSLIC assistance payments. For acquisitions occurring prior to May 10, 1989 (and financial assistance credited on or after March 4, 1991) any FSLIC assistance with respect to any loss of principal, capital, or similar amount upon the disposition of an asset, must be taken into account as compensation for such loss for the purpose of IRC Section 165. Any FSLIC assistance with respect to any debt must be taken into account for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts.

California Law

For taxable years beginning on or after January 1, 1988, the State of California adopted R&TC Section 24322. This section excluded FSLIC assistance from gross income, regardless of whether a note or other instrument was issued in exchange. It therefore precluded a reduction in the basis of assets of a domestic savings and loan association on account of money or other property received from FSLIC. It mandated an allowance for deductions, even for those deductions allocable to amounts excluded from gross income under this section. This section applied to payments received prior to December 31, 1988, or for FSLIC payments made pursuant to an acquisition or merger that occurred on or before December 31, 1988. This section included a sunset date of December 31, 1988.

Resolution Trust Corporation

The Resolution Trust Corporation (RTC) was created in August 1989 by enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). As part of FIRREA, FSLIC was dissolved and the Federal Deposit Insurance Corporation assumed FSLIC's inventory of failed savings & loan associations. From August 1989, to December 31, 1995, the RTC was appointed to administer the various receivership and conservatorship estates of approximately 730 different failed S&Ls in the United States, a number of which were doing business in California.

Under federal law, the RTC has great power and latitude to act as a receiver of a failed savings & loan association.

Typically, the RTC assumed control and acted as a receiver of an insolvent S&L using the general procedure. At times the designations, time periods, and methods were different, but the result, from the viewpoint of the State of California and the Franchise Tax Board, has been about the same.

First, the Office of Thrift Supervision determined that an S&L was insolvent and requested the RTC to assume control of the S&L. On Day 1, the RTC assumed control of the insolvent S&L and placed it in receivership (Old Receivership). On the same date the RTC created a new "federal mutual de novo association," a federal corporation, with its own charter, and immediately placed this federal mutual de novo association in conservatorship.

In a very short time, on Day 1 or within a few days, there was a purchase and assumption agreement between the Old Receivership and the conservatorship. The Old Receivership primarily retained the liabilities (other than deposits), and the conservatorship received the assets with remaining liabilities (primarily deposits). The depositors of the failed S&L dealt with the conservatorship for their financial transactions and probably did not realize there was a change.

The prime function of the Old Receivership was to dispose of liabilities, according to the federal claims process provided under FIRREA, for those pre-receivership liabilities that were retained by the Old Receivership. As of the date of receivership, FIRREA exempted the Old Receivership from all local and state taxes other than ad valorem property taxes.

The primary goal of the conservatorship was to continue to service the depositors until the deposits (assets and liabilities as a package if possible) could be sold to another financial institution to avoid a cash pay out to depositors. The conservatorship attempted to dispose of its other assets in the best manner (most profitable) possible.

Always, and normally within six months, the conservatorship, the new federal corporation, was placed into receivership status. This receivership (New Receivership) liquidated the remaining assets, with the proceeds going to the RTC as subrogation to the depositors, whose deposits had been guaranteed and paid by the RTC. As of the date of receivership, FIRREA exempted the New Receivership from all local and state taxes other than ad valorem property taxes.

The Old Receivership, the conservatorship, and the New Receivership retained the California corporate number of the Old Receivership as a matter of convenience. The process of insuring deposits and closing down insolvent S&Ls required massive infusions of funds from the federal government, administered by the RTC, with as much as $2 billion required for a single institution.

Conclusion on State Taxability of Federal Financial Assistance

The State of California did not adopt the current IRC Section 597. However, under general tax principles (R&TC Section 24271 and IRC Section 61), federal financial assistance received by the acquiring bank or domestic building and loan association would be taxable if it met the definition of gross income. On the other hand, if the transaction were structured as a loan (thus not income under R&TC Section 24271 and IRC Section 61), federal financial assistance would not be included in gross income.

Current Status

Carryover Losses

There is no legal rationale for an acquiring institution to use carryover losses based on assets acquired in a typical sale by the RTC or FDIC. R&TC Section 24451 creates conformity of California law to IRC Section 381 and IRC Section 382. These sections are designed to prevent abuse in trafficking of tax benefits. IRC Section 381 carryovers in certain corporate acquisitions, limits carryover tax attributes in case of the acquisition of assets of a corporation by another corporation to one of the following situations:

- In a distribution to such other corporation to which Section 332 applies (relating to liquidation of subsidiaries).
- In a transfer to which Section 361 (relating to non-recognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization, described in subparagraph (A), (C), (D), (F), or (G) of Section 368(a)(1).

Neither of the requirements is met by the acquisition of assets from the FDIC or RTC by an acquiring institution. Carryovers are not allowed under the California Revenue and Taxation Code in conformity with IRC Section 381.

IRC Section 382 further provides a limitation on net operating loss carry-forwards and certain built-in losses that qualify under Section 381. Since the acquisition of assets from the FDIC or RTC does not qualify under Section 381, the Section 382 limitations are not applicable.

Priority of Payment by the RTC/FDIC

The National Depositor Preference Act was passed during August 1993. Prior to this act, liabilities for unpaid state taxes were considered administrative expenses according to California law. As such, state taxes were paid prior to paying depositors. After the National Depositor Preference Act, all state taxes were considered general liabilities and were paid after depositors were paid. After the failure of a bank or S&L, it is much less likely that there will be funds remaining to pay general creditors and state tax liabilities after depositors have been paid.

