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Bank Tax Tutorial

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Agenda

- Overview of Bank Definition and Bank-Specific Code Sections
- Interest and Fee Income
- Debt Modifications
- Mortgage Servicing
- Bad Debts and Real Estate Foreclosures
- Nonperforming Loans
- Capital Gains and Losses
- Mark-to-Market Rules
- Interest Expense
- Capitalization of Intangible Costs
- Hedging Transactions
- Phase-out of Deduction for FDIC Premiums

Overview of Bank Definition and Bank-Specific Code Sections

Overview of Bank Definition and Bank-Specific Code Sections

- Definitional Code Sections
  - §581 – Definition of a bank
  - §7701(a)(19) – Definition of a thrift

- Bad Debt Deduction Code Sections
  - §585 - Small bank reserve method
  - §166 – Applies to large banks, but is not specific to banking
  - §593 – Reserve method formerly available to thrifts

Overview of Bank Definition and Bank-Specific Code Sections

- Interest Expense Disallowance Code Sections
  - §265(b) – Disallowed interest expense allocation to tax-exempt municipal securities
  - §291(e)(1) - same
- Characterization of Gain / Loss on Debt Obligations
  - §582(c) – “Ordinary” character of gain / loss on all debt obligations
- Phase-out of Deduction for FDIC Premiums
  - §162(r) – Applies to banks with consolidated total assets > $10 billion

§581 – Definition of a Bank

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

§7701(a)(19) – Definition of a Thrift

- Described in the Internal Revenue Code (“IRC”) as a “domestic building and loan association”
- For tax purposes this term is used interchangeably with the terms, “thrift” and “savings and loan”
- The definition is based upon an asset test which requires that at least 60% of the total assets be “qualified assets”
- This definition is not often used for federal income tax purposes anymore since the repeal of certain thrift-specific tax provisions (i.e. §593)

Polling Question

Interest and Fee Income

Interest and Fee Income

- Understanding the facts surrounding interest income and fee arrangements, and the related tax rules, is imperative to arriving at the correct tax treatment of these items

- Furthermore, an understanding of the treatment of these items on the general ledger is often required to arrive at the correct tax adjustment

Interest and Fee Income

- Lenders often charge fees when a loan is originated
  - Examples of these types of fees include:
    - Fees for services – charged at closing to cover title searches, paperwork, administrative costs of the lender, etc.
    - Commitment fees – fees paid to a lender to keep a line of credit open for a certain period of time (whether or not the money is ever borrowed)

Interest and Fee Income

- General rule for including loan fee income in taxable income:
  - For accrual basis taxpayers – loan fees are taxable upon the earlier of:
    - 1) the date the fees are received; or
    - 2) the date the fees are earned
  - For cash basis taxpayers – loan fees are taxable when received

Interest and Fee Income

- Treatment of loan fees charged for services and commitment fees
  - These fees do not represent interest income, but are charged for services rendered by the bank
  - Do not represent “points” because they are not charged for the use or forbearance of money (i.e. interest) – see discussion below

Interest and Fee Income

- Treatment of loan fees charged for services and commitment fees
  - Therefore, they must be included in taxable income under the general rule:
    - For cash basis taxpayers – when received
    - For accrual basis taxpayers - earlier of when received or earned
- Tax treatment is likely to differ from financial accounting treatment under SFAS 91, so a tax adjustment is often required in the tax calculation

Interest and Fee Income

- Interest and fees on loans and securities can take a variety of forms

- Stated interest accrues on a loan or security periodically and is paid at stated intervals (i.e. the interest income collected from mortgage loans as monthly payments are received)

- Points paid at loan closing generally represent prepayments of interest and often impact the interest rate charged on the loan

Interest and Fee Income

- Original issue discount ("OID") generally arises when a debt instrument is issued with its interest yield arising, at least in part, from a discount to the maturity price and this discount is created under the original terms of the debt issuance

- Market discount generally arises when a debt instrument is purchased after its original issuance and, due to rising interest rates, the buyer pays less than the face amount of the debt instrument in order to achieve a market rate yield-to-maturity

Interest and Fee Income

- General rule for including interest income in taxable income:
  - For accrual basis taxpayers – interest is taxable as it properly accrues under the terms of the underlying debt instrument
  - For cash basis taxpayers – interest is generally taxable when it is received
  - Exceptions – OID and market discount

Interest and Fee Income

- Original Issue Discount ("OID")
  - Defined in §1273 as the excess of the "stated redemption price at maturity" of a debt instrument over its "issue price"
  - The "stated redemption price at maturity" generally refers to the amount due and payable at maturity, including all deferred interest that is not payable during the term of the instrument

Interest and Fee Income

- Original Issue Discount ("OID")
  - The "issue price" of a debt instrument is generally the amount paid for the debt instrument by the issuer
  - For bank loans, the issue price is generally the amount remitted to the loan customer [§1273(b)(2)]
  - OID is generally required to be included in taxable income under the constant yield method [§1272(a)(1)]

Interest and Fee Income

- Original Issue Discount ("OID")
  - Exceptions:
    - 1) "Deminimis" OID – if the amount of OID is determined to be deminimis, the OID can be included in income under either the constant yield **or** the principal reduction method
      - Deminimis OID is generally calculated by multiplying 0.0025 by the product of the stated redemption price at maturity(A) and the number of complete years to maturity from the issue date (B) [i.e., .0025 x A x B]
      - The weighted average years to maturity is used for self-amortizing loans

Interest and Fee Income

- Original Issue Discount ("OID")
  - At the taxpayer's election, deminimis OID on a self-amortizing loan can be calculated by multiplying 0.00167 by the product of the stated redemption price at maturity(A) and the number of complete years to maturity from the issue date (B) [i.e., .00167 x A x B]

Interest and Fee Income

- Original Issue Discount (“OID”)
  - Exceptions
    - 2) Short term debt instruments – OID can not exist on a short term debt instrument because the payment of interest can not possibly be deferred for more than 12 months on such obligations
  - OID rules apply to both cash basis and accrual basis taxpayers alike (i.e. cash basis taxpayers generally can not defer OID income until maturity when such interest is actually paid)

Polling Question

Interest and Fee Income

- **Points defined** - Rev. Rul. 70-540 defines points as “a charge made by the lender (mortgagee) to the borrower (mortgagor), which is in addition to the stated annual interest rate, and is paid by the borrower to the lender as an adjustment of the stated interest to reflect the actual cost of borrowing money. The amount of the ‘points’ charged is determined by the lender upon consideration of the factors that usually dictate an acceptable rate of interest. Thus, ‘points,’ as used in this Revenue Ruling are for the use or forbearance of money and are considered to be interest.”

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Interest and Fee Income

- **Points defined**
  - Thus, in order to be considered points, amounts charged must represent prepaid interest
  - Loan fees collected from the borrower to cover services and administrative costs provided by the bank are not points
  - Commitment fees are not points

Interest and Fee Income

- Treatment of points collected at loan origination
  - Final regulations issued under the OID rules in 1994 [§1.1273-2(g)] clarified that points collected from the borrower at loan origination are to be treated as a reduction in the issue price of the loan
  - Such treatment results in the creation of OID for the amount of the points charged
  - Thus, the OID created by the points charged can be taken into taxable income over the life of the loan under the general OID principals
  - The same would arguably apply to any amount charged to the customer at loan origination that is not a fee for services or to cover the lender’s costs

Interest and Fee Income

- Treatment of points collected at loan origination
  - Treatment of deminimis OID related to points
    - The OID created by points charged at loan origination may be deminimis under the calculation described earlier
    - If so, the bank can choose one of two methods for including the deminimis OID in taxable income:
      - 1) the principal reduction method; or
      - 2) the constant yield method

Interest and Fee Income

- Treatment of points collected at loan origination
  - Treatment of deminimis OID related to points
    - Rev. Proc. 97-39 provides guidance to banks that wish to utilize the principal reduction method of recognizing deminimis OID related to points

Recent Example – OID v. Service Fee Income

- Treatment of credit card merchant discount
  - *Capital One Financial Corporation and Subsidiaries v. Commissioner* [133 T.C. No. 8, (September 21, 2009)]:
    - Holds that the card issuer's interchange income creates OID (interest income) on a pool of the underlying credit card loans
    - Interchange was not determined to be charged for services provided by the issuer
    - Interchange is taken into interest income over time under the OID rules
    - **But this treatment was overturned by the new IRC §451(b) rules effective in 2019 – see discussion on following slides**

Polling Question

Interest and Fee Income

- Treatment of market discount
  - §1278 defines a "market discount bond" as any bond with a stated redemption price at maturity in excess of a taxpayer's basis in that bond immediately after its acquisition by the taxpayer
  - If the bond has OID, the amount of the market discount is limited only to the excess of the calculated discount, if any, in excess of the OID
  - The primary difference between market discount and OID is that market discount arises from the purchase of a bond subsequent to its original issuance

Interest and Fee Income

- Treatment of market discount
  - §1278(a)(1)(B) excludes from the definition of market discount bond, and bond that is:
    - A short-term obligation
    - A United States Savings Bond
    - A §453B installment obligation
  - §1276 generally allows the taxability of market discount to be deferred until the disposition of the underlying bond (i.e. upon sale or maturity of the bond)

Interest and Fee Income

- Treatment of market discount
  - §1278(b) provides taxpayers the opportunity to elect not to defer the recognition of discount income on market discount bonds
  - If elected, discount is accreted into taxable income using either a ratable daily inclusion method or the constant yield method
  - If elected, applies to all market discount bonds acquired by the taxpayer on or after the first day of the first taxable year to which the election applies

Interest and Fee Income

- Treatment of market discount
  - However, §1276(a)(3) requires that the accrued market discount be recognized up to the amount of partial principal payments as those payments are received
  - As a result, the opportunity for deferral of market discount recognition is often mitigated or eliminated for various forms of mortgage backed securities and purchased loans

Interest and Fee Income

- Treatment of market discount
  - §1276 also requires that the market discount income recognized is generally to be treated as interest income, rather than a capital gain
  - This rule precludes non-bank taxpayers from claiming capital gains on what is essentially interest income
  - However, this rule does not apply to market discount on tax-exempt obligations (must be treated as ordinary income, but is not treated as tax-exempt interest; applies even if taxpayer elects not to defer the market discount income)

Comparison of Market Discount and OID on Bonds

- Original Issue Discount (OID)
  - Arises from the acquisition of the bond at original issuance
  - Is required to be included in taxable income over the term of the bond (unless deminimis)
  - If deminimis, can be taken into income over the life of the bond or ratably as principal payments are received
  - Is treated as interest income and as tax-exempt interest income if related to a tax-exempt municipal bond

- Market Discount
  - Arises from the acquisition of the bond subsequent to its original issuance
  - Unless elected otherwise, is not taxable until sale or maturity of the bond, but accrued accretion does have to be recognized to the extend of principal payments received
  - Is treated as interest income, but **<u>not</u>** as tax-exempt interest income if related to a tax-exempt municipal bond

Application of IRC §451(b) to Banks

- New TCJA rule for accrual basis taxpayers generally prohibits income recognition for tax purposes to be deferred beyond the timing of recognition in the “applicable financial statement”
- Certain exceptions apply:
  - Taxable income subject to special tax accounting methods
  - Any item of gross income in connection with a mortgage servicing contract

Application of IRC §451(b) to Banks

- Aside from taxable income deferrals associated with mortgage servicing arrangements, most community banks do not have many taxable income deferral items
- Those that do arise likely pertain to original issue discount (“OID”) or market discount that are favorably addressed by recently-issued proposed regulations
- Taxable income deferrals associated with credit card fees remain the primary area of focus in applying this rule to banks

Application of IRC §451(b) to Banks

- **Proposed regulations under §1.451-3 and §1.1275-2**
- Exempts the following from the new timing rule:
  - De minimis OID
    - Likely covers most deferred loan fees charged for interest (i.e. points)
    - So these fees will remain subject to existing rules
  - Income associated with debt instruments that is accounted for as discount or otherwise taken into income as an adjustment to the yield of a debt instrument over the life of that debt instrument (such as non-de minimis OID / points) on the taxpayer's applicable financial statement
  - Market discount

Application of IRC §451(b) to Banks

- **Proposed regulations under §1.451-3 and §1.1275-2**
- So what remains impacted by the new timing rule?
  - **"Specified fees"** – i.e. Income associated with debt instruments that is NOT accounted for as discount or otherwise taken into income as an adjustment to the yield of a debt instrument over the life of that debt instrument on the taxpayer's applicable financial statement
  - OID rules are "turned off" with respect to such income

Application of IRC §451(b) to Banks

- **Proposed regulations under §1.451-3 and §1.1275-2**
- **“Specified credit card fees”** are subject to the new rule
  - Credit card late fees – obsoletes Rev. Proc. 2004-33
  - Credit card cash advance fees – obsoletes Rev. Proc. 2005-47
  - Credit card interchange fees / merchant discount – obsoletes the decision in *Capital One Financial Corporation and Subsidiaries v. Commissioner* [133 T.C. No. 8, (September 21, 2009)]
- Tax accounting method changes resulting from the application of the new rules to specified credit card fees are a 2019 automatic change with a 6-year IRC §481(a) adjustment period

What About Purchase Premium on Bonds?

