TAXATION OF COMMERCIAL BANKS AND THRIFT INSTITUTIONS
I. General Considerations

A. Economic Functions of Banks
   1. Intermediation between liquid deposits and illiquid investments.
   2. Pooling of investments and investment diversity.

B. Types of Bank Organizations
   1. Permanent Stock Form
      a. Have both depositors and stockholders.
      b. Upon liquidation, depositors are paid first (as creditors), then stockholders.
   2. Mutual Form
      a. Depositors are “members,” and deposits are “savings capital.”
      b. Depositors cast one vote per $X of deposits, up to a maximum number of votes. Borrowers may, at some mutuals, be entitled to cast one vote per loan.
      c. Upon liquidation, members are entitled to liquidation proceeds.

II. General Classifications Of Banks

A. Commercial Banks
   2. Includes Federal Reserve banks, national banks, and state bank and trust companies.
   3. National banks are regulated by the Comptroller of the Currency and are members of the Federal Reserve System. State-chartered banks may be members of the Federal Reserve and are regulated by the FDIC if they have FDIC insurance.
   4. Deposits are insured by the bank insurance fund (BIF) of the FDIC.

B. Thrift Institutions
   1. Savings and Loan Associations (S&Ls)
      a. Incorporated under state or federal law.
b. S&L associations may be in either stock or mutual form.

c. Federal S&Ls are regulated by the Office of Thrift Supervision (OTS).

d. Deposits are insured by the Savings Association Insurance Fund (SAIF) of the Federal Deposit Insurance Corporation (FDIC).

2. Mutual Savings Banks -- Located in New England states, these are state-chartered “cooperative banks” (i.e., non-profit mutual banks).

C. Credit Unions

Federal credit unions may be exempt under section 501(c)(1). Mutual credit unions may be exempt under section 501(c)(14).

III. Definitions

A. Definition of a “Bank”

1. Code section 581 definition

   a. A “bank or trust company.”

   b. Incorporated and doing business under federal or state law. Treasury Regulation § 1.581-1 requires that a bank be a corporation for federal income tax purposes.

   c. A “substantial part” of the business of which consists of:

      (1) Receiving deposits, and making loans and discounts;

      (2) Or, exercising certain fiduciary powers.

   d. Subject by law to supervision and examination (federal or state).

2. “Receiving Deposits”


   c. Austin State Bank v. Comm’r, 57 T.C 180 (1973) (bank received no more than 35% of its deposits from related sources and the court held that it was a bank under section 581).
3. “Making Loans and Discounts”


4. “Subject by Law to Supervision”


5. The definition of “banks” includes thrift institutions. Section 581.

B. Definitions of Thrift Institutions

1. Definition of a “S&L Association”
   
a. Code section 7701(a)(19) provides three tests that must be satisfied. See Treas. Reg. § 301.7701-13A.

   (1) The Supervisory Test: The association must be either (i) a federally insured institution or (ii) subject to federal or state supervision and examination.

   (2) The Business Operations Test: The association must principally acquire the savings of the public and invest in loans. See Treas. Reg. § 301.7701-13A(c).

   (a) The “savings” test is met if savings are acquired in accordance with regulations. Alternatively, more than 75% of deposits must be made by the general public, and not more than 25% of debt must consist of notes and bonds (rather than deposits).

   (b) The “investing” test is met if more than 75% of gross income consists of interest on loans, etc.

   (3) The Assets Test: At least 60 percent of assets must be “qualifying” assets, such as cash, government obligations, and specific types of loans (generally, real property residential mortgage loans).

b. The purpose of the definition is to include only associations that primarily make real property mortgage loans.

(domestic building and loan associations that obtained bank charters prior to their acquisition held no longer entitled to use the reserve method of accounting for bad debts under section 593).

2. Definition of a “Mutual Savings Bank”

Code section 591(b) defines a mutual savings bank as a bank that issues capital stock and that is regulated under laws applicable to mutual savings banks.