Status of RTC

On December 31, 1995, the RTC was dissolved. By federal statute, the Federal Deposit Insurance Corporation (FDIC) replaced the RTC for any savings & loans' claims, liabilities, or assets that were not fully resolved or disposed of by the RTC. The FDIC has the same powers of the RTC with respect to any unresolved issues.

0418 Interest Income-Accrual for Troubled Loans

A question arises when an accrual basis bank or financial corporation should stop the accrual of interest from delinquent loans. Treas. Reg. Section 1.451-1(a) states "... Under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy..."

Rev. Rul. 68-220 provides, in part, that where an administrative agency requires a method of accounting as to a particular item, this treatment is not controlling for federal income tax purposes. This is similar to our bad debt reserve regulations. The amount of the reserve required by the regulatory agency, or independent auditors, is not important; however, is it very important the auditor collects the facts upon which the taxpayer relied in order to determine the reserve amount.

In *Greer-Robbins Co. V. Commissioner*, (9th Cir. 1941) 119 F. 2d 92, it was held that in determining whether the collection of interest was doubtful, the burden of proof was on the taxpayer to show the bad debt character of the accrued interest.

Rev. Rul. 80-361 provides that interest income should be accrued to the point the loan becomes uncollectible. Any accrued interest not collected should be treated as a bad debt pursuant to IRC Section 166(a) and charged off through the bad debt reserve.

The position of the IRS concerning accrual of interest is:

- If a bank, which is subject to supervision by federal authorities or by state authorities maintaining substantially equivalent standards, has been given specific instructions by a regulatory agency that a loan (in whole or in part) should be charged off as a bad debt, then no interest should be accrued on the amount charged off. Previously accrued but uncollected interest should be charged off as well. Interest should continue to be accrued until the date the account is charged off.

- The loan must be charged off to stop the accrual of interest. The regulatory agency may require that the bank stop the accrual of interest on delinquent loans, although they do not have to charge off the loan. Delinquent loans may be defined as loans in which interest has not been paid for a predetermined number of days, i.e., 30, 60, or 90 days. In this example, the policy is not controlling for tax purposes. Interest will continue to be accrued, unless other facts show that it is not collectible.

- Note that many state-chartered banks or savings & loan associations have federal deposit insurance. These entities would need to meet both state and federal regulatory requirements.

- On loans not charged off, the taxpayer must, on a loan-by-loan basis substantiate that the interest is not collectible.

0419 Interest Received in Excess of a Maximum Amount (CAP)

Some loan agreements contain provisions that during the term of the loan interest will be charged at a fluctuating rate, but the total interest charged over the life of the loan will be limited to a maximum amount. This maximum amount is called the "CAP" amount. For example, a loan agreement may provide for monthly payments based on interest equal to the prime rate, although the total interest over the life of the loan is limited to 13%. The prime rate for one month may be 15%. The difference between the 15% rate of interest paid and the 13% CAP may be credited to a liability account. Many of the agreements provide that the excess interest paid over the CAP is forfeited to the lender if the mortgage is paid off early.

A reconciliation of payments made during the life of the loan and the maximum interest allowed is done at the end of the loan term and an additional charge or refund will be made.

The audit issue is, if the amount paid in excess of the CAP is current income or a liability?

Treas. Reg. Section 1.451-1 provides that, under the accrual method of income, income is included in gross income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.

Rev. Rul. 66-347 states that a taxpayer must include in gross income, payments where the taxpayer has unrestricted use of the cash even if the payment is subject to a contingent liability to return it. The proper tax treatment is to include the payment in income and take a deduction when and if the refund is made.

Corliss v. Bowers, (1930) 281 US 376, held that income received unrestricted as to use is current income.

The Tax Court addressed the issue in *Continental Illinois Corp. v. Comm.,* (1989) T.C. Memo 1989-636. The bank stopped the accrual of interest in excess of the cap for tax purposes due to the following:

a) The all events test was not satisfied.

b) Due to the high probability of repayment the claim of right doctrine did not apply.

c) The excess payment was a deposit.

d) Cases on prepaid income did not apply to their facts.

The Tax Court agreed with the IRS that the income could not be deferred. The bank's right to receive the payment was fixed. The potential refund was a contingent liability that did not affect the right to receive the interest in the current year.

0420 Loan Acquisition Costs

All reasonably identifiable costs applicable to acquiring loans should be capitalized and written off over the average life of the related loans. Legal or similar expenses attributable to making loans, foreclosures, etc. (fees paid to outside brokers, appraisal fees) should also be capitalized and amortized over the life of the loan.

A review of the taxpayer's chart of accounts should disclose the likely accounts where such expenses might be classified. The accounts should then be reviewed for the above types of items. Note: beware of the possibility of a book/tax accounting difference, i.e., the taxpayer may capitalize the items for book purposes and deduct them for tax purposes. Schedule M-1 should disclose any accounting differences.

0420.1 FASB 91 Costs

The Financial Accounting Standards Board issued Statement of Financial Accounting Standard Number 91 (FASB 91), effective for accounting years beginning after December 31, 1987, provides guidance on the proper treatment of non-refundable fees and costs associated with originating or acquiring loans.

The accounting profession was criticized for being a party in hiding the scope of the problems in the savings & loan industry during the 1980's. One area of criticism was that income was overstated by the industry's practice of including loan fees in book gross income currently. In response, FASB 91 was issued which calls for the deferral of loan fees.

FASB 91 also requires that the incremental direct costs of making the loan be netted with the loan's fees and the net amount is brought into income over the life of the loan.