- Treatment of purchase premium on taxable bonds
  - §171(c) permits taxpayers to elect to amortize purchase premium on bonds
  - If elected, applies to all bonds held as of the beginning of the tax year of the election and applies to all subsequent tax years and future bond acquisitions
  - Amortization must be calculated using the constant yield method for post 9/27/85 bonds
  - Tax basis of the bond is reduced by the amount of deductible amortization

What About Purchase Premium on Bonds?

- Treatment of purchase premium on tax-exempt bonds
  - §171 requires the bond purchase premium to be amortized (the amortization is not elective)
  - **However**, no tax deduction is permitted for the amortization
  - **Furthermore**, the tax basis of the bond is reduced by the amount of the calculated amortization, even though no deduction is permitted
  - This effectively makes the premium amortization a permanently disallowed deduction

Permanent M for Exempt Interest

• General ledger account for muni coupon interest	xxxxxxx
• General ledger account for muni premium amortization	(xxxxxxx)
• OID muni accretion*	<u>xxxxxxx</u>
• Exempt Interest M Adjustment	xxxxxxx

* Must not include market discount accretion; if not isolated in a separate general ledger account (typically is not), then need to pull OID-only data from the securities discount accretion reports

Polling Question

CASE 1 - Interest and Fee Income

- In the current year, Bank charges the following amounts to its customers:
  - $300,000 of points on residential mortgages
  - $600,000 of loan origination fees to cover services rendered in underwriting various types of loans
  - $250,000 in commitment fees to hold open commercial lines of credit
  - What amount of total fee income must Bank recognize in the current year for tax purposes?

CASE 2 - Interest and Fee Income

- Bank's current year general ledger shows the following amounts:
  - $500,000 of fee income
  - Deferred fees (for services – i.e. not points) account: $300,000 opening balance; $375,000 closing balance
  - Deferred commitment fees account: $150,000 opening balance; $120,000 closing balance
  - What amount of total fee income must Bank recognize in the current year for tax purposes?

CASE 3 - Interest and Fee Income

- Bank's current year general ledger shows the following amounts:
  - $500,000 of fee income
  - Deferred points account: $300,000 opening balance; $375,000 closing balance
  - Deferred commitment fees account: $150,000 opening balance; $120,000 closing balance
  - Assume Bank uses OID accrual methods for financial accounting for all deferred loan fees
  - What amount of total fee income must Bank recognize in the current year for tax purposes?

CASE 4 - Interest and Fee Income

- Bank purchases a tax-exempt municipal bond with a principal amount of $1,000,000 on the secondary market for $985,000
- What is the amount of market discount on this bond?
- What amount of taxable income related to this market discount must be recognized on this bond prior to sale or maturity, if no current election is in place with respect to market discount?
- What amount of income must be recognized at maturity with respect to this bond? What will be the character of that income?

CASE 5 - Interest and Fee Income

- Bank purchases a tax-exempt municipal bond with a principal amount of $1,000,000 at original issue for $985,000
- What is the amount of market discount on this bond?
- What is the amount of OID on this bond?
- What amount of taxable income related to this bond must be recognized prior to sale or maturity?
- What amount of taxable income must be recognized at maturity with respect to this bond?

Debt Modifications

Debt Modifications – General Concepts

- The SCOTUS ruled in *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991) that when two banks exchange pools of loans, each bank can deduct the loss on the exchange because the underlying debt obligations transferred are materially different than the debt obligations received in the exchange
  - e.g., different obligors, different loan collateral, etc.
- In response to this ruling, Treasury issued regulation §1.1001-3, which addresses when modifications of a debt instrument (including a loan) are deemed to result in a taxable exchange of the "old" (pre-modification) debt for the "new" (modified) debt
- The regulation holds that only a "significant modification" of a debt instrument will result in a deemed taxable exchange of the old debt for the new debt

Debt Modifications – General Concepts

- **Impact of deemed taxable exchange:**
  - If FMV of the new debt is greater than the tax basis of the old debt:
    - **Taxable gain** on the deemed exchange
    - **Gain added to tax basis** of the new debt (amortizable purchase premium if tax basis > principal balance)
  - If FMV of the new debt is less than the tax basis of the old debt:
    - **Taxable loss** on the deemed exchange
    - **Loss reduces tax basis** of the new debt / (OID if tax basis < principal balance)
  - Borrower recognizes reciprocal tax impact

Debt Modifications – Regulation §1.1001-3

- **What is a modification?**
- Any alteration of the terms of the debt instrument, but…
  - An alteration that occurs by operation of the existing terms is not a modification, unless the alteration changes the obligor or changes the recourse nature of the debt (e.g., a scheduled rate adjustment on a variable rate loan is not a modification)
  - The exercise of a unilateral option by either the lender or borrower is not a modification, provided that, in the case of an option exercised by the lender, no deferral or reduction to scheduled payments results
  - An alteration that results in an instrument that is not debt for federal income tax purposes is generally a modification

Debt Modifications – Regulation §1.1001-3

- **When is a modification significant?**
- Results in a yield change of more than the greater of:
  - 0.25%; or
  - 5% of the annual yield on the original ("old") debt
- Or results in a deferral of the originally scheduled payments by longer than the lesser of:
  - 5 years; or
  - 50% of the original term of the debt instrument
- Or results in the substitution of a new obligor on a recourse debt instrument (certain exceptions apply)
- For this purposes, the impact of a series of modifications is measured collectively

Debt Modifications – What is the FMV of the New Debt?

- For a debt that is not publicly traded, the FMV is the principal balance of the new debt, provided the new debt has adequate stated interest
- In this scenario, a modification of a loan originated by the taxpayer will often not result in any significant tax gain or loss
- **Example:**
- Bank is an accrual basis taxpayer
- Tax basis in loan, accrued interest and fees receivable = $500,000
- Significant modification results in a deemed new loan with a principal balance of $500,000
- RESULT – no taxable gain or loss on the deemed exchange

Debt Modifications – What is the FMV of the New Debt?

- However, there could be a meaningful tax gain if the taxpayer had previously purchased the old loan at a discount in a taxable asset purchase
- **Example:**
- Loan principal balance prior to modification = $500,000
- Tax basis in loan = $300,000 (because Bank previously purchased the loan for a credit discount in a prior taxable transaction)
- Significant modification results in a deemed new loan with a principal balance of $500,000
- RESULT – $200,000 of taxable gain on the deemed exchange / $500,000 tax basis in new loan (equals its principal amount)

Debt Modifications – What is the FMV of the New Debt?

- A special rule found in regulation §1.166-3(a)(3) provides for a deemed partial charge-off (and available bad debt deduction) when taxable gain is recognized under regulation §1.1001-1(a) as a result of a significant modification <u>and</u> the taxpayer has claimed a deduction for partial worthlessness of the debt in any prior taxable year
- The amount of the deemed charge-off is the amount, if any, by which the tax basis in the modified debt exceeds the greater of: 1) the FMV of the modified debt, or 2) the amount of the modified debt on the taxpayer's books reduced by a specific allowance for loan losses
- **Example:**
- Legal principal balance of outstanding loan prior to modification = $500,000
- Partial tax bad debt deduction claimed in prior periods = $200,000
- Tax basis in loan = $300,000 ($500,000 original basis less $200,000 bad debt deduction)
- Significant modification results in a deemed new loan with a principal balance of $500,000 and a book value and FMV of $300,000
- RESULT – $200,000 taxable gain on the deemed exchange, $200,000 deemed partial charge-off (and available bad debt deduction), $300,000 tax basis in new loan

Debt Modifications – What is the FMV of the New Debt?

- For a debt that is publicly traded, the FMV is the quoted value on the public exchange
- In this scenario, a debt modification may produce a deductible tax loss because credit risk is factored into the FMV of the new debt
- **Example:**
- Holder of debt is an accrual basis taxpayer
- Tax basis in debt, accrued interest and fees receivable = $500,000
- Significant modification results in a deemed new debt with a principal balance of $500,000 and a FMV of $450,000 (considers credit risk)
- RESULT – $50,000 taxable loss, $450,000 tax basis in new debt and OID on the new debt of $50,000 that is recognized over the remaining debt term

Polling Question

Mortgage Servicing

Mortgage Servicing

- "Mortgage servicing" defines a business relationship under which a taxpayer (often a bank) will provide all of the customary services pertaining to the administration of a loan – i.e. collection of payments, maintenance of escrow accounts, pursuit of delinquency procedures, etc.
- The bank generally collects a servicing fee that is calculated as a set percentage of the loan balance and is retained from loan payments collected
- The context of this business relationship for tax purposes is usually one where the bank servicing the loan does not own the loan

Mortgage Servicing

- There is an important distinction for tax purposes between two common types of mortgage servicing arrangements:
  - 1) Originated mortgage servicing; and
  - 2) Purchased mortgage servicing

Mortgage Servicing

- **Originated mortgage servicing**
  - Describes an arrangement under which a bank originates (i.e. underwrites) a loan, and then sells the loan to a third party, but retains the rights to service the loan
- **Purchased mortgage servicing**
  - Describes an arrangement under which a bank purchases the rights to service a loan from a third party (in this case the bank does not generally originate the loan)

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - Unless the taxpayer receives a loan servicing fee that is deemed to be an "excess servicing fee," there are no special tax accounting considerations – i.e. the servicing fees are simply included in taxable income as received (or earned) under the taxpayer's overall method of accounting
  - However, if the arrangement results in the taxpayer receiving an excess servicing fee, special tax calculations must be applied

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - What is an “excess servicing fee?”
    - Rev. Rul. 91-46 simply describes excess servicing fees as fees received that exceed what is reasonable compensation for the services to be provided under the servicing agreement
    - Rev. Proc. 91-50 provides safe harbors for determining what is “normal servicing” for various loan types

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - Annual safe harbors provided in Rev. Proc. 91-50 for one-to-four unit residential mortgages:
    - 0.25% of outstanding principal for conventional, fixed rate mortgages (but see last item)
    - 0.44% of outstanding principal for mortgages that are less than a year old and insured by the FHA, VA or Farmers Home Administration
    - 0.375% of outstanding principal for any other mortgages (but see last item)
    - 0.44% for any mortgage (including those described above) if the original principal balance of the mortgage was <$50,000

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - Rules for applying the safe harbors of Rev. Proc. 91-50:
    - Taxpayers must elect to apply these safe harbors by attaching a statement to the tax return for the year of the election
    - The election can be revoked by the taxpayer by following the same procedures
    - If the safe harbors are not elected, then the determination of excess servicing fees must be made on a facts and circumstances basis

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - Excess servicing fees are not commonplace within standard community bank loan sale programs where servicing is retained by the originating bank

  - Excess servicing is more common among larger banks, especially in situations where the loans being serviced are not standard mortgage loans

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - The special tax calculations required when excess servicing fees are collected are governed by Rev. Rul. 91-46
  - This pronouncement applies the “stripped bonds” concept of §1286(e)(3) to the transaction
  - Under this calculation, the tax basis in the originated loan is allocated between the loan and the excess servicing right retained, based upon the relative fair market values of each

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - This basis allocation is made immediately before the loan is sold
  - Thus, the basis allocated to the excess servicing right will reduce the basis of the loan and increase the gain on the sale of the loan
  - The basis allocated to the <u>excess</u> servicing right is amortized into taxable income over the life of the servicing agreement

Mortgage Servicing

- Tax treatment of originated mortgage servicing
  - While no basis allocation is necessary for tax purposes if the taxpayer collects only a normal servicing fee (i.e. no excess servicing fees), financial accounting generally requires a similar basis allocation and gain / amortization calculation for the entire servicing fee retained
  - Thus, the tax calculation will often show an adjustment for loan servicing fees even if the taxpayer is not collecting an excess servicing fee (i.e. to reverse the financial accounting calculation)

Polling Question

Mortgage Servicing

- Tax treatment of purchased mortgage servicing
  - The tax treatment of purchased mortgage servicing rights is governed by §167(f) for servicing rights acquired after 8/10/93 (unless acquired in a taxable asset purchase to which §197 applies)
  - §167(f)(3) requires that the purchased mortgage servicing rights be amortized straight-line over 108 months (9 years)

Mortgage Servicing

- Tax treatment of purchased mortgage servicing
  - All mortgage servicing rights related to a pool of mortgages are considered to be a single asset for purposes of §167(f)
  - As a result, no loss or accelerated amortization can be claimed if some, but not all, of the underlying mortgages pay off early
  - However, regulations under §1.167(a)14(d) (2)(ii) allow taxpayers to identify multiple accounts within the loan pools at the time the rights are purchased to mitigate this situation

Mortgage Servicing

- Tax treatment of purchased mortgage servicing
  - If the mortgage servicing rights are acquired in a taxable asset purchase to which §197 applies, then the amortization period is governed by §197 (i.e. 15 year straight-line)
  - Similar rules apply under §197 that prohibit the accelerated amortization or loss on the servicing rights for partial payoffs of the underlying mortgage loan pools

CASE 6 - Mortgage Servicing

- Bank originates a pool of mortgage loans and sells those loans on the secondary market
- At the same time, Bank enters into a contract to service the sold loans
- Assume the following conditions:
  - Loan principal = $10,000,000
  - Value of excess loan servicing asset = $50,000
  - Sales price for the loans = $10,000,000

CASE 6 - Mortgage Servicing

- What amount of taxable gain results from the loan sale?
- What amount of tax basis does Bank have in its loan servicing asset?
- What impact does the loan servicing asset have on future taxable income?