C. Banks and thrifts are excluded from the definition of “personal holding company.” Section 542(c)(2).

IV. Taxation of Banks

A. Introduction -- In general, banks are taxed under generally applicable rules, similarly to other corporations.

1. Accounting Rules Applicable to all Corporations

   a. Section 446(a) provides that taxable income should be computed under the “method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books” unless the method “does not clearly reflect income.” In any such case, taxable income is computed under “such method as, in the opinion of the Secretary, does clearly reflect income.”

   b. The two major accounting methods are the cash method and the accrual method. Very few corporate taxpayers are permitted to use the cash method (a C corporation that has at least $5 million in annual gross receipts is prohibited from using the cash method of accounting). Section 448. Accordingly, this outline focuses on the accrual method.

   c. Income -- Generally, under an accrual method, income is included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (i.e., the “all events test”).

      (1) The all events test is modified with respect to debts that are subject to risks of uncollectibility.

      (2) When a debtor becomes insolvent with the result that interest on the debt isn’t collectible, interest must be accrued to the date of insolvency but not thereafter. This is true even though interest accrued during the same taxable year but before the date of insolvency is uncollectible.
Rev. Rul. 80-361. Whether a debt is uncollectible is an area of dispute.

d. Deduction -- A liability is incurred, and generally taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Treas. Reg. § 1.446-1(c)(1)(ii)(A).

B. While banks are generally taxed as other corporations, Code sections 581 to 597 contain several special provisions that are specifically applicable to banks. Below, the following special provisions are discussed: bad debt deductions for losses on loans and special gain and loss provisions (includes worthless securities, worthless stock, and sales and exchanges of indebtedness).

C. Bad Debt Deductions for Losses on Loans

1. In general, the usual section 166 rules govern the bad debt deduction. Section 166 provides a deduction for any debt which becomes worthless within the taxable year. Whether a debt is worthless in whole or in part is a question of fact that must be determined from all the evidence, including the value of any collateral and the financial condition of the debtor. Treas. Reg §1.166-2(a).

2. However, there are special rules for banks with respect to bad debt deductions.

3. Current rules --

a. Small banks may (1) take a bad debt deduction by using the specific charge-off method, or (2) take a deduction under section 585 for a reasonable addition to a reserve for bad debts (the reserve method), computed using the experience method.

b. Large banks must use the specific charge-off method and do not have the option of using the reserve method.

4. The changing statutory scheme

a. Banks have always had the option of using the specific charge-off method for bad debts in respect of loans.

b. From 1986 to 1987, all banks could elect to use the reserve method for bad debts in respect of loans. After 1987, “large banks” were no longer permitted to use the reserve method; only small banks can use the reserve method.
c. Under the reserve method, banks could use either the “percentage of loans” method or the “experience” method.

(1) The percentage of loans method was phased out over the 18-year period from 1969 to 1987.

(2) After 1987, under the reserve method, banks could use only the experience method.

5. The specific charge-off method

a. Specific loans must be:

(1) Determined to be worthless - Treas. Reg. § 1.166-2, and then

(2) Charged off - Treas. Reg. § 1.166-3(a)(2).

b. Two unique timing rules are available:

(1) Treas. Reg. § 1.166-2(d)(1) provides that if a bank is required to charge off a loan, or if a bank charges off a loan and that action is confirmed on examination or audit, then worthlessness is conclusively presumed to have existed. See Rev. Rul. 81-18, 1981-1 C.B. 295, and Rev. Rul. 92-14, 1992-1 C.B. 93.

(2) Treas. Reg. § 1.166-2(d)(3) provides a “conformity election,” pursuant to which the treatment of bad loans on the bank’s regulatory books conclusively determines the treatment of bad loans for tax purposes. See Rev. Proc. 92-84, 1992-2 C.B. 489, regarding making this election. See also, Rev. Rul. 2001-59, 2001-51 I.R.B. 1, where the IRS concluded that a bank that elected this method of accounting for bad debts fell within the conformity rule despite having erroneously charged off certain credit card debts, because the bank’s deduction for worthless debts was not “substantially in excess of the amount warranted by reasonable business judgment under applicable regulatory standards.”

6. The reserve methods available to banks

a. Under the reserve method, a deduction is allowed for reasonable additions to a reserve for bad debts. Specific bad debts are not deducted, but are charged to the reserve.
Section 585 formerly provided two methods to determine the amount of the reserve addition under the reserve method: the percentage of loans method and the experience method.

(a) As of 1986, a bank could use either method for any year. The maximum reserve addition was the greater of the amounts computed under the two methods. Section 585(b)(1). Treas. Reg. §1.585-2(a)(1).