The incremental direct costs incurred in originating the loan include: costs that result from and are essential to the lending transaction; and, costs that would not have been incurred by the lender had the lending transaction not occurred. The costs are typically payroll and employee benefits incurred in evaluating the borrowers financial condition, evaluating and recording title, guarantees or collateral, negotiation of loan terms, preparing, processing, and closing the loan transaction.

IRC Section 162 provides for the deduction of all ordinary and necessary business expenses.

IRC Section 263(a) provides that no deduction shall be allowed for capital expenditures.

An issue arises whether FASB 91 costs are period costs, thus deductible under IRC Section 162, or a capital asset per IRC Section 263?

In 2000, a federal court of appeals specifically rejected any reliance on FASB 91 as a principle to be followed for tax purposes, ruling such costs were deductible under IRC Section 162. (See *PNC Bancorp v. Commissioner* (3d Cir. 2000) 212 F.3d 822.)

Treas. Reg. Section 1.461-1(a) provides the general rule for the taxable year of deduction which is that any expenditure that results in the creation of an asset having a useful life that extends substantially beyond the close of the taxable year may not be deductible, or may only be deductible in part, i.e., through depreciation or amortization deductions.

The U.S. Supreme Court in *Commissioner v. Lincoln Savings and Loan Association,* (1971) 403 U.S. 345, held that the premium paid into the FSLIC secondary reserve was a capital asset and not currently deductible. The test adopted by the Court requires capitalization of an expense if it serves to create or enhance a separate and distinct capital asset with an ascertainable and measurable value. The test became known as the **separate asset rule**.

In applying the separate asset rule, a court in *Briarcliff Candy Corp. v. Commissioner*, (2d Cir. 1973) 475 F.2d 775, held that IRC Section 263(a) could be applied to intangible assets even though the language in the section only addresses tangible property.

The U.S. Supreme Court in *INDOPCO, Inc., Petitioner v. Commissioner of the Internal Revenue*, (1992) 503 U.S. 79, 117 L Ed 226, held that amounts paid for investment banker fees, legal fees, proxy costs, and S.E.C. fees incurred in a friendly take-over were non-deductible capital expenditures rather than currently deductible ordinary and necessary expenses.

Although the taxpayer argued that *Lincoln Savings* established that the deductibility under IRC Section 162 was the rule rather than the exception, the Court had created an exclusive test pursuant to which an expenditure must either create or enhance an asset in order to be capitalized.

The Supreme Court in *INDOPCO* told the taxpayer that they "over-read *Lincoln Savings,*" Further explaining that *Lincoln Savings* held creation of a separate and distinct asset may be a sufficient condition for classification as a capital asset. It continued:

> Although the mere presence of an incidental future benefit—some future aspect—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.

In *PNC Bancorp v. Commissioner*, , 110 TC 349, 1998 U.S. Tax Ct., it was held that loan origination expenditures are not currently deductible under IRC Section162(a), and must be capitalized under IRC Section 263(a). The loan origination expenditures were incurred in the creation of loans. These loans were separate and distinct assets that generated revenue over a period beyond the current taxable year.

However, the *PNC Bancorp v. Commissioner* supra, court reversed the judgment of the Tax Court, holding that the costs at issue were deductible as ordinary and necessary expenses of the banking business within the meaning of IRC Section 162, and that these costs did not fall within the purview of IRC Section 263. The court noted that loan operations were the primary method of income production for the subject banks, and thus found that expenses incurred in loan origination were normal and routine in the particular business of banking.

The IRS published a notice of proposed rulemaking on January 24, 2002, describing and explaining rules and standards expected to be proposed to clarify the application of IRC Section 263(a) to expenditures (including transaction costs) incurred in acquiring, creating, or enhancing intangible rules or benefits. According to Chief Counsel Notice CC-2002-021, March 15, 2002, the IRS will not litigate certain transaction cost issues while in the process of proposed rulemaking. The IRS will not assert capitalization under Section 263(a) for employee compensation (other than bonuses and commissions that are paid with respect to the transaction), fixed overhead, or de minimis costs related to the acquisition, creation, or enhancement of intangible assets or benefits. Costs are considered de minimis to the extent they do not exceed $5,000 per transaction.

0421 Loan Fees

Several different types of fees may be charged at the close of escrow when acquiring a mortgage, including:

- Points, which are a charge by the lender to the borrower that is in addition to the stated rate of interest, i.e., an adjustment to the interest yield. Points are paid at the beginning of the loan to reduce the amount of interest charged over the life of the loan. Thus points are the present value of the reduction of interest over the life of the loan.

- Commitment fees, which are charged for entering into an agreement that obligates the lender to keep a loan available at a stated interest rate and loan amount for an agreed period of time.

- Service fees, which represent amounts charged to the borrower by the lender for processing the loan, recording the transaction, credit inspection, appraisal costs, etc.

Rev. Rul. 70-540 provided various rules for the inclusion of the above fees in taxable income, but was superseded and made obsolete by Rev. Proc. 94-29.

The IRS issued Treas. Reg. Section 1.1271, Treas. Reg. Section 1.1272, Treas. Reg. Section 1.1273, Treas. Reg. Section 1.1274, and Treas. Reg. Section 1.1275, Special Rules for Bonds and Other Debt Instruments on January 27,1994. The regulations provide guidance on treatment of de minimis OID.

Rev. Proc. 94-29 was issued in April 1994. Rev. Proc. 94-29 provides:

- The use of the principle-reduction method is limited to the accounting for *de minimis OID.*

- There are certain cut-off dates depending on taxpayer elections. The earliest cut-off date is December 22, 1992 while the last cut-off date is the first day of the tax year after April 4, 1994.