- BONUS QUESTION – does the treatment of the excess servicing asset impact the total amount of taxable income that the taxpayer will ever recognize with respect to the sale/servicing transaction?

CASE 7 - Mortgage Servicing

- How would the answer change in Case 6 if it was determined that the servicing fees to be collected under the servicing arrangement did not result in "excess servicing fees?"

- Would there likely be any book-tax difference under these circumstances?

Bad Debts and Real Estate Foreclosures

Bad Debts and Real Estate Foreclosures

- The timing of tax deductions for bad debts on loan losses is a contentious issue with the IRS and has historically resulted in proposed examination adjustments

- Financial institution taxpayers need to understand the different rules applicable in this area to:
  - Small banks
  - Large banks
  - Thrifts (recapture rules)

Bad Debts and Real Estate Foreclosures

- §166 generally governs the timing and amount of bad debt deductions claimed by a lender on losses from uncollectible (i.e. worthless) loans
- These rules allow taxpayers to claim a deduction for the entire amount of a wholly worthless debt obligation or a partial deduction for a partially worthless debt obligation
- For a bank, this section applies to both loans and debt obligations evidenced by a security; non-bank taxpayers must look to §165 for losses on debt securities

Bad Debts and Real Estate Foreclosures

- According to §166(a)(1), a deduction for a wholly worthless debt obligation is allowed, and must be claimed, in the year that the debt becomes wholly worthless

- According to §166(a)(2), a deduction for a partially worthless debt obligation is allowed, but <u>not in excess</u> of the portion of the debt charged off in the current year

Bad Debts and Real Estate Foreclosures

- According to §1.166-3(b), any amount which has not been allowed as a deduction in prior tax years shall be claimed as a deduction in the year the debt becomes wholly worthless
- According to §1.166-1(f), if any amount previously deducted as a worthless debt in a prior year is recovered, the amount recovered must be included in taxable income in the year of the recovery

Bad Debts and Real Estate Foreclosures

- What factors determine whether a debt obligation is worthless under §166?
  - §1.166-2 provides some guidance in this area:
    - Largely based upon facts and circumstances
    - Value of the underlying loan collateral
    - Bankruptcy of the borrower

Bad Debts and Real Estate Foreclosures

- According to §1.166-2(d)(1), for banks and other regulated entities, worthlessness is presumed for:
  - Loans charged-off in obedience to specific regulatory orders; and
  - Loans charged-off in accordance with the established policies of the regulatory authorities **and**, upon the first examination after the charge-off, the regulators confirm in writing that they would have ordered the charge-off
- Neither scenario is common in practice

Bad Debts and Real Estate Foreclosures

- As a result, absent the conformity election (discussed below), taxpayers are often left in a position of having to defend their contention of worthlessness on a loan-by-loan basis considering the underlying facts and circumstances surrounding each deduction

Bad Debts and Real Estate Foreclosures

- What does the IRS look for in the bad debt area?
  - Has the loan been charged-off for financial reporting and / or regulatory purposes?
  - Does the information in the loan file support the taxpayer's argument that the loan principal is not likely to be collected? Borrower's condition? Payment history? Value of collateral?
  - Has full of partial recovery on the loan occurred as of the time of the IRS examination?

Bad Debts and Real Estate Foreclosures

- What can taxpayers do to mitigate or avoid an adjustment in the bad debt area?
  - Make sure that loan file documentation is accurate and depicts the true financial condition of the borrower and outlook of collectability
  - Look for the (unlikely) occurrence of loans that were charged-off in obedience to a specific regulatory order to do so
  - Consider adopting the bad debt conformity election (discussed below)

Bad Debts and Real Estate Foreclosures

- Any bad debt deduction disallowed by the IRS re-establishes tax basis in that loan
- If a subsequent evaluation determines the loan to be worthless, the taxpayer can then claim a bad debt deduction for the worthless amount
- If ultimately collected, the loan basis can be used to offset the cash collected and no taxable gain will result

Polling Question

Bad Debts and Real Estate Foreclosures

- With the potential exception of the charge off requirement for partially worthless debt obligations [§166(a)(2)], there is no statutory requirement that taxpayers limit their tax deductions for bad debts to those loans reported as charge-offs for financial reporting or regulatory purposes

- Likewise, there is no statutory requirement indicating that the IRS must accept the taxpayer's deductions for bad debts reported as charge-offs for financial reporting or regulatory purposes

Bad Debts and Real Estate Foreclosures

- In an effort to reduce the level of disagreement between bank taxpayers and the IRS over the timing of bad debt deductions for loan losses, Treasury established the "bad debt conformity election" found in §1.166-2(d)(3)
- If elected, the conformity election provides a <u>conclusive</u> <u>presumption</u> of worthlessness for loans:
  - Classified in whole or in part as "loss assets" using loss asset classification standards set forth by the bank's primary regulator; or
  - Charged-off in obedience to a specific regulatory order to do so

Bad Debts and Real Estate Foreclosures

- Rev. Rul. 2001-59
  - Issued to provide some clarification regarding the procedures necessary to memorialize the classification of loans as loss assets for regulatory purposes
  - Suggests that various procedures can be used to classify loans as loss assets, including:
    - Officer or employee documentation in writing
    - Reliance on internal loan or credit committee reports
    - Existence of a policy that only loans meeting the loss asset standard are permitted to be charged off

Bad Debts and Real Estate Foreclosures

- Rev. Rul. 2001-59
  - The facts considered in this pronouncement indicate a willingness to accept a process that is substantially correct, even though strict adherence to the rules was not demonstrated in all respects
    - Taxpayer inadvertently classified certain loans as loss assets in error
    - Given that the results of the taxpayer's process for loan loss classification was substantially correct, all of the taxpayers deductions were allowed (even the ones claimed in error)

Bad Debts and Real Estate Foreclosures

- Compliance requirements for the bad debt conformity election:
  - Taxpayer must secure an “express determination letter” from its primary regulator in connection with its most recent regulatory examination stating that “the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority”

Bad Debts and Real Estate Foreclosures

- Compliance requirements for the bad debt conformity election:
  - The conformity election is considered a method of accounting and must be formally adopted
  - It can also be easily revoked:
    - Voluntary revocation (requires form 3115)
    - Automatic revocation for failure to secure the express determination letter

Bad Debts and Real Estate Foreclosures

- **IRS Revenue Procedure 2015-14**
- Provides banks the opportunity to re-elect the standard bad debt conformity election via an automatic tax accounting method change (IRS form 3115) if the election had previously been revoked due to failure to secure the express determination letter
- But must have a current letter to re-elect
- This had previously been a consent request (i.e., not automatic and IRS user fee required)

Bad Debts and Real Estate Foreclosures

- **Standard Bad Debt Conformity Election**
- Benefits:
  - IRS audit protection for bad debt deductions and estimated selling costs related to loans
  - Permits the regulatory / book treatment of non-performing loan interest to be followed for tax purposes, except for actual interest payments collected (which must be included in taxable income if not recorded in book income) – See Revenue Ruling 2007-32

Bad Debts and Real Estate Foreclosures

- **Standard Bad Debt Conformity Election**
- Drawbacks:
  - Requires bank to routinely secure an "Express Determination Letter" from its primary federal regulator confirming its loan loss classification process
  - Does not extend protection to bank-owned subsidiaries

Bad Debts and Real Estate Foreclosures

- **Standard Bad Debt Conformity Election**
- Drawbacks:
  - Its application to bank-owned debt securities is questionable
  - Somewhat uncertain how the conformity election applies to bad debt deductions for loans not covered by “loss asset” classification

Bad Debts and Real Estate Foreclosures

- **Standard Bad Debt Conformity Election**
- Drawbacks:
  - Requires bad debt deductions to match the timing of loan charge-offs, which eliminates any flexibility to defer bad debt deductions for partial loan charge-offs
    - This flexibility may be useful for taxpayers trying to utilize NOL carryforwards or under certain IRC §382 built-in loss scenarios

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
  - LB&I-04-1014-008 issued in October 2014
  - Attempted to expand both the availability and the scope of elective bad debt conformity
  - Structured as an internal IRS audit directive to be applied under examination, so it does not carry the authority of law or regulation
  - Generally favorable, but raises some concerns

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
  - Could have been adopted in any tax year from 2010 through 2014
  - Once adopted, the directive provisions must be followed consistently going forward

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
  - The adoption is only formalized under IRS audit by providing written certification upon request of the examining agent
  - However, failure to follow the directive provisions in any intervening year between adoption and examination presumably forfeits its application
  - The directive appears to be irrevocable

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
- Benefits:
  - Eliminates the requirement to secure the Express Determination Letter
  - Provides the same bad debt protections for loan charge-offs as the standard election
  - Extends this same protection to loan charge-offs of bank-owned subsidiaries

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
- Benefits:
  - Expressly provides conformity for:
    - Estimated selling costs in loan foreclosures
    - Bad debt deductions for certain credit-related losses on bank-owned debt securities
  - Allows for a cumulative effect catch-up deduction in the year of adoption for any covered deductions not claimed in prior years

Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
- Concerns:
  - Small banks using the IRC §585 bad debt reserve method are expressly excluded from the scope of the directive
  - The scope of loans covered by the directive refers to GAAP pronouncements that appear to be incorrectly cited

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Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
- Concerns:
  - No mention of application to non-performing loan interest
  - Cumulative effect catch-up deduction for credit-related losses on bank-owned debt securities appears to be unavailable to banks that utilize the standard conformity election

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Bad Debts and Real Estate Foreclosures

- **IRS Audit Directive Conformity Election**
- Concerns:
  - Somewhat uncertain how the conformity election applies to bad debt deductions for loans not covered by “loss asset” classification
  - Appears to be irrevocable once adopted

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Bad Debts and Real Estate Foreclosures

- **Banks That Should Consider the Standard Conformity Election**
  - Can secure the Express Determination Letter without difficulty
  - Would not significantly benefit from conformity protection applied to subsidiaries
  - No significant credit-related OTTI deduction potential
  - Utilize the IRC §585 bad debt reserve method

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Bad Debts and Real Estate Foreclosures

- **Banks That Should Have Considered the Directive Conformity Election**
  - Have difficulty securing the Express Determination Letter
  - May benefit from conformity protection applied to subsidiaries
  - Significant credit-related OTTI deduction potential
  - Do not currently utilize the IRC §585 bad debt reserve method

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Polling Question

Bad Debts and Real Estate Foreclosures

- Different rules apply for:
  - Small banks
  - Large banks
  - Thrifts (recapture rules)
- Large bank practitioners and tax directors should understand the rules applicable to small banks and thrifts because of the recapture issues applicable to acquisitions of these entities (discussed below)

Bad Debts and Real Estate Foreclosures

- Large bank method of accounting for bad debt deductions related to loan losses:
  - Large bank is defined as a bank that is a member of a controlled group of corporations with average total assets in excess of $500 million
  - Large banks must simply follow the rules and procedures set forth in §166 discussed above
    - Deduction available for worthless loans
    - Recovery of a previously deducted bad debt is current taxable income

Bad Debts and Real Estate Foreclosures

- Small bank method of accounting for bad debt deductions related to loan losses:
  - Small bank is defined as a bank that is not a large bank (defined above)
  - Small banks are permitted to use a reserve method of accounting for bad debt deductions under §585
  - Under this reserve method, the available tax deduction for a given year is the amount that would restore the tax reserve balance to its calculated level

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - §585(b)(2) provides two methods for calculating the allowable reserve balance

  - The maximum available tax deduction is the greater of the deductions calculated under either method

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Method 1 - §585(b)(2)(A)
  - Available reserve balance is calculated by applying a ratio to the balance of total loans outstanding at year end
  - The numerator of the ratio is the sum of the total bad debts realized on worthless loans net of recoveries (i.e. the amount of the deduction that would have been claimed under §166) for the current year and five previous taxable years

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - The denominator is the sum of the total outstanding loans as of the end of the current year and five previous taxable years
  - The product of this ratio and the balance of total loans outstanding at the end of the current year is the allowable balance of the reserve

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Method 2 - §585(b)(2)(B)
  - Available reserve balance is calculated by reference to the bad debt reserve outstanding as of the end of the "base year"
  - The base year is the last taxable year beginning before 1988 (i.e. the 1987 tax year)
  - If the total loans outstanding as of the end of the current year are equal to or greater than the balance of total loans outstanding at the end of the base year, then the available reserve balance is equal to the base year reserve

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - If the total loans outstanding as of the end of the current year are less than the balance of total loans outstanding at the end of the base year, then the available reserve balance under this method is reduced
  - This reduction is calculated by multiplying the balance of the base year reserve by the ratio of total loans outstanding at the end of the current year divided by the total loans outstanding at the end of the base year

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Understanding the mechanics of the bad debt reserve activity are necessary to understanding how the deduction works:
    - The opening balance of the reserve would be the amount calculated at the close of the previous year
    - Realized losses on worthless loans (using §166 method) decrease the balance of the reserve
    - Recoveries of previously realized loan losses increase the balance of the reserve