(b) However, after 1987 “large banks” are no longer permitted to use the reserve method and “small banks” may only use the experience method (banks may no longer use the percentage method).

b. The reserve methods can be used only for losses on “loans.” In general, the term “loan” means debt as the term “debt” is used in section 166 and the regulations thereunder. Treas. Reg. § 1.585-2(e)(2). See LTR 8928002 (Mar. 22, 1989) and LTR 9423002 (Jan. 25, 1994) (interests in mortgage pools constitute “loans”).

(1) REMIC regular interests are “loans.”

(2) A bank that holds only servicing rights to mortgage loans owned by others may not include the loans in its balance of loans outstanding. LTR 200439041 (June 16, 2004).

c. The allowable deduction under the reserve method is the amount necessary to increase the opening bad debt reserve (reduced by specific bad debts charged off during the year) to the maximum allowable ending bad debt reserve for the year.

7. The Percentage of Loans Method

a. In general, and subject to exceptions, the reserve addition was the amount that increased the bad debt reserve to the “allowable percentage” of “eligible loans.”

b. The allowable percentage was set by statute, and was phased out over a transition period:

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969-1976</td>
<td>1.8 percent</td>
</tr>
<tr>
<td>1976-1981</td>
<td>1.2 percent</td>
</tr>
<tr>
<td>1982</td>
<td>1.0 percent</td>
</tr>
<tr>
<td>1983-1987</td>
<td>0.6 percent</td>
</tr>
</tbody>
</table>
c. “Eligible loans” were a certain type of “loans,” as defined in section 585(b)(4). See Treas. Reg. § 1.585-2(e)(3).

d. In 1987 and subsequent years, the percentage method is no longer available.

8. The Experience Method

a. Prior to 1987, banks could elect to use the experience method. In 1987 and subsequent years, it is the only reserve method that is allowed (except for “large” banks). Section 585(b)(1).

b. The maximum reserve addition is the amount necessary to increase the reserve to the greater of (1) the “six-year moving average amount” or (2) the “base year amount.”

c. The six-year moving average amount is the amount which bears the same ratio to current loans outstanding as (1) the total of (net) bad debts sustained for the current year and the preceding five years, bears to (2) the sum of the loans outstanding at the close of those same six years.

d. A period of less than six years may be used if there is a change in the type of loans outstanding such that the risk of loss on the loan portfolio is substantially increased. Treas. Reg. § 1.585-2(c)(1)(ii). See LTR 8425059 (Mar. 20, 1984), 8544030 (July 31, 1985), and LTR 8929061 (Apr. 26, 1989).

e. The base year amount is the lesser of (1) the reserve balance as of the close of the base year, and (2) if loans outstanding have decreased, the base year reserve balance proportionately reduced.

f. The base year is the year before the most recent election of the experience method. For years after 1987, the base year is 1987.

g. See Examples #1 and #2.

9. Changes in reserve method

a. Prior to 1988, a bank could change back and forth between the percentage method and the experience method of determining the amount of the reserve addition. After 1987, however, the percentage of loans method is no longer available.

b. A bank must elect to use either the specific charge-off method or the reserve method. A change from one to the other is a change in method of accounting, and requires the consent of the Commissioner. See Treas. Reg. § 1.585-2(d); Rev. Proc. 2002-9.
10. Elimination of reserve method for “large” commercial banks

a. For taxable years after 1986, “large banks” are no longer allowed to use the reserve method for bad debts. They instead must use the specific charge-off method. Section 585(c). See Treas. Reg. §1.585-5 through -8.

b. Definition of a “large bank”

(1) A “large bank” is a bank with assets the aggregate adjusted basis of which exceed $500 million. See Section 585(c)(2)(A); Treas. Reg. § 1.585-5(b).

(2) Assets of banks in a parent-subsidiary controlled group are aggregated for purposes of this test.

(3) Once a bank becomes a “large bank,” it remains a large bank, even if its assets decrease to less than $500 million. Treas. Reg. § 1.585-5(b)(3), Example (2).

c. In 1987, or in any subsequent year in which a bank becomes a “large bank,” existing bad debt reserves must be either (1) “recaptured” or (ii) “run off.”

d. Recapture of bad debt reserves

(1) In the year in which a bank becomes a “large bank,” a change in method of accounting occurs, and the bank thereafter uses the specific charge-off method. See Treas. Reg. § 1.585-6.