- That the principal-reduction method only applies to loans originated by the taxpayer and the loans produce ordinary income or gain when sold or exchanged.

- That the loans must be separated into sufficiently homogeneous groups.

- That the principal-reduction method only applies to loans that do not have OID or have de minimis OID.

Rev. Proc. 94-29 also declares obsolete Rev. Rul. 53-216 (composite method), Rev. Rul. 54-367 (composite method/discount), Rev. Rul. 64-278 (loan liquidation method), Rev. Rul. 70-540 (treatment of points by the lender) and Rev. Rul. 74-607.

Rev. Proc. 97-39 provides that taxpayers is allowed to adopt or change to principal reduction method of accounting for de minimis original issue discount on certain loans. To qualify, loans must be acquired by taxpayer at origination, not have OID (or be treated as not having OID, because OID is de minimis), not be issued at premium, not be subject to Reg. §1.1272-3 election, and produce ordinary gain or loss for taxpayer when sold or exchanged. Rev. Proc. 94-29, 1994-1 CB 616, is modified and superseded.

Many S&L's continued to use the loan liquidation method, a permissible method for cash basis accounting even though they were required to change to the accrual method of accounting as a result of the Tax Reform Act of 1986. The Internal Revenue Service will not require a change of accounting method from the loan liquidation method even though the taxpayer is no longer using the cash basis method of accounting.

Rev. Proc. 94-28, Rev. Proc. 94-29 and 94-30 are guidelines for change in accounting procedures. .

0422 Loans—Loss on Concurrent Swap or Sale

Savings & loan associations traditionally have held loans to maturity. Prior to 1980, the Federal Home Loan Bank Board (FHLBB) required S&Ls to deduct any losses from mortgage sales.

In the early 1980's, most S&Ls held mortgages at low interest rates compared to market rates at the time. If the loans were sold for cash in a closed transaction, the S&L would have a loss of 30 to 50 percent of their basis in the loan. In many instances this would result in the S&L having a negative net worth. The FHLBB issued Memorandum R-49 (R-49) introducing a regulatory accounting principle (RAP), which must be followed in filing financial statements with the FHLBB.

R-49 provides that "a loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded". Mortgage loans are identical only when each of the following criteria is met. The loans involved must:

- Be single-family residential mortgages.
- Be of a similar type (e.g. conventional loans for conventional loans).
- Have the same stated terms to maturity (e.g. 30 years).
- Have identical stated interest rates.
- Have similar seasoning (i.e., remaining terms to maturity).
- Have aggregate principal amounts within the lessor of 2.5% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash.
- Be sold without recourse.
- Have similar market values.
- Have similar loan-to-value ratios at the time of the reciprocal sale.
- Have all security properties for both sides of the transaction in the same state.

Under GAAP, no gain or loss will be recognized if the first nine items listed in R-49 are present.

For tax purposes, most S&Ls have deducted a loss of the difference between their basis in the mortgages given up and the fair market value of the mortgages received.

Rev. Rul. 81-204 explained the IRS position where three unrelated S&Ls exchanged mortgage pools that were substantially the same resulting in no gain or loss for book purposes. The ruling held that the transaction does not result in a loss for tax purposes, as the mortgages given up were not substantially different than the ones received. The loss was also denied, as the exchange had no purpose or utility other than anticipated tax benefits.

Rev. Rul. 85-125 involves the same type of transaction as Rev. Rul. 81-204, except that the three S&Ls entered into a series of concurrent transactions in which the mortgage pools were sold for cash and purchased by one another instead of exchanged. Again, the IRS concluded that the economic condition of the taxpayer had not changed, thus there was no tax loss.

In late 1981, the Federal Home Loan Mortgage Corporation (FHLMC) started a mortgage loan swap program in which S&Ls could enhance their liquidity position by replacing mortgage loans with guaranteed FHLMC mortgage participation certificates (PCs). These PCs were eligible collateral for borrowing. Since the PCs were backed by loans made by several lenders and not one, a gain or loss resulted for RAP purposes.

The initial program was changed to provide that the loans exchanged for PCs were economically matched resulting in no gain or loss for RAP purposes. In PLR 8327008 (1983) the IRS held that this type of transaction resulted in no gain or loss for tax purposes.

The cases of *U.S. v. Centennial Savings Bank FSB*, (1991) 499 U.S. 573, and *Cottage Savings Assn. v. Comm.*, (1991) 499 U.S. 554, involved financial institutions regulated by the FHLBB.

In *Cottage Savings Association*, *supra*, the taxpayer simultaneously sold and purchased 90% participation interests in mortgage loans with other lenders. All of the loans were secured by single-family homes that for the most part were located in the same geographic area. In *Centennial Savings Bank, supra, the taxpayer* exchanged 90% participation interest in a set of mortgage loans with the Federal National Mortgage Association. No gain or loss was reported for regulatory or book purposes.

For tax purposes, taxpayers in *Cottage Savings Association* and *Centennial Savings Bank* claimed a deduction under IRC Section 1001(a) for the difference between their basis in the participation loans given up and the fair market value of the participation loans received. The IRS disallowed the deduction, arguing that the requirements for a "disposition of property" under IRC Section 1001 were not met as the properties were not materially different and did not differ in economic substance.

The Supreme Court agreed with the IRS that an exchange of property gives rise to a realization event under IRC Section 1001(a) only if the properties exchanged are materially different, citing Treas. Reg. Section 1.1001-1. The Supreme Court then found that the properties were materially different and ruled against the IRS.