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Thus, the available tax deduction for a given year is calculated as follows:
    - Step 1 - Determine the largest available bad debt reserve balance at year end (using either method)
    - Step 2 - Take the beginning reserve balance, subtract loan losses, add loan recoveries
    - Step 3 - subtract Step 2 balance from Step 1 balance for the available tax deduction; no deduction is available if zero or negative

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - The maximum available tax deduction is the greater of the deductions calculated under these two methods
  - The tax deduction will not necessarily equal the realized losses on worthless loans as calculated under §166
  - Recoveries are not included in current taxable income; they simply increase the balance of the reserve (which may impact the calculated deduction)

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Total loans are an important factor in the calculation of the allowable reserve
  - §1.585-2(e)(2) defines "loans" for purposes of the reserve calculation:
  - <u>Included</u> – loans, accrued interest, overdrafts, bankers acceptances, loan participations (to the extent the taxpayer bears a risk of loss)
  - <u>Excluded</u> – discount not yet included in income, commercial paper, certain debt evidenced by a security, unfunded commitments and loans acquired specifically to inflate the §585 reserve

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Total loans – special considerations:
    - Only amounts in which the taxpayer has basis are included (i.e. a cash basis taxpayer can not include accrued interest receivable)
    - IRS private letter rulings have held that mortgage-backed securities and REMICs can also be included because they represent a pass-through interest in the underlying loans and the taxpayer bears the risk of loss on these loans

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Special rules:
    - §585(b)(1) suggests that taxpayers are not required to claim the full deduction available under the reserve method; however, §1.585-2(a)(2) requires a "minimum addition" of at least the six year moving average amount (Method 1 discussed above)
    - New taxpayers - §1.585-2(c)(2) allows de novo banks to "borrow" the experience of a comparable bank for its 5 year history

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Recapture of the §585 bad debt reserve into taxable income is required when the taxpayer becomes a “large bank”
  - §585(c)(2) defines a large bank as one with average total assets in excess of $500 million; or a bank that is a member of a parent-subsidiary controlled group with average total assets in excess of $500 million
  - §1.585-5(c) requires that total assets be calculated quarterly using tax basis

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Three methods of recapture are available
  - Taxpayer can elect any of these methods in the year of recapture, but must continue with the selected method
  - The recapture applies to the opening bad debt reserve balance outstanding as of the beginning of the tax year during which the asset threshold is exceeded (the “disqualification year”), and that year is the first year of the recapture period

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Method 1 - §585(c)(3)(A)(iii) – requires the balance of the reserve to be recaptured as follows:
    - 10% of the reserve balance in the disqualification year
    - 20% in the following tax year
    - 30% in the second following tax year
    - 40% in the third following tax year

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Method 2 - §585(c)(3)(A)(iii) – not really a separate method, but an elective variation of method 1:
    - xx% of the reserve balance in the disqualification year (any % elected by the taxpayer greater than 10%)
    - 2/9 of the remaining balance
    - 1/3 of the balance remaining after year 1
    - 4/9 of the balance remaining after year 1

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Method 3 - §585(c)(4) – Elective cut-off method
  - Requires the taxpayer to bifurcate its loans into two categories for purposes of tracking the charge-off activity for tax purposes
  - “Old loans” are those originated prior to the disqualification year
  - “New loans” are those originated during or after the disqualification year

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Net charge-offs on new loans are accounted for under §166 for purposes of calculating bad debt deductions (i.e. the large bank method)
  - Net charge-offs on old loans are charged against the unrecaptured balance of the §585 reserve without any related tax deduction (i.e. these charge-offs reduce the balance of this reserve)
  - Once the §585 reserve balance is fully depleted, further charge-offs of old loans are accounted for under §166 and result in a bad debt deduction

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - The balance of the §585 reserve must also be recaptured to the extent the reserve balance exceeds the remaining balance of the old loans
  - This mechanism ensures that the reserve balance will eventually be recaptured as the old loans run off

Bad Debts and Real Estate Foreclosures

- Small bank bad debt reserve method
  - Benefits of electing the cut-off method (Method 3) over the 4-year spread methods (1&2)
    - May substantially lengthen the recapture period if the old loan pool is made up of high quality loans that will remain on the books for a long period of time
  - Drawbacks to the cut-off method
    - Recordkeeping requirements

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Up until 1995, thrifts enjoyed a fairly generous tax reserve method of deducting bad debt losses
  - Under these rules, most thrifts could claim a bad debt deduction equal to 8% of thrift taxable income, regardless of whether any bad debt losses were actually realized
  - This favorable method was repealed for tax years beginning after December 31, 1995 [§593(f)]

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Beginning with the first taxable year beginning after December 31, 1995, thrifts were required to recapture their “applicable excess reserves,” as defined in §593(g)(2)
  - Generally, the applicable excess reserves was the excess of the balance of all bad debt tax reserves as of the beginning of that tax year over the larger of – 1) the balance of those reserves as of the close of the base year (1987); or 2) the balance of the §585 experience reserve for thrifts meeting the definition of a small bank

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - The reserve recapture was to be realized evenly over a period of six taxable years
  - However, the recapture could be delayed for two taxable years if the thrift met certain mortgage lending thresholds
  - In any event, all thrifts should now have fully recaptured all of their applicable excess reserves
  - What remains of the thrift reserves as of the base year will be recaptured upon the occurrence of certain events and remains a tax pitfall

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - The balance of the base year thrift reserves (which can be substantial, given the generous additions to these reserves over the years) will be recaptured into taxable income upon the occurrence of any of these events:
    - Taxable liquidation of the thrift
    - The thrift ceases to engage in the business of banking
    - Distributions in excess of earnings and profits
    - Distributions in redemption of thrift stock

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Given that the unrecaptured reserves are a tax attribute to which §381 applies, the potential for recapture is inherited by any financial institution that acquires a thrift in a tax free reorganization
  - Thus, any bank or thrift that acquires a thrift with unrecaptured reserves must be mindful of the potential recapture events to ensure that they do not occur (or at least be mindful of the adverse tax impact of the reserve recapture)

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Recapture events upon certain distributions:
    - Under §593(e), the order of any <u>dividend</u> distribution made by a corporation with unrecaptured thrift bad debt reserves is treated as:
      - Coming first out of current or accumulated earnings and profits (no recapture)
      - Then out of the accumulated thrift bad debt reserves (recapture)

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Recapture events upon certain distributions:
    - Under §593(e), the order of any <u>taxable distribution made in redemption or partial or complete liquidation</u> by a corporation with unrecaptured thrift bad debt reserves is treated as:
      - Coming first out of the accumulated thrift bad debt reserves (recapture)
      - Then out of current or accumulated earnings and profits (no recapture)

Bad Debts and Real Estate Foreclosures

- Recapture of thrift bad debt reserves
  - Many thrifts that converted from mutual associations to stock corporations in the 1990s raised significant amounts of capital at the thrift level
  - Thus, many of these thrifts have enough excess capital to make a distribution in excess of E&P
  - These thrifts need to be mindful of the potential recapture, especially if they reside in a state that levies a tax based upon net worth (i.e. where minimizing capital is encouraged)

Bad Debts and Real Estate Foreclosures

- Foreclosed property is required to be taken into possession with a tax basis equal to its FMV [see Reg. §1.166-6(b)]
- Once OREO is taken into possession, subsequent write-downs to FMV are not deductible for tax purposes until the property is sold
- Under examination, there is often disagreement about what the FMV of the OREO was at the foreclosure date based upon the timing of appraisals

Bad Debts and Real Estate Foreclosures

- For post-foreclosure appraisals:
  - IRS may argue that declines in value occurred after the foreclosure date, rendering the decline a non-deductible post-foreclosure write-down
  - IRS may argue that an appraised value in excess of the foreclosure date recorded value means the charge-off was overstated (i.e. the increased value was there at the foreclosure date)
- Ideally, appraisals dated on, or very close to, the foreclosure date should be used to support the amount of the charge-off claimed upon foreclosure

Bad Debts and Real Estate Foreclosures

- If the value of the property is in dispute, the taxable income or loss determined on the foreclosure date may be an issue under examination
- IRS may challenge taxpayers who reduce the FMV of OREO at foreclosure by anticipated selling costs - see Bank of Kirksville, case – taxpayer favorable but IRS has indicted they will not follow the decision
- If the taxpayer is under the bad debt conformity election and the bad debt deduction claimed matches the portion of the loan classified as a loss asset for regulatory purposes, the deduction should be protected under examination

Bad Debts and Real Estate Foreclosures

- In recent years, there had been a coordinated effort by the IRS to require capitalization of carrying costs on non-income producing OREO property
- The IRS argument was based upon an assertion that the OREO property is "inventory" acquired for resale and, consequently, §263A requires all carrying costs to be capitalized to the basis of the individual properties (which would permit them to be deducted upon disposal of the applicable properties)

Bad Debts and Real Estate Foreclosures

- Numerous taxpayers conceded this issue under examination because the IRS would not settle the issue in Appeals
- In March 2013, the IRS released a memorandum (AM 2013-001) indicating a reversal of their position on this issue

Bad Debts and Real Estate Foreclosures

- The IRS officially abandoned this position with the issuance of Revenue Procedure 2014-16 in January of 2014

- This pronouncement reverses the capitalization initiative and allows taxpayers who had capitalized these costs to correct the issue with an automatic change in tax accounting method (IRS form 3115)

Bad Debts and Real Estate Foreclosures

- Losses on worthless securities
  - Is governed by §166 for debt obligations held by a bank and evidenced by a security
  - Is governed by §165 for all other taxpayers
  - The significance of the loss being governed by §166 for a bank is that this section allows deductions for both partial and total worthlessness (no taxable sale or exchange is necessary)
  - For non-bank taxpayers, §165(g)(1) provides only a deduction for total worthlessness in the absence of a taxable sale or exchange

Bad Debts and Real Estate Foreclosures

- Losses on worthless securities
  - Similar to loans, debt securities may be considered wholly or partially worthless for tax purposes
  - For tax purposes, worthlessness is based upon a demonstrated likelihood that the debt will be uncollectible in whole or in part and is generally based upon identifiable debtor events (i.e. default on the security, bankruptcy, mounting financial losses, lack of sufficient collateral, etc.) – see IRC Section 166
  - Any deduction for partial worthlessness must be accompanied by a charge off of the worthless portion of the debt

Bad Debts and Real Estate Foreclosures

- Losses on worthless securities
  - Only banks are permitted to claim a bad debt deduction for partially worthless debt securities
  - Other taxpayers must wait until the security is sold or is considered wholly worthless to deduct these losses (per §165)

  - For banks and non-banks alike, no deduction is available for partially worthless equity securities (i.e. stocks, mutual funds, FNMA and FHLMC preferred, etc.) must follow §165

Bad Debts and Real Estate Foreclosures

- Losses on worthless securities
  - While the GAAP standards for recording other-than-temporary impairment ("OTTI") against investment securities is not determinative of the tax deduction (the GAAP impairment standards are generally more liberal than the tax deduction standards), the securities should be examined for available deductions under the tax bad debt standards

CASE 8 - Bad Debts

- Bank is a “large bank” entitled to a bad debt deduction under §166
- Assume the following circumstances:
  - Loans the became wholly or partially worthless in the current year = $150,000
  - Recoveries on loans that were deemed to have been wholly or partially worthless in prior years = $20,000
- What is Bank’s allowable bad debt deduction for the current year?

CASE 9 - Bad Debts

- Assume the same facts as presented in Case 8
- What would be the effect on taxable income if the recoveries were $150,000 and the loans that became worthless in the current year totaled $20,000?

CASE 10 - Bad Debts

- Assume the same facts as presented in Case 8
- If Bank was audited by the IRS, what potential challenges might the IRS assert against the $130,000 of net bad debt deductions?
- How might the taxpayer defend its deductions?
- What effect would the conformity election have on this situation?

CASE 11 - Bad Debts

- Bank is a “small bank” eligible to utilize the §585 reserve method of calculating its bad debt deductions
- Assume the following facts:
  - Total loans outstanding at the end of the current year = $200,000,000
  - Net charge-offs for the current year = $100,000
  - Total loans outstanding at the end of the…prior year = $200,000,000; second prior year = $200,000,000; third prior year = $150,000,000; fourth prior year = $150,000,000; fifth prior year = $100,000,000

CASE 11 - Bad Debts

- Assume the following facts (continued):
  - Total net charge-offs for the…prior year = $200,000; second prior year = $200,000; third prior year = $300,000; fourth prior year = $200,000; fifth prior year = $200,000
  - Reserve balance at the beginning of the year = $180,000
  - Base year reserve balance is = $120,000
  - Total loans outstanding at the end of the base year = $125,000,000

CASE 11 - Bad Debts

- What tax deduction is available to Bank in the current year?