(2) The balance of the bad debt reserve as of the close of the preceding year is brought into income over a four-year spread period:

   Year 1 - 10 percent  
   Year 2 - 20 percent  
   Year 3 - 30 percent  
   Year 4 - 40 percent  

   (Year 1 is the year of change.)

(3) The bank may elect to include a larger portion in income in Year 1. If so, the remaining amount is included in income over the next three years to the extent of 2/9, 1/3, and 4/9 of the remaining amount, respectively.
There will be no recapture for any year in which a bank is “financially troubled,” i.e., if the amount of its nonperforming loans exceeds 75 percent of its equity capital (assets less liabilities). Recapture is merely suspended, and restarts when the bank is no longer troubled.

e. In lieu of recapturing its reserves, a large bank may elect to “cut off” use of the reserve method for new loans, and “run off” its existing reserves for old loans.

(1) Under this alternative, there is no change in method of accounting for the “pre-disqualification loans” and the bank continues to hold its bad debt reserve with respect to those loans. See Treas. Reg. § 1.585-7.

(2) Because the reserve covers only existing loans (loans held by the bank as of the first day that it becomes a large bank), only losses on those loans are charged against the reserve, and only recoveries on those loans are credited to the reserve, without being items of expense or income.

(3) Once the reserve balance reaches zero, further charge-offs with respect those loans may be charged off under the specific method.

(4) New loans are accounted for under the specific charge-off method.

f. See Example #3.

D. Special Gain and Loss Provisions

1. Worthless Securities

a. Generally applicable rules to corporations:

(1) Bad debts typically are deductible under section 166.

(2) A special rule applies to “securities.” Section 165(g)(1) provides that when a “security” which is a capital asset becomes worthless, the loss is deemed to result from a sale or exchange of the asset. See sections 165(f) and 1211 (limiting capital losses to the extent of gains).

(3) Definition of “security”

§165(g)(2)(A) - stock
§ 165(g)(2)(B) - warrants, etc.
§165(g)(2)(C) - debt issued by a corporation or government, with interest coupons, or in registered form.

(4) As a corollary, section 166(e) provides that section 166 (Bad Debts) does not apply to section 165(g)(2)(C) debt “securities.” [Note, section 165(g)(2)(A) and (B) debt “securities” do not fall within the definition of a debt under section 166. See Treas. Reg. § 1.166-1(c).]

b. Special rule for banks -- A special rule applies to banks for losses upon worthlessness of section 165(g)(2)(C) debt “securities”:

Section 582(a) provides that losses on worthlessness of section 165(g)(2)(C) debt “securities” are deductible by banks under section 166 as bad debts.

c. In general, the usual section 166 rules govern the bad debt deduction.

d. The reserve method for bad debts (former section 166(c)) was repealed by the 1986 Act. (The section 585 reserve provisions do not apply to “security” debt. See Treas. Reg. § 1.585-2(e)(2)(ii); LTR 7921016 (Feb. 12, 1979).)

e. As a result, the specific charge-off method of section 166(a) applies. However, as discussed above, two unique timing rules are available.

(1) Treas. Reg. § 1.166-2(d)(1) provides that debts will be conclusively presumed to be worthless if ordered to be charged off by examining authorities, or if charged off in accordance with established policies and confirmed on subsequent audit or examination. Rev. Rul. 81-18, 1981-1 C.B. 295, and Rev. Rul. 92-14, 1992-1 C.B. 93, illustrate the operation of the conclusive presumption.


2. Worthless Stock

a. Generally applicable rules:
(1) Section 165(g)(1) states the general rule: when a “security” which is a capital asset becomes worthless, the loss is deemed to result from a sale or exchange of the asset.

(2) For ordinary corporations, section 165(g)(3) provides an exception for 80-percent owned domestic corporations, 90 percent of the income of which is from an active trade or business.

b. A special rule applies to losses upon worthlessness of affiliated bank stock:

Section 582(b) provides that if a bank holds at least 80 percent of stock in another bank, that stock will not be treated as a capital asset.

c. As to other stock held for investment purposes, under section 165(g)(1) the loss upon worthlessness is capital.

d. Treas. Reg. § 1.165-4 provides that if a bank is required to charge off stock, that action will be considered prima facie evidence of worthlessness.