Based on the above, the auditor should determine how the taxpayer reported the deferred loan fees on the loans sold. For example:

> Safe & Secure S&L made 10 loans of $100,000 each, three years ago. Current interest rates are much higher than when the loans were made. In connection with the loans the S&L received $60,000 in loan fees that were properly deferred. Under an acceptable method of accounting 10% of the loan principal was paid off and 10% of the loan fees were previously included in taxable income. The fair market value of loans received in the swap was $500,000. The swap qualified for non-recognition of loss for regulatory purposes.
>
> The taxpayer computed the tax loss as follows:

Fair Market Value of Loans Received	500,000
Basis in Loans Exchanged ($1,000,000 x 90%)	(900,000)
Loss on Exchange	(400,000)

> How did the taxpayer report the $54,000 in deferred loan fees? These amounts must be accelerated into income, as the related loans are no longer owned.

The Supreme Court did not resolve all problems related to losses on loan swaps. For example:

- The loss was not reported for book purposes. For alternative minimum tax purposes, this will impact the BURP adjustment and the loss will increase the adjusted current earnings (ACE) adjustment. See Bank & Financial Handbook Section 0600, PREFERENCE TAX COMPUTATION AND ALTERNATIVE MINIMUM TAX (AMT), for a discussion of AMT.

- It was easy for the court to look at secured real property and determine that the loans are materially different. What about loans secured by the general assets of the corporation?

What about unsecured loans? Assume two banks exchange unsecured loans made to two third world countries that are in arrears. Are the loans different?

0423 Merger Between a Stock Savings & Loan and a Mutual Savings & Loan

In the U.S. Supreme Court case, *Harold T. Paulson vs. Commissioner* (1985) 469 U.S. 131, the court held that a merger of a stock savings & loan association into a mutual savings & loan association does not qualify as a tax-free reorganization under IRC Section 354(a)(1) and IRC Section 368(a)(1)(A). The distinction between the two associations is that in a mutual savings & loan association the passbook account holders (depositors) are owners of the association—they are contingently liable for the S&L's debts. A stock S&L has stockholders that are owners of the association. The Supreme Court held that there was "no continuity of interest" as required by IRC Section 354. The stock S&L, Commerce Savings and Loan Association was merged into Citizens Federal Savings & Loan Association. The stockholders of Commerce received CD's in exchange for their stock. The court held that the merger was in fact a sale and that the stockholders were taxable on the gain realized in the exchange. See IRC Section 331 (R&TC Section 24501) . Note in the case of a FSLIC, FDIC or State Agency assisted merger the continuity of interest requirement is waived by IRC Section 368.

0424 Merger / Liquidation Tax Effects

There are a variety of tax consequences that can result from a merger or liquidation. See also Bank & Financial Handbook Section 0423, MERGER BETWEEN A STOCK SAVINGS & LOAN AND A MUTUAL SAVINGS & LOAN.

- In a merger, what is the proper treatment of the unamortized loan fees, etc. that are carried over to the resulting corporation? Auditors must refer to the taxpayer's private letter ruling authorizing the loan liquidation method. Normally, the amount should be accelerated into income.

- In some instances, the auditor may find that the merged company has sold a large loan (GNMA/FNMA) portfolio at a substantial loss. The acquiring corporation may have entered into a simultaneous agreement to buy back this same portfolio 30-90 days after the merger. In this situation, the auditor should question substance vs. form and determine whether the transaction lacks economic substance. Audit might also argue that the transaction was a sham or merely a financing arrangement. See Bank and Financial Handbook Section 0460, LOANS-LOSS ON CONCURRENT SWAP OR SALE.

- Where the sale is not followed by a repurchase agreement, the auditor should look to the legal requirements to qualify as an S&L. The bad debt reserve balance may need to be recaptured into income if the company no longer qualifies as an S&L.

- If the S&L sells its loan portfolios (as in the case of a liquidation), they must also accelerate the reporting of the unamortized loan fees, points, odd days interest, etc. The amounts must be removed from the loan liquidation schedule and reported currently.

- Did the acquired corporation utilize the same method of accounting as the acquiring corporation?

A common problem in this area involves the takeover of an S&L that did not utilize the loan liquidation method by one that did use the method. The taxpayer cites IRC Section 381(c)(4) as authority for the use of the following method:

> The acquiring S&L, using a statistical sample, re-computes the acquired S&L's income on a historical basis as if it should have been using the loan liquidation method all along. The difference (in loan fees, odd-days interest, etc.) between what was actually reported using their method and what would have been reported under the loan liquidation method is used to reduce current year's income of the acquiring corporation. The figure on the return is a net figure with the actual adjustment normally found on the tax spreadsheet.

There is no basis in law to allow this manipulation of income by the taxpayer. Treas. Reg. Section 1.381(c)(4)-(1)(a)(1)(ii) states that the acquiring corporation shall take into its accounts the dollar balances of those accounts of the transferor corporation representing items of income which because of its method of accounting were not required or permitted to be included by the transferor corporation in computing taxable income for the taxable years ending on or before the date of transfer. The taxpayer's action appears to be in direct contravention to this requirement.

Another argument that could be raised is that the taxpayer's position distorts income. That is contrary to the provisions of Treas. Reg. Section 1.381(c)(4)-1(c). By picking up the transferor's original balances from the loan portfolios and adjusting income, they are in effect adjusting the income in one year of the acquiring S&L for what they claim is an over reporting of income over multiple years by the transferor S&L.

0425 Net Loans

A bank may loan funds to foreign persons or corporations. The foreign country will most likely treat the bank as a taxpayer subject to withholding tax.