Polling Question

Nonperforming Loans

Nonperforming Loans

- The tax treatment of interest on nonperforming loans is a contentious issue with the IRS and often results in a proposed adjustment upon examination
- For financial and regulatory accounting purposes, interest accrued on loans that are in a delinquent status is often not recognized, so the financial condition of the bank is not overstated
- This conservative approach to financial reporting is often viewed by the IRS as aggressive for tax accounting purposes

Nonperforming Loans

- While there is no specific code section which addresses the accrual of interest on nonperforming loans, there are some pronouncements and judicial decisions that provide some guidance in this area
- The general rule for the inclusion of accrued interest income in taxable income is governed by IRC §451 and the regulations thereunder
- Specifically, §1.451-1(a) provides that an amount "is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy"

Nonperforming Loans

- The condition that the accrual is subject to a determination of “reasonable accuracy” suggests that anticipated uncollectibility should be factored into the determination of the taxable amount
- There is significant support for this position:
  - “If the facts show that…it was reasonably certain for any reason that the interest would never be received, [the taxpayer] was justified in reporting only such amounts as were actually…received” Atlantic Coast Line Railroad Co. v. Commissioner, 31 BTA 730 (1934)

Nonperforming Loans

- "When tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received." Corn Exchange Bank v. U.S. 37 F.2d 34 (CA 2)

Nonperforming Loans

- The IRS even agrees with this fundamental concept:
  - "A fixed right to a determinable amount does not require accrual…if the income item is uncollectible when the right to receive the item arises." Rev. Rul. 80-361
  - "On loans not charged off, the taxpayer must, on a loan by loan basis, substantiate that the interest is uncollectible in accord with Revenue Ruling 80-361." IRS Coordinated Issue Paper regarding accrued interest on nonperforming loans

Nonperforming Loans

- Then why is the accrual of interest on nonperforming loans such a contentious issue upon examination?
  - There has historically been no safe harbor or conformity election that the IRS will accept as conclusive evidence supporting the non-accrual of interest (but see discussion of Rev. Rul. 2007-32 and Rev. Proc. 2007-33 below)
  - Taxpayers are left to defend their treatment of nonperforming loans on a loan by loan basis
  - Most arguments in this area are subjective and open to debate

Nonperforming Loans

- What does the IRS look for in the nonperforming loan area?
  - Has the loan been charged-off for tax purposes? If so, the IRS will accept the non-accrual of interest if it accepts the charge-off of the loan
  - If not charged-off, has the interest been recovered as of the time of the IRS examination?
  - If not charged-off, does the information in the loan file support the taxpayer’s argument that the interest is not likely to be collected? Borrower’s condition? Payment history? Value of collateral?

Nonperforming Loans

- What can taxpayers do to mitigate or avoid an adjustment in the nonperforming loans area?
  - Make sure that loan file documentation is accurate and depicts the true financial condition of the borrower and outlook of collectability
  - Look for loan charge-offs subsequent to the close of the year being examined to prove that the interest was never collected

Nonperforming Loans

- Any interest accrued on nonperforming loans for tax purposes establishes basis in that interest receivable
- If ultimately determined to be uncollectible, taxpayer can claim a charge-off for the balance accrued through income but later determined to be uncollectible
- If ultimately collected, this amount would run through book income, so an offsetting schedule M adjustment reducing taxable income would be appropriate

Nonperforming Loans

- In an effort to reduce some of the controversy between taxpayers and the IRS over the treatment of non-accrual loan interest, the Treasury recently issued two pronouncements
- Both pronouncements are brand new and Treasury is seeking public commentary on their provisions
- While the pronouncements do offer some safe harbors, not all taxpayers will necessarily find the pronouncements to be beneficial

Nonperforming Loans

- **Revenue Ruling 2007-32**
- Appears to provide a safe harbor for following the book treatment of non-accrual loan interest if the taxpayer has the bad debt conformity election (discussed above) in place
- However, the taxpayer must formally record the non-accrual interest as a charge-off and treat all subsequent payments received as first applied to interest income (rather than loan principal)

Nonperforming Loans

- **Revenue Procedure 2007-33**
- Available (elective) to taxpayers that have not made the bad debt conformity election – is the only safe harbor available to these institutions
- Applies a loan collectability ratio to the non-accrual interest based upon total loan payments collected (principal and interest) for the previous 5 years over the total loan payments due (principal and interest) for the same period - this portion of the non-accrual interest must be recognized

Nonperforming Loans

- <u>Taxpayer alternatives:</u>
- 1) Apply the Rev. Rul. 2007-32 safe harbor if the bad debt conformity election is in place (consider making the election if not in place);
- 2) Elect the Rev. Proc. 2007-33 safe harbor if the bad debt conformity election is not in place (taxability under this method is likely to be the highest of the three); or
- 3) Continue with current method (and argue to support non-accrual treatment under examination based upon the underlying facts and circumstances)

CASE 12 - Nonperforming Loans

- Bank is currently under an IRS examination and the examining agent is looking into the non-accrual of interest on nonperforming loans. The agent has asked about the following non-accrued interest:
  - $40,000 on loans that were charged-off in the same year and the agent has agreed to the charge-off treatment
  - $60,000 on loans that are 90 days past due
- What issue is the examining agent likely to raise?
- How might the Bank defend its non-accrual position?

Polling Question

Capital Gains and Losses

Capital Gains and Losses

- All capital gains realized by a C-corporation are taxed at the same rate as ordinary income under current law (i.e. there is no tax rate benefit for long-term capital gains)
- Capital gains realized by an S-corporation pass through to the shareholders and retain their character as capital gains
- As such, long-term capital gains realized by an S-corporation can be taxed to the individual shareholders at the reduced tax rate applicable to individual long-term capital gains

Capital Gains and Losses

- Net capital losses realized within a C-corporation can only be used to offset capital gains within the "utilization period" discussed below; they can not be deducted directly or used to offset any other type of income
- The "utilization period" for offsetting a net capital loss against capital gain income is:
  - Three taxable years prior to the year of the net loss (via carryback); or
  - Five taxable years subsequent to the year of the net loss

Capital Gains and Losses

- Thus, capital gains within a C-corporation carry no specific tax benefit other than to provide an opportunity to offset net capital losses within the utilization period
- Given their financial orientation, §582(c) provides banks with some protection against capital loss treatment on bonds and other debt instruments
- Specifically, this section holds that, in the case of a bank, "the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness shall not be considered a sale or exchange of a capital asset."

Capital Gains and Losses

- Specifically absent from this definition is an investment which constitutes an equity interest in the issuer
- Thus, losses from the sales of equity investments, such as stocks, partnership interests, etc. are considered as capital losses, even for a bank
- However, see special treatment for FNMA and FHLMC preferred stock (below)

Capital Gains and Losses

- **Emergency Economic Stabilization Act of 2008**
- Provides, legislatively, that gains and losses on disposals of FNMA and FHLMC preferred stock investments will be treated as ordinary, provided:
  - The preferred stock was held by a financial institution defined in §582(c)(2) [includes banks, thrifts and certain other financial entities] or a depository institution holding company, and
  - The sale occurs on or after 1/1/08 and before 9/7/08

Capital Gains and Losses

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  - The preferred stock was held by a financial institution defined in §582(c)(2) [includes banks, thrifts and certain other financial entities] or a depository institution holding company, and
  - The sale occurs anytime after 9/6/08, but only if the preferred stock is held at all times between 9/6/08 and the sale date by the taxpayer and the taxpayer continues to meet one of the above definitions at all times between 9/6/08 and the sale date

Capital Gains and Losses

- **Rev. Proc. 2008-64**
- Extends the ordinary gain / loss treatment for sales or disposals of FNMA and FHLMC preferred stock to:
- Sales by a direct or indirect bank-owned subsidiary, provided the subsidiary joins in a consolidated call report and tax return with the bank
- Most sales by certain “auction rate security” partnerships owned by one of the qualified taxpayers listed previously
- Stock transferred in a carryover basis transaction, provided the transferor would have otherwise qualified for the ordinary gain / loss treatment

Capital Gains and Losses

- Losses from the sale of bank investments in mutual funds will likely be treated as capital losses, even though the underlying investments of the mutual funds may consist of bonds and other debt securities [see *Community Trust Bancorp, Inc. v. United States* 99-2 USTC ¶50,698]

Capital Gains and Losses

- The application of §582(c) provides protection to banks with regard to the sale of loans, debt securities and other forms of debt, as losses on such sales are deductible as ordinary losses
- However, for a bank with a net capital loss these same rules can make it very difficult to generate a capital gain

Capital Gains and Losses

- Sources of potential capital gains for a bank:
  - Gain on the sale of equity investments (stock, partnership interests, mutual funds, etc.)
  - Gain on the sale of any security, investment or debt obligation held by a non-bank affiliate in the same consolidated group

Capital Gains and Losses

- Sources of potential capital gains for a bank:
  - Gain on the sale of vacant land
  - Gain on the sale of depreciable real estate, but consider §1250 recapture, §291(a)(1) recapture and rules regarding non-recaptured §1231 losses [§1231(c)] – sale-leaseback transactions
  - Gain on the sale of loan servicing assets, if held for more than one year (somewhat unclear as to whether these may qualify as §1231 assets)

Capital Gains and Losses

- Sources of potential capital gains for a bank:
  - Gain on redemption of Federal Home Loan Bank (“FHLB”) stock
  - But only if the FHLB district had previously paid stock dividends (as opposed to cash dividends) to FHLB stockholders, thereby reducing the tax basis of the FHLB stock in the owner’s hands
  - This is the only way a taxable gain will result on the redemption of FHLB stock

Capital Gains and Losses

- Can gain from the sale of property acquired through loan foreclosure be considered a capital gain?
  - Not likely…
  - The IRS would likely argue for this gain (and loss) to be treated as ordinary in character [see AM 2013-001, where IRS acknowledges that OREO is held for sale to customers under §1221(a)(1)]
  - Would likely require the bank to argue that the property was held as an investment at the time of its disposal

Capital Gains and Losses

- The conclusion reached in *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993) may lend support to the treatment of these gains and losses as ordinary in character

- Taxpayers may also consider arguing for §1231 treatment by supporting the position that the foreclosed property is used in its trade or business – would likely require significant evidence to support this conclusion

CASE 13 - Capital Gains and Losses

- Bank realizes the following gains and losses in the current year:
  - $40,000 loss from the sale of mutual fund investments
  - $100,000 loss from the sale of FNMA preferred stock
  - $120,000 gain from the sale of corporate bonds
  - $60,000 loss from the sale of loans
- What amount of the losses are disallowed in the current year?
- What must be done with any capital losses not utilized in the current year?

CASE 14 - Capital Gains and Losses

- Bank Holding Company realizes the following gains and losses in the current year:
  - $50,000 loss from the sale of mutual fund investments
  - $120,000 gain from the sale of corporate bonds
  - Assume Bank subsidiary has no net capital gain or loss for the current year
- What amount of the losses are disallowed in the current year?
- What must be done with any capital losses not utilized in the current year?

Mark to Market Rules

Mark to Market Rules

- §475 governs these rules (adopted in 1993)
- Generally requires the application of mark to market accounting to certain securities held by a "dealer in securities"
- §475(c)(1) defines a dealer in securities as "a taxpayer who – (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business."

Mark to Market Rules

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Mark to Market Rules

- §475(c)(2) defines the term “security” to mean:
  - Shares of stock in a corporation
  - Partnership interest
  - **Note, bond, debenture, or other evidence of indebtedness**
  - Interest rate, currency, or equity notional principal contract
  - Derivative interest in any of the above
  - A position that is a hedge with respect to any of the above and is identified as such

Mark to Market Rules

- These rules have evolved to include in the definition of a dealer in securities a bank that regularly originates loans for sale on the secondary loan market

- The IRS has issued several pronouncements and information releases indicating its position that a bank is a dealer in securities if it regularly originates loans and sells those loans on the secondary market

Mark to Market Rules

- For purposes of offering a bright-line definition of whether such activities are carried on “regularly,” §1.475(c)-1(c) provides a “negligible sales” exclusion
- This exclusion from the definition of a dealer in securities applies if certain conditions are met
- Even if the exclusion applies, taxpayers can elect to be treated as a dealer in securities if desired

Mark to Market Rules

- Conditions for the negligible sales exclusion to apply to the sale of debt instruments:
  - The taxpayer sells all or part of fewer than 60 debt instruments during the taxable year; or
  - The total adjusted basis of the debt instruments sold is less than 5% of the total basis of the debt instruments that it acquired during the taxable year

Mark to Market Rules

- For purposes of applying the negligible sales exclusion, sales of debt instruments under the following circumstances are disregarded
  - Sales necessitated by exceptional circumstances and that are not undertaken as recurring business activities
  - Sales of debt instruments that decline in quality while held by the taxpayer and that are sold pursuant to an established policy of disposing of debt instruments below a certain quality
  - Acquisitions and sales that are qualitatively different from all debt securities that the taxpayer purchased from customers in the ordinary course of its business

Polling Question #1

Mark to Market Rules

- If a bank is determined to be a dealer in securities, the application of the mark to market rules can be applied narrowly or widely, depending upon the identification procedures followed by the bank

- §475(a) holds that securities which are "inventory" in the hands of a dealer in securities must be marked to market

Mark to Market Rules

- §475(b) excludes from mark to market treatment:
  - any security held for investment
  - Any debt obligation acquired by the taxpayer (including loans originated by the taxpayer) in the ordinary course of its trade or business and not held for sale; and
  - Any security which is a hedge with respect to a security exempt from mark to market treatment
  - **However**, none of these exclusions apply unless the taxpayer clearly identifies these securities as exempt securities

Mark to Market Rules

- §475(b)(2) requires the identification of exempt securities to be made:
  - In the dealer's records; and
  - Before the close of the day on which it was acquired, originated, or entered into
- Rev. Rul. 97-39 offers detailed guidance regarding practical approaches to complying with the §475 identification requirements