3. Sales and Exchanges of Indebtedness

a. Generally applicable rule:

(1) A “sale or exchange” of a “capital asset” results in capital gain or loss. Sections 1001 and 1221.


b. A special rule applies to banks:

(1) Section 582(c) provides that sales or exchanges of indebtedness shall not be considered sales or exchanges of capital assets. Thus, ordinary income and losses result from such sales and exchanges.

(2) Regular and residual interests in REMICs and regular interests in FASITs constitute “indebtedness” for purposes of section 582.

(3) Community Trust Bancorp v. U.S., 1999-2 USTC ¶ 50,698 - Section 582(c) does not apply to a bank’s mutual fund losses where the mutual fund invests in debt securities.
c. Prior law rule, for pre-1969 indebtedness:

(1) Under prior law, sales and exchanges of indebtedness were accorded capital gain, ordinary loss treatment.

(2) This special treatment was repealed by the 1969 Tax Reform Act.

(3) A transitional rule providing grandfather relief, section 582(c)(2) to (4), was repealed by the 1990 Act.

V. Taxation of Thrift Institutions

A. Reserves for Losses on Loans

1. Thrifts are generally taxed in the same manner as commercial banks.

a. Thrifts can use the specific charge-off method, which is the same as that used by commercial banks.

b. Thrifts can use the reserve method.

(1) If a thrift is treated as a “large bank,” it must use the specific charge-off method.

(2) Otherwise, the thrift can use the section 585 experience method (or the specific charge-off method).

(3) If a thrift becomes a “large bank,” see IV.C.10, V.A.3, and Example #4.

(4) If a thrift becomes a “small bank,” see Example #5.

2. Historical Background


(1) Under section 593(c), a thrift had three reserves:

(a) The reserve for losses on “qualifying real property loans” (the “Q” reserve),

i) Qualifying real property loans are loans secured by an interest in improved real property or by an interest in real property which is to be improved out of the proceeds of the loan. Section 593(d)(1); Treas. Reg. § 1.593-11.
ii) Interests in certain REMICs can be qualifying real property loans. Section 593(d)(4).

iii) The Q reserve is computed using the percentage of taxable income method, or experience method.

(b) The reserve for losses on nonqualifying loans (consisting of all loans that are not qualifying real property loans) (the “non-Q” reserve),

i) The Non-Q reserve addition must be separately computed under the experience method. Section 593(b)(1)(A).

(c) The supplemental reserve (in general, no deduction is allowed for additions to this reserve).

(2) Losses on the various types of loans must be charged against the appropriate reserve. Recoveries on loans charged off as bad debts are credited to the appropriate reserve.

b. In the 1996 Small Business Act, section 593 was repealed, effective for years after 1995.

(1) Thus, the percentage of taxable income method, formerly allowed to thrifts, is not available after 1995. Section 593(f).

(2) Congress believed that use of the former method mismeasured economic income (by allowing deductions too soon), and provided thrifts with too great a benefit relative to banks.

(3) Beginning in 1996, thrifts are required to use a new method to determine their bad debt deductions.

(a) If the thrift is treated as a “large bank,” it must begin to use the specific charge-off method.

(b) Otherwise, the thrift can utilize the section 585 experience method (or the specific charge-off method).

(4) This change in treatment is treated as a change in method of accounting. Section 593(g)(1).
Ordinarily, the entire amount of the year-end 1995 bad debt reserve would have to be taken into account under the section 481 change in accounting method rules. However, special rules provide for some relief. Section 593(g).

(a) Until 1988, under financial accounting standards, deferred tax liabilities were not required for deductions attributable to the bad debt reserve method for thrifts. This treatment changed in 1988.

(b) If thrifts were required to “recapture” pre-1988 bad debt reserves, adverse financial accounting treatment would result. (This problem is not present for post-1987 reserve additions.)

(c) For this reason, Congress provided a partial “fresh start” with respect to pre-1988 bad debt reserve additions.

(d) The portion of the bad debt reserve not granted a “fresh start” (the portion attributable to post-1987 reserve additions) must be brought into income ratably over 6 years. Section 593(g)(1)(C).