> For example, a California bank may loan $1,000,000 to a Brazilian corporation with $200,000 annual loan payments. The government of Brazil may withhold 30% of the interest paid. Assuming the payment is all interest in year 1, then Brazil would have withheld $60,000. For Federal income tax purposes, the bank would have included $200,000 in gross income and either deducted foreign taxes of $60,000 or used the $60,000 as a foreign tax credit.

An audit issue arises where the bank makes a net loan and only includes the net amount in gross income. In a net loan the foreign person or corporation is responsible for the foreign income tax on the loan. Assume that in the above example the loan agreement provides for a net loan with no reduction in the loan payments. The Brazilian corporation would pay $200,000 to the domestic bank and $60,000 to the government of Brazil. The issue is how to record the above transaction for tax purposes. Many banks are recording net income of $200,000. If one discharges the tax liability of another, the taxpayer who is liable for the tax realizes additional income, *Old Colony Trust v. Commissioner* (1929) 279 U.S. 716.

An accrual basis taxpayer must accrue additional income for taxes, assumed by another, at the time such taxes are properly accruable and the obligation is assumed, and not at a time in the future when the assumed obligation is ultimately satisfied (Rev. Rul. 57-106 as modified by Rev. Rul. 78-258).

The position of the IRS is that:

- The income must be recorded at gross. In the above example the $60,000 income tax liability of the domestic bank paid by the Brazilian corporation on behalf of the bank would be included in gross income.

- The bank must take a deduction under IRC Section 166 for the appropriate charge to its bad debt reserve to the extent of the foreign borrower's failure to pay the foreign tax liability.

  In the above example, the bank would record $260,000 of gross income in year one. If Brazil asks the bank for payment of tax in year two due to the failure of the borrower to pay the tax, then in year two, the bank would take a charge to the bad debt reserve for taxes paid to Brazil.

- The taxpayer must provide the documentation required by IRC Section 905(b) and Treas. Reg. Section 1.905-2 to receive the foreign tax credit.

The IRS won the issue in regards to gross-up of the income but lost on the foreign tax credit issues in a series of Tax Court cases. See *Nissho Iwai American Corp. v. Comm.,* (1987) 89 TC 765, , the consolidated cases of Continental Illinois Corp. v.Commissioner, TC Memo. 1988-318, , Citizens and Southern Corp. v. Commissioner, 919 F.2d 1492 (11th Cir. 1990), *First Chicago Corp. v. Comm.* (1991) TCM 1991-44 and *Norwest Corp. v. Comm.* (1992) TCM 1992-282.

For California income tax purposes, the bank must report the tax paid by the foreign borrower on behalf of the bank in gross income. The California Revenue and Taxation Code does not provide for a deduction for taxes measured by income. Since California taxes only income from California sources, there is no foreign tax credit.

To audit the issue, the auditor would:

- Request the loan documents for foreign borrowers to see if they have net loan provisions. If the bank has several foreign loans, it is suggested that the auditor use random sample techniques.

- If the bank has net loans, determine if the taxpayer recorded the transaction at gross or net.

- Reconcile book income to the federal 1120. Review the schedule M-1 adjustments to see if the book method and tax method of recording the foreign loan is the same.

- Adjust any net loans to gross.

0426 Odd-Days Interest

Escrow interest, also known as odd-days interest or loan in process interest, is the interest charged from the time the loan is funded to the start of the period covered by the first mortgage payment. Mortgage payments are generally made 30 days in arrears. For example, mortgage interest for the month of July is usually due August 1.

Assume a mortgage is funded on June 15. The financial institution will demand interest from the time funded until the loan is paid in full. The first mortgage payment is August 1 which is for the period of July 1-July 31. The financial institution will require at the close of escrow, an interest payment for the period of June 15-June 30. The interest for this period is odd-days interest.

In some instances, odd-days interest will be paid in cash by the borrower, although most of the time the interest is paid by deducting it from the loan proceeds. The variety of the loan documents for a typical loan make it difficult to determine if odd days interest, along with other loan fees and charges, was paid with fresh funds or financed as a part of the loan.

In 1965, most savings & loan associations asked for a change in accounting method to use the loan liquidation method as provided by Rev. Rul. 64-278. The ruling provided that loan fees or points that are paid to allow the mortgage to be made at a discounted interest rate are recognized over the life of the loan since this is an interest adjustment. Rev. Proc. 94-29 announced that Rev. Rul. 64-278 is now obsolete and allows taxpayers to use the principal-reduction method of accounting for de minimis OID. Rev. Proc. 94-29, 1994-1 CB 616, is modified and superseded by Rev. Proc. 97-39. Pursuant to Rev. Proc. 97-39, IRS is allowing taxpayers to adopt or change to principal reduction method of accounting for de minimis original issue discount on certain loans. To qualify, loans must be acquired by taxpayer at origination, not have OID (or be treated as not having OID, because OID is de minimis), not be issued at premium, not be subject to Reg. §1.1272-3 election, and produce ordinary gain or loss for taxpayer when sold or exchanged.

Many savings & loan associations included odd-days interest in the amount of interest to be deferred on the loan liquidation method. The problem with including the odd-days interest in this method of income deferral is that the interest does not relate to future periods, but instead relates to the current period only.

It is FTB policy to not pursue the issue of including odd-days interest in current income under Rev. Proc. 94-29 or Rev. Proc. 97-39

0427 Sale of Accrued Interest

Many savings & loan associations experienced net operating losses during the early 1980's. For federal purposes, prior to the Tax Reform Act of 1986, financial institutions could carryback NOLs for ten years and carry-forward the NOL for five years. A financial institution may be in a position where they will lose the benefit of the NOL carryover, i.e., the taxpayer has a small loss in 1982 and the 1977 NOL carry-forward will expire in 1982.