Mark to Market Rules

- Useful guidance offered in Rev. Rul. 97-39:
  - Holding #6
    - No special procedures are required to document the identification of exempt securities; any reasonable method will be accepted
    - Identification must be made on, and retained as part of, the dealer’s books and records
    - Must clearly identify the security or securities being identified and indicate that the identification is being made for purposes of §475

Mark to Market Rules

- Useful guidance offered in Rev. Rul. 97-39:
  - Holding #6
    - Alternatively,
    - Allows taxpayers to make a de-facto identification by identifying specific accounts as containing only securities meeting a specific exemption; or
    - Allows taxpayers to make a de-facto negative identification by identifying an isolated account as only containing non-exempt securities, with all other securities held as meeting a specific exemption

Mark to Market Rules

- As a result of the identification requirement, taxpayers can choose to apply mark to market accounting to any or all securities (including loans)
- While securities that are held as "inventory" must be marked to market, any or all other securities could also be marked to market by purposefully failing to identify them as exempt securities
- This would be beneficial in a rising interest rate environment, but detrimental in a falling interest rate environment

Mark to Market Rules

- Lack of proper identification can also be an IRS audit risk if the exemption is desired
- Once a security is subject to mark to market treatment through failure to identify the security as qualifying for a specific exemption, mark to market treatment must continue until sale or maturity of the security
- As a result, a long-term perspective must be taken into account in any planning scenario involving identifications or failed identifications

Mark to Market Rules

- §475(a)(1) requires that any security which is inventory in the hands of the dealer shall be included in inventory at its fair market value

- §475(a)(2) requires that any security which is subject to mark to market treatment and which is not inventory in the hands of the dealer shall be treated as if it were sold for its fair market value on the last day of the taxable year

Mark to Market Rules

- Thus, MTM gains and losses from securities deemed to be inventory are always ordinary gains and losses
- MTM Gains and losses from securities not deemed to be inventory (i.e. are market to market because of a failed identification) are either capital or ordinary in character, depending upon the character of the underlying security [see §475(d)(3)(B)(ii)]
- For a bank, MTM gain or loss on loans and debt securities will always be ordinary in character [§582]
- MTM gains and losses on equity securities held by a bank and all securities held by a non-bank will likely be capital in nature, if not deemed to be inventory

Mark to Market Rules

- On April 6, 2011, the IRS issued a field directive (LB&I-4-1110-033) indicating the IRS will not challenge a taxpayer’s use of financial statement market values for purposes of the MTM calculations required by §475, provided the taxpayer is required to file public financial statements

- In order to secure this safe harbor, taxpayers must file a signed certification statement with the examining agent with 30 days of the agent’s request to do so

Mark to Market Rules

- If the taxpayer fails to (or refuses to) timely file the certification statement, the MTM values presented in the tax return can potentially be challenged by the examining agent in the normal fashion
- Thus, the safe harbor is elective
- If the safe harbor is not timely elected under examination, neither the taxpayer nor the IRS are bound to use the values presented in the public financial statements (if it is determined that the true FMV is different than the GAAP-based values presented in the financial statements)

Mark to Market Rules

- Coordination with the bad debt deduction rules
  - Basis reduction in a loan resulting from a bad debt deduction under §166 must be taken into consideration in determining the basis of a loan also subject to mark to market treatment
  - Gain from a subsequent mark to market adjustment should be considered a loan recovery and accounted for as such under the bad debt accounting rules discussed above (i.e. income for a large bank, increase in the reserve for a §585 small bank)

CASE 15 - Mark to Market Rules

- Bank is considered to be a “dealer in securities” for purposes of §475 with respect to its loans originated for resale on the secondary market
- At the end of the current year, the loans held for resale reflected an unrealized gain of $35,000
- Bank’s investment securities portfolio is not held in Bank’s capacity as a “dealer in securities” and shows an unrealized loss of $350,000
- What mark to market adjustment must bank recognize in current year taxable income if it properly identified the investment securities as exempt from §475

Polling Question #1

Interest Expense

Interest Expense

- General rule for deducting interest expense:
  - For accrual basis taxpayers:
    - Deduct interest expense as it properly accrues

  - For cash basis taxpayers:
    - Deduct interest expense as it is paid
      - Exceptions:
        - Deduct interest expense related to debt obligations with OID under the OID rules (as it accrues)

Interest Expense

- Limitations on deducting interest expense:
  - The general interest expense disallowance - §265(a)(2)
  - The TEFRA disallowance - §265(b) and §291(e)

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - States simply that “no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle.”
  - Applies to all taxpayers individually, including all of the non-bank members of a consolidated group of corporations (i.e. bank holding company, bank subsidiary, other affiliates)

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - Rev. Proc. 72-18 provides taxpayers with guidance on how to apply the general disallowance rule
  - Generally requires a direct link between the borrowing and the investment in tax-exempt obligations
  - 100% of the interest expense allocated to the tax-exempt investments is disallowed

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - Rev. Proc. 72-18 provides some relief for taxpayers with an insubstantial level of tax-exempt investments
  - Applies if the average tax basis of tax-exempt obligations is less than 2% of the average tax basis of total assets for a particular year
  - The exemption is not available to dealers in tax-exempt obligations

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - Taxpayer attempts to thwart the application of this disallowance by merely separating the borrowing entity from the investing entity have been overruled by the courts
  - In H Enterprises Int'l, Inc. TC Memo 1998-97, aff'd, 183 F3d 907 (8th Cir. 1999), a direct link was determined to exist where:
    - Subsidiary borrows a large sum of money;
    - Distributes that money (in excess of E&P) to its parent; and
    - Parent invests in tax-exempt obligations

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - Does the general disallowance rule also apply to banks?

    - Yes, according to the bank specific rules contained in §265(b)(6) – this section makes reference to the application of the general disallowance rule to banks

Interest Expense

- General interest expense disallowance - §265(a)(2)
  - However, the application of the general disallowance rule to a bank should be an exception (i.e. an unusual event)
  - Previous IRS pronouncements in this area have applied the general disallowance rule to banks only in situations that are outside the scope of the bank’s normal business operations and where a very direct link exists between the borrowing and the investment in tax-exempt bonds

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Applies only to banks and thrifts
  - Mandates the disallowance of interest expense related to investments in tax-exempt debt obligations (i.e. bonds and loans – “bonds”)
  - Relies upon a formula-based disallowance calculation that applies to all sources of interest expense incurred by the bank
  - Thus, no direct link between the borrowing and the tax-free bond is required for the disallowance to apply

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - The interest expense deemed allocated to tax-exempt bond investments is calculated as follows:
    - A / B x C = allocated interest
    - A = average tax basis of tax-exempt bonds for the year
    - B = average tax basis of total assets for the year
    - C = total interest expense from all sources

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - The formula is only applied at the bank level – i.e. does not include the interest expense or assets of other affiliated group members (however, see discussion below regarding bank investment subsidiaries)
  - According to Rev. Rul. 90-44:
    - the tax basis of total assets is calculated on a quarterly basis
    - the tax basis of tax-exempt bond investments is calculated on a monthly basis

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Not all of the allocated interest determined under the formula approach is necessarily disallowed
  - Special rules apply for tax-exempt bonds:
    - acquired before January 1, 1983
    - acquired after December 31, 1982 but before August 8, 1986
    - that are “bank qualified” obligations
    - issued in 2009 or 2010

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Tax-exempt bonds acquired before January 1, 1983:
    - Not subject to any automatic interest expense disallowance calculation
    - Are subject to the general disallowance rule that applies only if a direct link can be established (unlikely for a bank, but not impossible)

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Tax-exempt bonds acquired after December 31, 1982, but before August 8, 1986:
    - Are subject to the interest expense disallowance formula provided in §291(e)(1)(B)
    - Allocated interest expense is determined in the same manner as provided above
    - However, only 20% of the interest expense so allocated is disallowed

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Tax-exempt bonds acquired after August 7, 1986:
    - General rule:
      - Are subject to the interest expense disallowance formula provided in §265(b)(2)
      - Allocated interest expense is determined in the same manner as provided above
      - 100% of the interest expense so allocated is disallowed

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Tax-exempt bonds acquired after August 7, 1986:
    - Exception to the general rule:
      - "Qualified tax-exempt obligations"
      - Allocated interest expense is determined in the same manner as provided above
      - However, only 20% of the interest expense so allocated is disallowed

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - What is a “qualified tax-exempt obligation?”
    - Defined in §265(b)(3)(B)
    - Generally defined as a tax-exempt bond that:
      - 1) is issued after August 7, 1986;
      - 2) is issued by a “qualified small issuer;”
      - 3) is not a private activity bond; and
      - 4) is designated as a qualified tax-exempt obligation by the issuer

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - What is a “qualified small issuer?”
    - Defined in §265(b)(3)(C)
    - Generally refers to an issuer that issues no more than $10 million of tax-exempt debt during any calendar year
    - Limit raised to $30 million for tax-exempt debt issued in 2009 and 2010
    - Qualified status should be designated at the time the bond is issued (Form 8038)

Interest Expense

- The TEFRA disallowance - §265(b) and §291(e)
  - Tax-exempt bonds issued in 2009 and 2010 (regardless of when acquired)
    - §265(b)(7) and §291(e)(1)(B)(iv):
      - Bonds otherwise treated as non-qualified obligations (i.e. subject to 100% disallowance) will be subjected to the same 20% interest expense disallowance as qualified obligations
      - Limited to 2% of bank's average total assets
      - Refunding bonds treated as being issued on the date the refunded bond was issued

Interest Expense

- Example:
- Assume a bank has $1 billion of average total assets

- Assume the prevailing coupon rates on tax-exempt municipal bonds is 3% for bank-qualified obligations and 3.45% for non-bank-qualified obligations

Interest Expense

- Example - continued:
- The bank could invest up to $20 million in non-bank qualified obligations issued in 2009 or 2010 and suffer only the same 20% interest expense disallowance associated with bank-qualified obligations
- The earnings enhancement is simply measured by the incremental coupon yield – annual benefit of $90,000 ($20,000,000 x .0045)
- The 2% of total assets limitation is cumulative and is measured annually

Interest Expense

- Example - continued:
- Thus, if the bank's average total assets dropped to $900 million in year 2, then $2 million of the $20 million of non-bank-qualified obligations purchased in year 1 would revert back to the 100% TEFRA interest expense disallowance in year 2
- Conversely, if the bank's average total assets increased to $1.1 billion in year 2, then the bank could purchase an additional $2 million of non-bank-qualified obligations in year 2 and still only suffer the 20% TEFRA interest expense disallowance

Interest Expense

- Discussion point…
  - Are investments in bank-owned life insurance contracts (i.e. “BOLI”) required to be considered in the calculation of disallowed interest expense?

Interest Expense

- Discussion point…
  - Answer – Generally, no [see §264(f)]
  - §265(b)(4) defines the term "tax-exempt obligation" as "an obligation the interest on which is wholly exempt from taxes imposed by this subtitle"
  - While the underlying BOLI investments may consist of bond investments, the BOLI contract itself is not an asset that generates interest income

Application of TEFRA to Bank-Owned Subsidiary

- The statutory framework of §265(b) provides that the interest expense disallowance enumerated in that section only applies to a bank, not to any other affiliate in a bank consolidated group

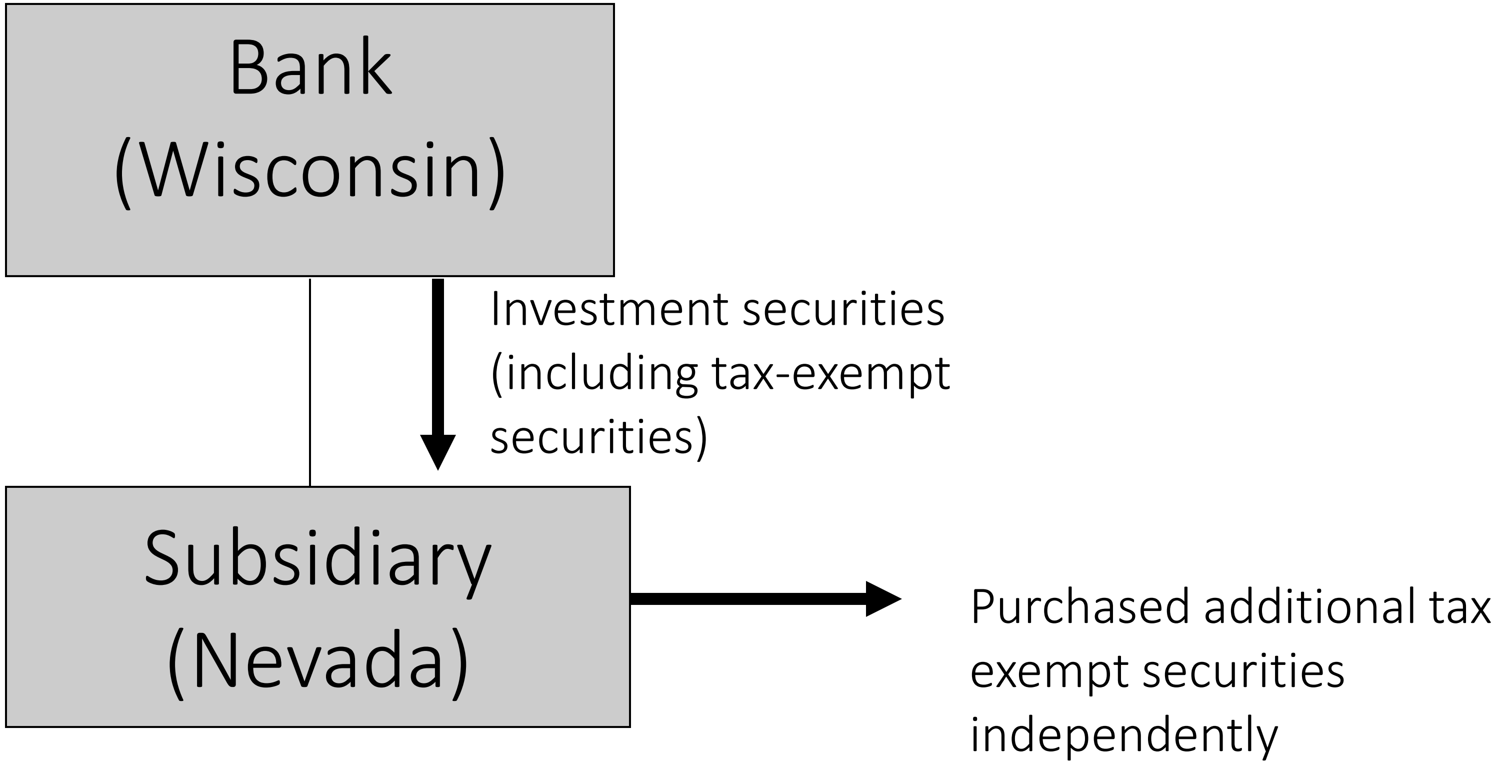
- The IRS, at one point, tried to take the position that the TEFRA disallowance can be extended to include a bank’s wholly owned non-bank subsidiary where the subsidiary was capitalized, in part, through a transfer of tax-exempt municipal securities from the bank