To take full advantage of the NOL tax benefit, the taxpayer would want to accelerate income into 1982 and push expenses from 1982 to 1983. Since most financial institutions are on the cash method of accounting for tax purposes prior to the Tax Reform Act of 1986 they can more easily move income and expenses between years.

One method used to accelerate income is to enter into an agreement to sell accrued or future interest income. A calendar year savings & loan association may agree in December 1982 to sell the first one to three months of interest income of 1983 to another financial institution. Since the savings & loan association is a cash basis taxpayer they will report the income in year 1982. This will result in more income being recognized in a loss year. They hope that 1983 will be profitable for the savings & loan.

The taxpayer may also enter into this transaction to accelerate income into a loss year, as the California Revenue and Taxation Code did not provide for a NOL carry-forward prior to taxable years ending before January 1, 1987, except in limited situations.

Current audit policy states that, if the transaction has certain characteristics, FTB may hold that the transaction is really a loan and not a sale, or alternatively the purchased interest must be included in the year earned (1983) to more clearly reflect income. Note, a related issue is discussed at Bank &

Financial Handbook Section 0431, STRIPPED COUPON BONDS, in connection with the allocation of the basis between the interest sold and the asset held. It is important for the auditor to follow up and increase income in the years after the sale of future interest due to the reduced basis in the loan.

0428 Sale of Loan Participations

Some financials sell parts of their loan portfolios in exchange for participation certificates (PCs). PCs are considered a form of ownership/equity ownership in the underlying mortgage (see Rev. Rul. 84-10). Therefore exchanging direct ownership for an indirect ownership does not constitute a sale. Only when the participation certificate is ultimately sold can there be recognition of a gain or loss.

As a means to avoid this non-recognition some financials may sell their loan portfolios for PCs backed by different loan portfolios. It is important to compare the nature of these loan portfolios (interest rate, value, and net return) to the nature of the loan portfolios sold or exchanged for the PCs. If they are essentially the same the auditor should question the deductibility of the loss. How was the loss treated for book purposes?**0429 Secondary Reserve Transfers**

All institutions insured with the Federal Savings and Loan Insurance Corporation (FSLIC) are required to make premium payments for deposit insurance. Between 1961 and 1970, insured thrifts also were required to pay the FSLIC an additional annual premium to a secondary reserve. The secondary reserve was available to the FSLIC only when the regular reserve was insufficient. In 1970 thrifts were no longer required to make payments to the secondary reserve and beginning in 1970 earnings on amounts paid into the secondary reserve were used to reduce payments to the regular reserve.

Section 404 of the National Housing Act was amended in 1973 to require the FHLB to charge part of the regular premium to the secondary reserve in certain circumstances. This may also result in a refund of cash.

Section 404 of the National Housing Act was again amended in October 1974 to provide for a cash refund of the thrift's secondary reserve during the month of May for the next ten years. The combined amount in the regular and secondary reserve must equal or exceed 1.25% of the total amount of insured accounts for all member institutions.

The refund is shown on the Annual History Statement, which together with the annual insurance premium is mailed to the thrift at the end of each calendar year. The National Housing Act provides that the Annual History Statement must separately show the amount of principal repayment and accrued interest based on the ratio of these two items in the thrift's secondary reserve immediately prior to the refund. For tax purposes the payment to the secondary reserve was treated as an asset and not deductible. Payments to the secondary reserve are a separate, distinct assets that may be transferred in consolidations or mergers and may be refunded if the thrift liquidates. Since the thrift did not have use of the interest income on amounts paid into the secondary reserve such interest was not included in the thrift's taxable income.

If an amount is transferred from the secondary reserve to the regular reserve, then the portion of the amount transferred which is interest earned on the amounts in the secondary reserve is considered includible in taxable income. The entire amount transferred is allowed as a deduction for deposit insurance.

For example, assume the thrift has an account balance of $1,000 in the secondary reserve that represents $700 principal and $300 interest earned on the principal. The FSLIC decides to refund $100 of the secondary reserve that will be used to offset the premium payment to the regular reserve. For tax purposes, the thrift will include $30 in taxable income [($300/$1,000) x $100]. The thrift will deduct $100 as an ordinary and necessary business expense.

The above method is allowable by Rev. Rul. 72-366 if the FSLIC provides the breakdown of principal and interest. The only other acceptable method is to allocate the transfer first to interest earned on principle and then to principle after all the interest was included in taxable income (Rev. Rul. 74-371).

Suggested audit procedures:

- Request the annual history statement for the year immediately prior to the first year under audit and all years under audit. Reconcile changes in the secondary reserve between taxable years. This should reveal:
  - The amount of transfers from the secondary reserve to pay regular deposit insurance premiums.
  - The amount of the transfer that should be included as interest income.
- Trace the transaction through the thrift's accounts to determine the book treatment. Finally, review the federal Form 1120, schedule M-1 and CA Form 100, state adjustment section to determine the state income tax treatment.

During 1987, the FSLIC notified insured thrifts that the balance of their secondary account was being transferred to the primary account in accordance with section 404(e) of the National Housing Act. A General Accounting Office (GAO) audit report of May 1, 1987 required the FSLIC to recognize certain contingent losses. Recognition of the contingent losses caused the FSLIC liabilities to exceed assets as of December 31, 1987.

The Competitive Equity Banking Act of 1987 (CEBA), P.L. 100-86 section 307, permits an offset against future insurance premiums based on the amount of premiums transferred from the secondary reserve to the primary reserve.