Application of TEFRA to Bank-Owned Subsidiary

- This issue was litigated in the Tax Court and decided in favor of the taxpayer – PSB Holdings, Inc. v. Commissioner, 129 T.C. No. 15 (November 1, 2007)

- The case involves a bank which transferred a substantial securities portfolio to a wholly-owned subsidiary for various business reasons, including state income tax savings

PSB Holdings, Inc. v. Commissioner



Application of TEFRA to Bank-Owned Subsidiary

- The primary IRS argument for the inclusion of the subsidiary’s tax-exempt securities in the bank’s TEFRA calculation was that such inclusion is required to “clearly reflect income” (as set forth in Revenue Ruling 90-44)

- The taxpayer asserted that such reliance is misplaced because the statute and underlying regulations limiting the disallowance to the bank are clear and unambiguous

Application of TEFRA to Bank Subsidiary

- TEFRA disallowance formula if no municipals owned by the subsidiary are included:

Average munis / Average total assets

(none of sub's munis included) (includes investment in subsidiary)

x

Interest Expense

Application of TEFRA to Bank Subsidiary

- TEFRA disallowance formula as applied on returns filed by PSB:

Average munis / Average total assets

(none of sub's munis transferred by Bank)	**(includes investment in subsidiary)**

x

Interest Expense

Application of TEFRA to Bank-Owned Subsidiary

- The *PSB Holdings* decision only addressed the exclusion of municipal securities independently purchased and owned by the subsidiary from the bank's TEFRA calculations
- However, the reasoning behind the decision would likely support the exclusion of all municipal securities owned by the subsidiary
- The IRS did not appeal the *PSB Holdings* decision, but has remained silent on the issue of its application to transferred securities

Interest Expense Deduction Limitation – IRC §163(j)

- Subjects the deduction for net business interest expense (i.e., interest expense in excess of interest income) to an annual limitation
- Limitation is generally 30% of EBITDA plus floor plan financing interest expense
- Applied on a consolidated tax return basis
- Disallowed amount can be carried forward indefinitely and used in future calculations
- Taxpayers with average 3-year gross receipts not exceeding $25 million and certain electing real estate businesses are exempt

Interest Expense Deduction Limitation – IRC §163(j)

- This provision is unlikely to impact banks, as nearly all banks are in a net interest income position
  - But watch for the impact of certain bank captive REIT structures
  - Could also impact partnerships in which the bank is invested
- The limitation could impose a substantial burden on the bank's highly-leveraged commercial loan customers, making debt financing more expensive than other alternatives
- Some of these customers may turn to leasing as a means of securing more tax-favorable financing

CASE 16 - Interest Expense

- Consider the following facts:
  - Bank has:
    - Current year interest expense of $5,000,000
    - Current year average tax basis of total assets of $400,000,000
    - Current year average tax basis of tax-exempt municipal bonds and loans (all acquired after August 7, 1986) of $30,000,000
- What amount of interest expense is disallowed if all of the tax-exempt bonds and loans are "qualified?"

CASE 17 - Interest Expense

- Consider the same facts as in Case 16, except that none of the tax-exempt bonds and loans are “qualified”
- What amount of interest expense is disallowed?

Capitalization of Intangible Costs

Capitalization of Intangible Costs

- The capitalization of intangible costs (verses the current deductibility of these costs) has been one of the most contentious and litigated issues in corporate taxation
- A new regime of capitalization standards was solidified with the landmark 1992 U.S. Supreme Court decision of *INDOPCO, Inc. v. Commissioner* [90-1278, 2/26/92, 503 US 79, 112 SCt 1039, Affirming CA-3, 90-2 USTC ¶50,571, 918 F.2d 426]

Capitalization of Intangible Costs

- The *INDOPCO* decision generally held that:
  - Any expense incurred that produces a long-term benefit must be capitalized, rather than deducted currently – regardless of whether the expense results in the creation of a separate and distinct (i.e. identifiable) asset
  - No amortization of any amount so capitalized will be permitted unless it can be demonstrated that the benefit resulting from the expense has a limited useful life and that life can be measured with reasonable accuracy

Capitalization of Intangible Costs

- The IRS routinely cites the *INDOPCO* decision as support for its arguments in favor of cost capitalization

- Several significant Tax Court Decisions upheld the IRS argument for cost capitalization, citing agreement with the IRS interpretation of the *INDOPCO* standards for capitalization

Capitalization of Intangible Costs

- However, some of these Tax Court decisions were later overturned on appeal by the various federal circuit courts, holding that both the IRS and the Tax Court had applied the *INDOPCO* rationale too liberally

- In reversing the Tax Court, the federal appellate courts ruled that the expenses at issue were currently deductible

Capitalization of Intangible Costs

- Examples:
- *PNC Bancorp, Inc. v. Commissioner* [2000-1 USTC ¶50,483], CA-3, 99-6020, 5/19/2000
  - Current deduction for taxpayer's <u>loan origination costs</u> was restored
- *Wells Fargo & Company v. Commissioner* [2000-2 USTC ¶50,697], CA-8, 99-3307, 224 F3d, 874 (8/29/00)
  - Current deduction for certain taxpayer <u>merger-related costs</u> was restored
- These examples illustrate the significance of these issues in the banking industry

Capitalization of Intangible Costs

- In an effort to relieve some of the controversy and litigation in this area, Treasury issued regulations under §263(a) to provide some level of objectivity in the application of cost capitalization standards
- While the regulations do provide some bright line tests and safe harbors, certain areas of cost capitalization (i.e. mergers and acquisitions) involve inherently subjective judgments and will always be open to disagreement

Capitalization of Intangible Costs

- Nevertheless, the regulations provide some concessions on the part of the IRS that many banks will find favorable
- In some cases, these concessions embody the rationale set forth in the *PNC Bancorp* and *Wells Fargo & Company* appellate decisions referenced above
- The regulations deal with “amounts paid to acquire or create intangibles” and offer extensive guidelines for determining whether certain costs are currently deductible or must be capitalized

Capitalization of Intangible Costs

- Regulation §1.263(a)-4 deals primarily with transactions other than mergers and acquisitions
- Regulation §1.263(a)-5 deals primarily with transactions involving mergers and acquisitions
- While the regulations cover many different areas and transactions, the areas of primary interest to financial institutions are:
  - Tax treatment of loan origination costs
  - Tax treatment of merger and acquisition costs

Capitalization of Intangible Costs

- The regulations contain two overriding conventions that simplify the determination of deduction v. capitalization for certain transaction costs:
   1. Current deduction for employee compensation and overhead

   2. Current deduction for de minimis costs

Current Deduction for Employee Compensation and Overhead Costs

- §1.263(a)-4(e)(4)(i),(ii) / §1.263(a)-5(d)(1),(2)
- Eliminates any requirement to capitalize these costs no matter how closely related to a particular transaction
- Includes director fees for attendance at regular meetings, but not special meetings
- Includes payments to non-employee service providers only if the work performed is secretarial, clerical or administrative
- Taxpayers can elect to capitalize these costs

Current Deduction for De Minimis Costs

- §1.263(a)-4(e)(4)(iii) / §1.263(a)-5(d)(3)
- Applies to costs other than deductible employee compensation and overhead
- Applies if the aggregate of all such costs incurred in pursuing a particular transaction do not exceed $5,000
- If the aggregate costs exceed $5,000, all of the costs must be capitalized (not just the excess over $5,000)

Current Deduction for De Minimis Costs

- Taxpayers engaged in 25 or more similar transactions can make the $5,000 threshold determination on a pooled basis
- The de-minimis exception to capitalization does not apply to commissions paid to third parties to facilitate the transaction
- Taxpayers can elect to capitalize these costs

Impact on Loan Origination Costs

- The application of these simplifying conventions effectively allows a current deduction for all loan origination costs with two exceptions:
    1. Commissions paid directly to third parties to originate loans (i.e. dealer reserve); and
    2. Loan costs, other than employee compensation and overhead, aggregating more than the $5,000 de minimis amount per loan (unlikely for most community banks); note that this determination can be made on a pooled bases for 25 or more similar loans

Impact on Loan Origination Costs

- The IRS will no longer challenge taxpayers over the current deductibility of loan origination costs rendered deductible by the regulations
- Taxpayers previously forced to capitalize and amortize these costs for tax purposes may now change their method of accounting
- Taxpayers can elect to capitalize and amortize these costs if desired

Impact on Merger and Acquisition Costs

- The regulations provide significant guidance on the deductibility v. capitalization of merger and acquisition costs [§1.263(a)-5]
- Some of this guidance is favorable and represents IRS concessions brought about as a result of recent judicial decisions
- While some of the conventions presented in the regulations offer more simplicity, the rigidity of these rules may reduce some opportunities previously available

Impact on Merger and Acquisition Costs

- The regulations resolve some, but not all, of the controversy in this area
- By conceding the deductibility of employee compensation related to merger and acquisition transactions, the IRS has removed a very significant area of frequent disagreement
- The regulations also provide a $5,000 de minimis threshold identical to that discussed previously
- Furthermore, the regulations make it clear that post-merger integration costs are currently deductible

Impact on Merger and Acquisition Costs

- Most merger and acquisition costs, other than employee compensation and overhead, are divided into two categories:
    1. Facilitative costs (capitalized); and
    2. Non-facilitative / investigatory costs (deductible)
- §1.263(a)-5(e)(1) provides a bright line test for determining whether expenses incurred in pursuing a transaction are facilitative or non-facilitative

Impact on Merger and Acquisition Costs

- The bright line test focuses on the <u>earlier</u> of:
  - The date on which the letter of intent, exclusivity agreement or similar written communication is executed; or
  - The date on which the material terms of the transaction are approved by the taxpayer's board of directors
- Costs incurred before the earlier of these dates are generally investigatory (deductible)
- Costs incurred on or after the earlier of these dates are generally facilitative (capitalized)

Impact on Merger and Acquisition Costs

- However, §1.263(a)-5(e)(2) holds that certain costs are "inherently facilitative" and therefore always capitalized no matter when they are incurred

- These costs generally include items such as costs incurred to draft the merger agreement, fairness opinions, negotiating the structure of the transac-tion (including tax opinions), preparation of proxy solicitation, obtaining regulatory approval, etc.

Impact on Merger and Acquisition Costs

- The regulations acknowledge the longstanding position that success-based fees, such as investment banker fees, can be broken down into investigatory / facilitative components based upon activities performed by the investment bankers
- §1.263(a)-5(f) provides guidance on the appropriate documentation necessary to support the deduction claimed for these fees

Impact on Merger and Acquisition Costs

- The documentation rules provide several requirements:
  - The documentation must be completed on or before the due date (including extensions) of the tax return on which the deduction is claimed
  - The documentation must consist of more than “merely an allocation” between investigatory and facilitative activities
  - The documentation must consist of supporting records
  - PLRs 200830009 and 201002036 uphold that time records are not the only source of acceptable documentation
  - CCA 201830011 ruled that the “typical” investment banker letter allocating estimated percentages to deductible activities without underlying documentation was insufficient to meet the documentation requirements

Impact on Merger and Acquisition Costs

- **Rev. Proc. 2011-29**
- Issued in April of 2011 to significantly reduce the level of disagreement between taxpayers and the IRS over what constitutes adequate documentation for success-based fees (such as investment banking fees)
- Provides a safe harbor to treat 70% of the success-based fee as non-facilitative (deductible) and 30% as facilitative (capitalized) without the need to gather any supporting documentation
- Available (separately) to both the buyer and the seller

Impact on Merger and Acquisition Costs

- **Rev. Proc. 2011-29**
- Applies to transactions described in §1.263(a)-5(e)(3) – i.e. most corporate acquisitions
- Applies to success-based fees paid or incurred in taxable years ending on or after April 8, 2011
- Election is irrevocable and is made by attaching a statement to the original federal income tax return for the taxable year the success-based fee is paid or incurred
- If not elected, taxpayer must justify its deduction based upon the adequacy of its documentation

Impact on Merger and Acquisition Costs

- In a series of subsequent rulings (CCA 201234027, LB&I-04-0413-002, LB&I-04-0114-001), the IRS ruled that non-refundable “milestone payments” credited toward an overall success-based fee for investment advisory services qualify for the 70% deduction election in Revenue Procedure 2011-29
- The guidance specifically applies to investment advisory fees paid under a success-based fee arrangement
- No mention of other types of success-based fee arrangements (i.e. legal or other)

Impact on Merger and Acquisition Costs

- **Example:**
- Investment banker charges Seller a $1 million success-based fee related to its acquisition by Buyer payable as follows:
  - $200,000 non-refundable installment payable upon issuance of a fairness opinion
  - $200,000 non-refundable installment payable upon signing of the definitive agreement
  - $600,000 non-refundable installment payable upon successful closing of the transaction ($1 million contingent fee less credit for the previous $400,000 of milestone payments applied)
- The safe harbor deduction would amount to $700,000 ($1,000,000 x 70%)

Impact on Merger and Acquisition Costs

- The regulations do not address the tax treatment of any costs capitalized pursuant to a tax-free reorganization
- Until further guidance is issued, these costs continue to be permanently capitalized (until dissolution)
- Will the IRS address this issue at some point? See Regulation §1.263(a)-5(g) [Reserved for future guidance]

CASE 18 - Capitalization of Intangible Costs

- Bank incurs the following loan origination costs in the current year:
  - $700,000 of allocated compensation and overhead costs for various loan types
  - $250,000 of allocated costs other than compensation and overhead for mortgage and consumer loans (average is less than $5,000 per loan)
  - $200,000 of allocated costs other than compensation and overhead for special circumstance commercial loans (average is more than $5,000 per loan)
  - $300,000 of commissions paid to local automobile dealers under an automobile loan referral program

CASE 18 - Capitalization of Intangible Costs

- What amount of Bank's loan origination costs is deductible in the current year?

- What amount is required to be capitalized?

CASE 19 - Capitalization of Intangible Costs

- Assume the following facts related to Bank A's acquisition of Bank B:
  - Bank A's board of directors approved the material terms of the transaction on October 1st of the current year
  - The transaction closed on December 31st of the current year
  - Bank A incurred the following professional fees:
    - $125,000 of legal fees related to due diligence services performed before October 1st

CASE 19 - Capitalization of Intangible Costs

- Bank A incurred the following professional fees CONTINUED:
  - $85,000 of legal fees related to drafting the merger agreement; services performed before October 1st
  - $140,000 of legal fees related to various due diligence services and closing matters performed on or after October 1st

CASE 19 - Capitalization of Intangible Costs

- Bank A incurred the following professional fees CONTINUED
  - $1,000,000 of investment banker advisory fees paid upon closing of the acquisition and calculated as a percentage of the consideration paid by Bank A; assume the safe harbor provided in Rev. Proc. 2011-29 is timely elected
- What amount of bank A's professional fees are deductible in the current year?

Hedging Transactions

Hedging Transactions

<u>Definition</u>

- A transaction entered into in the normal course of a trade or business primarily to:
  - 1) Reduce risk of price changes or currency fluctuations with respect to ordinary property (e.g., loans); OR
  - 2) Reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or ordinary obligations incurred (e.g., CD’s)

Hedging Transactions

<u>Authority</u>

- Reg. §1.1221-2 determines character and provides identification rules
- Reg. §1.446-4 determines timing and accounting method
  - Trumps Reg. §1.446-3 and any other rules that are inconsistent with the rules of this section

Hedging Transactions

Character

- If a transaction meets the §1.1221-2 definition of a hedge, the hedge position is not a capital asset
- Proper identification is required to qualify as a hedging transaction
- Transactions that are not entered into for the purpose of reducing risk (i.e., investments) are not hedging transactions, even if they have the effect of reducing risk

Hedging Transactions

<u>Examples</u>

- Interest rate swaps
- Interest rate caps
- Interest rate floors

Hedging Transactions

<u>Identification</u>

- A hedging transaction must be so identified on the same day it is entered into
- The item hedged must be identified within 35 days of acquiring the hedge position – This involves both identifying a transaction that creates risk and the type of risk created
  - This will typically be described in GAAP hedge accounting statement
  - Problem – What if no hedge designation for GAAP?
- The required identification must be unambiguous and must be made, and retained as part of, the books and records

Hedging Transactions

Identification (cont.)

- A tax policy may state that hedge identification for GAAP or regulatory purposes are also identifications for tax purposes
- A taxpayer may separately and explicitly identify each hedge transaction, or may establish a system identifying the hedge transaction by the type of transaction, or by how the transaction is completed or recorded
- Documentation has to say it’s a “hedge” for tax purposes
  - May be “no hedge” designation (i.e., freestanding) for GAAP

Hedging Transactions

Effect of Non-Identification

- A hedge identification is binding with respect to gain and ordinary income results – If the transaction is misidentified and is not in fact a hedging transaction, loss will generally be capital
- Absence of identification establishes that the transaction is not a hedge – Both gain and loss are capital
  - Only relevant if there are termination gains/losses or other settlement payments
- There is an anti-abuse rule to prevent manipulation of the character of gain or loss by failure to identify

Hedging Transactions

<u>Timing</u>

- Reg. §1.446-4 applies to hedging transactions as defined in Reg. §1.1221-2
- Purpose is to clearly reflect income by reasonably matching the timing of the income, deduction, gain or loss from a hedging transaction with the timing of income, deduction, gain or loss from the hedged item
- Does not apply to hedges of securities which are marked to market under Code §475

Hedging Transactions

Accounting Method

- No specific accounting method is prescribed
- GAAP accounting for hedges is considered to clearly reflect income in most cases
- Different accounting methods for different types of hedges or different types of hedged items are permissible
- A method of accounting, once adopted, must be applied consistently and may only be changed with the consent of the IRS

Hedging Transactions

Types of Payments

- Periodic
- Non-periodic
- Change in fair value*
- Termination

* Note – Change in fair value is a GAAP concept; it is not a “payment” and is not specifically addressed in Reg. §1.446-4

Hedging Transactions

<u>Periodic Payments</u>

- Payments made/received pursuant to derivative contract
- Tax treatment – Through income statement on constant yield basis over life of derivative [Reg. §1.446-3(e)]
- Book treatment – Through interest income/expense accounts, as accrued per contract terms over life of derivative
- For practical purposes, Tax COULD equal Book (difference may not be material)
  - Same treatment for CF and FV hedges, as well as freestanding

Hedging Transactions

<u>Non-Periodic Payments</u>

- Upfront premium paid on the derivative
  - Generally only applies to caps and floors
- Tax treatment – Through income statement on constant yield basis over life of derivative [Reg. §1.446-3(f)]
- Book treatment – Through interest income/expense accounts, based on value of "caplets" over life of derivative
  - Caps and floors generally not treated as FV hedges for GAAP
- If difference between tax and book treatment not material, then no "M" adjustment

Hedging Transactions

<u>Change in Fair Value</u>

- Tax treatment
  - Neither hedge nor hedged item should be fair-valued or marked-to-market
  - Since effectiveness is net result of FV changes, it should not be in taxable income
- Book treatment
  - Treatment differs depending on type of hedge designation (i.e., cash flow, fair value, or freestanding)
- Need for “M” adjustment will depend on tax accounting method being applied

Hedging Transactions

Change in FV – Cash Flow Hedge

- Book treatment
  - Change in FV of derivative runs through Accumulated Other Comprehensive Income on Balance Sheet
  - "Ineffectiveness" of the hedge recorded on Income Statement gain/loss account – Over life of derivative, ineffectiveness will net to zero if held to maturity
- "M" adjustment
  - Ineffectiveness should probably be an "M" adjustment, but may be difficult to track
  - May be reasonable for Tax = Book, if consistently applied and clear reflection of income under Reg. §1.446-4
  - See below for terminations

Hedging Transactions

<u>Change in FV – Fair Value Hedge</u>

- Book treatment
  - Change in FV of both derivative and hedged item recorded on Income Statement gain/loss account – Amounts that don't offset is the "ineffective" portion
  - Over life of derivative, ineffectiveness will net to zero <u>if held to maturity</u>
- "M" adjustment
  - Net of FV marks (i.e., ineffectiveness) should probably be an "M" adjustment, but may be difficult to track
  - May be reasonable for Tax = Book, if consistently applied and clear reflection of income under Reg. §1.446-4
  - See below for terminations

Hedging Transactions

<u>Change in FV – Freestanding Hedge</u>

- Book treatment
  - Change in FV of derivative recorded on Income Statement gain/loss account
  - There is no hedged item for GAAP purposes
- “M” adjustment
  - Tax ≠ Book
  - “M” adjustment required
  - Need to determine how to identify and track

Hedging Transactions

Termination Payments

- Tax treatment
  - Payment/gain/loss on termination is spread over remaining original term of derivative contract, but not to exceed life of hedged item (if/when hedged item also terminated)
  - See Revenue Ruling 2002-71
- Book treatment
  - Treatment differs depending on type of hedge designation (i.e., cash flow, fair value, or freestanding)
- Need for “M” adjustment will depend on tax accounting method being applied

Hedging Transactions

Termination – Cash Flow Hedge

- Book treatment
  - AOCI balance is updated to termination date FV
  - Balance amortized to Income Statement gain/loss account over remaining original term of derivative contract, but not to exceed life of hedged item
  - Write-off remaining Balance Sheet amounts if hedged item disposed
- “M” adjustment
  - Tax = Book (probably)
  - If ineffectiveness was an “M” adjustment (see Change in FV above), then need to reverse deferred balance

Hedging Transactions

<u>Termination – Fair Value Hedge</u>

- Book treatment
  - Derivative and hedged item are brought to FV on Balance Sheet at termination date
  - Derivative balance is settled with cash
  - Basis adjustment of the hedged item is amortized to Income Statement over remaining life of hedged item consistent with the type of hedged item (e.g., interest yield adjustment)
- “M” adjustment
  - Clear difference between tax and book treatment
  - May be reasonable for Tax = Book, if consistently applied and clear reflection of income under Reg. §1.446-4
  - If ineffectiveness was an “M” adjustment (see Change in FV above), then need to reverse deferred balance

Hedging Transactions

Termination – Freestanding Hedge

- Book treatment
  - All Balance Sheet items at termination date are written off to Income Statement gain/loss account
  - No subsequent Balance Sheet or Income Statement activity
- “M” adjustment
  - Tax ≠ Book
  - “M” adjustment required
  - Need to determine how to identify and track

Hedging Transactions

Application of IRC §475 – Mark-to-Market

- Hedging transactions are generally excepted from the mark-to-market rules
- In order for the exception to apply, the hedge contract must relate to a security that is not subject to the mark-to-market rules
- In other words, the hedged security must be:
  - 1) A security held for investment; OR
  - 2) An evidence of indebtedness, but only if the indebtedness is not held for sale to customers

Hedging Transactions

Application of IRC §475 – Mark-to-Market (cont.)

- The exception from the mark-to-market rules does not apply to hedge contracts if the taxpayer is a dealer in such contracts
- A taxpayer is a dealer in such contracts if the taxpayer, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a hedging transaction

Hedging Transactions

Examples

- Rate-lock real estate mortgage loan commitments
- Mandatory commitments to sell real estate mortgages

Hedging Transactions

<u>Change in Fair Value</u>

- Tax treatment
  - Change in fair value of derivative is recorded as taxable gain/loss
  - Gain/loss is ordinary, not capital
- Book treatment
  - FAS 159 fair value option – Gain/loss recorded on I/S
  - Lower of Cost or Market (LOCOM) – No gain, but could have loss recorded on I/S
- “M” adjustment
  - Depends on book treatment – FAS 159 or LOCOM
  - For example, if FAS 159 with book gain, then no “M” adjustment

Phase-out of Deduction For FDIC Premiums

FDIC Premium Deduction Phase-Out – IRC §162(r)

- Phased out for banks >$10 billion in total assets
- Lost deduction formula:

$$\frac{\text{Total consolidated assets at year end} > \$10\text{ billion}}{\$40\text{ billion}} \times \text{FDIC premiums otherwise deductible for the year}$$

- Deduction is entirely lost when year-end consolidated total assets equals or exceeds $50 billion

FDIC Premium Deduction Phase-Out – IRC §162(r)

- Consolidated total assets includes chains of corporations connected through >50% common ownership
  - Includes foreign corporations and insurance companies
  - Excludes REITs and RICs
- The definition of total assets draws from the definition of such term in the Dodd-Frank Act
- FICO assessments appear to fall outside the scope of the deduction limitation
- The disallowed deduction is a permanent difference that will need to be considered in the effective tax rate determination

Questions?