Many thrift institutions deducted the amount transferred from the secondary reserve on their 1987 tax return.

The IRS in TAM 9252002 held that the interest in the secondary reserve (which was never previously included in income) must be included in the tax return that includes May 1987. The interest was paid in satisfaction of an obligation.

The thrift is then entitled to a deduction in the amount of principal and interest included in the secondary account for the tax year that includes May 1987.

Auditors should ensure that thrift does not just deduct the amount in the secondary reserve and not include the interest.

The auditor should also ensure that for years after 1987 that the taxpayer only deducts the cash amount paid into the deposit reserve. The thrift may deduct the gross assessment and not take into account the credit for the May 1987 transfer from the secondary account.

0430 Stock Dividends Received From the Federal Home Loan Bank

Beginning in 1978, several Federal Home Loan Banks (FHLBs) declared stock dividends payable to their member associations. Stock dividends are normally not taxable as ordinary income, but since the FHLB stock's fair value is determined by its par value, it appears that each stockholder receives something of value upon receipt of the stock dividend. Under GAAP, the association is permitted to recognize such income in the year in which receipt of the dividend occurs. However, for tax return purposes most associations have taken the position that the stock dividend is non-taxable based on their interpretation of the criteria for non-recognition of income set forth in the Internal Revenue Code. In 1980, the IRS set forth in a technical advice memorandum its interpretation of the Code; namely, that stock dividends declared by the FHLB were fully taxable in the year received. The Service's position is based on the fact that the associations are entitled to immediately redeem the distributed stock if their holdings exceed the statutory required amount. Even though all associations are not in a similar excess holdings position, the Service concluded that, under the regulations, all associations must recognize the stock dividend as taxable income (Rev. Rul. 83-68).

In *Frontier Savings & Loan Assn. v. Commissioner.* (1986) 87 TC 665, the Tax Court held that the dividends were not in fact taxable. It further repudiated Rev. Rul. 83-68. The Seventh Circuit affirmed the Tax Court's decision in *Frontier Savings & Loan Assn. & Subsidiaries v. Comm.* (7th Cir. 1988) 854 F2d 1001.

The IRS acquiesced in the Tax Court holding (see 1990-1 CB 1 or AOD 1990-018). The IRS also issued Rev. Rul. 90-98 that modified Rev. Rul. 83-68.

0431 Stripped Coupon Bonds

An example of this type of transaction is:

> XY Corporation acquires a $1,000,000 bond for $950,000 that has detachable interest coupons. The coupons are submitted to the issuing corporation every 6 months for payment of interest.
>
> XY Corporation then sells the bond after removing the coupons.
>
> Assuming the bond, which is now non-interest bearing is sold for $700,000, XY Corporation takes a loss of $250,000 ($700,000 sales price less $950,000 basis) and continues to collect interest on the coupons.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added new provisions (now IRC Section 1286). These provisions basically require the taxpayer to include the pre-sale accrued interest in income, increase the basis of the bond by the accrued interest, and allocate the basis between the items retained and the items sold, based on fair market value of the two. These provisions covered sales made after 7/1/82.

In TAM 8827002, released 7/8/88, the IRS determined that a taxpayer must allocate their basis in a bond between the interest coupon detached and held and the principal of the note sold, according to fair market values. The TAM involved a transaction prior to 7/1/82, thus was based on pre-TEFRA law.

The IRS cited Treas. Reg. Section 1.61-6(a) in support of the requirement that an allocation of basis between items retained and disposed of is required. The regulation covered transfers of real property. The IRS compared the bond to real property in that the detached coupon was like a remainder interest and life estate in real property. The bond principal is also similar to a remainder interest. The IRS then compared the bonds and real property in that neither produces a cost recovery deduction as land is not depreciated and bonds are not amortized.

R&TC Section 24990 incorporates by reference IRC Section 1286 for taxable years beginning on or after January 1, 1987. IRC Section 1286 describes tax treatment of stripped bonds.

0432 Real Estate Mortgage Investment Conduit (REMIC)

REMICs are investment vehicles through which mortgage-backed securities are issued. A sponsor will transfer a pool of mortgages to an entity in exchange for interests in that entity. The entity that receives the mortgages will then elect REMIC status. The sponsor will not recognize any taxable gain from the exchange of the mortgages for the interests in the REMIC. Rather, the sponsor will recognize taxable gain when the interests in the REMIC are sold.

There are 2 types of REMIC interest holders (Regular and Residual):

- Regular interest holders are entitled to receive specified principal and interest payments. Regular interest holders are, in essence, treated as bondholders. Accordingly, the regular interest holder is taxed on the interest payment it receives.

- Residual interest holders own the portion of the REMIC that is not owned by the regular interest holders.

For tax purposes, a REMIC is not treated as a corporation or partnership or subject to tax at an entity level. Instead, the REMIC's income, after deducting payments to the regular interest holders, is reported by the residual interest holder. A residual interest that does not receive regular distributions is referred to as a "Noneconomic residual interest" (NERI).

The REMIC tax rules require that for any year in which there is REMIC income, in no event can the NERI holder report less than its proportionate share of the minimal amount of REMIC income, i.e., the Excess Income (EI) for that taxable year.

Legal Ruling 2009-01 addresses the application of the REMIC excess inclusion income rules in a unitary combined reporting group as follows:

1) The EI amount that the NERI holder must report for California purposes is determined on a post-apportioned basis.

2) In calculating the NERI's NOL carryforward, the NERI's NOL will not be reduced by the EI amount that was already taxed as minimal amount for that year.