3. Rules applicable to a thrift that is treated as a “large bank” and begins to use the specific charge-off method.

a. The full amount of the otherwise required section 481 adjustment (i.e., the amount of the year-end 1995 bad debt reserves) is not taken into account, but only the amount attributable to “applicable excess reserves.”

b. “Applicable excess reserves” are the portion of the bad debt reserves attributable to post-1987 years, as follows (Section-593(g)(2)(A)):

   (1) The balance of the Q and the non-Q reserves as of year-end 1995 are reduced by,

   (2) The balance of the Q and the non-Q reserves as of year-end 1987 (the “pre-1988 reserves”).

c. The applicable excess reserves must be brought into income ratably over a six-year period beginning with 1996.

d. Three special rules may apply to modify this treatment.
1. In computing applicable excess reserves, the balance of pre-1988 reserves is proportionally reduced if the balance of loans outstanding as of 1995 is less than the balance as of 1988. Section 593(g)(2)(A)(ii)(I).

2. The timing of the recapture of the applicable excess reserves is delayed for a 1- or 2-year period if the thrift meets the “residential loan requirement.” Section 593(g)(4).

   a. The requirement is met if the thrift continues to make residential mortgage loans in an annual amount at least equal to the average annual amount of such loans made during the period 1990-1995.

   b. Recapture can be delayed only for either 1996 and 1997.

   c. If, during any year after 1995, the thrift ceases to be treated as a “bank,” the pre-1988 reserves (and the supplemental reserve) must be brought into income over a 6-year period. Section 593(g)(3).

4. Rules applicable to a thrift that is not treated as a “large bank” and begins to use the experience method.

   a. An opening 1996 reserve is established under the experience method, and the amount of the otherwise required section 481 adjustment is limited to the “applicable excess reserves.” Section 593(g)(2)(B).

   b. “Applicable excess reserves” are the portion of the bad debt reserves attributable to post-1987 years, but excluding any portion of reserves included in opening reserves for 1996, as follows (Section 593(g)(2)(B)(i)):

      1. The balance of the Q and the non-Q reserves as of year-end 1995 are reduced by,

         a. The greater of:

            i) balance of the Q and the non-Q reserves as of year-end 1987 (the “pre-1988 reserves”), and

            ii) the opening 1996 bad debt reserves under the experience method.
(2) The applicable excess reserves must be brought into income ratably over a six-year period beginning with 1996.

(a) The amount of the opening 1996 reserve actually used under the experience method for 1996 is the “greater of” amount set forth in the second preceding paragraph. Section 593(g)(2)(B)(ii).

(3) The three special rules discussed above may apply to modify the required recapture treatment.

(4) If the thrift subsequently becomes a “large bank,” the “pre-1988” reserves continue to receive the “fresh start” and are not recaptured. Section 593(g)(5).

B. Deduction for Dividends on Deposits

1. Section 591(a) allows mutual thrift institutions to deduct dividends or interest credited to depositors’ accounts.


3. Interest is deductible in the year in which it may be withdrawn on demand subject only to customary notice of intention to withdraw.

4. Note: The depositor treats such amounts as interest, not as dividends.

5. Stock associations are not allowed to deduct dividends paid or credited with respect to their stock.

6. Deductions not covered by section 591 (a) are subject to section 593(e). This provision prevents the thrift’s shareholders from benefiting from the section 593 reserve method.

   a. In general, distributions to shareholders are treated as first out of earnings and profits and second out of the reserve for losses on qualifying real property loans. In both cases, the distributions constitute ordinary income to shareholders.

   b. In years after 1995, after the repeal of the section 593 bad debt reserve method, distributions to shareholders are treated as first out of earnings and profits and second out of “pre-1988” reserves. In both cases, the distributions constitute ordinary income to shareholders. Thus, in this shareholder context, there is no “fresh start” for pre-1988 reserves. Section 593(e).
VI. **Proration Rules Applicable to Banks and Thrifts**

A. Interest on bank deposits is deductible under section 163.

B. Section 265(a)(2) provides that interest on indebtedness incurred to purchase or carry tax-exempt obligations is nondeductible. Generally, this calls for a factual inquiry to determine the taxpayer’s intent.

C. Nevertheless, banks historically were permitted to invest deposited funds in tax-exempt obligations and deduct in full the interest paid to depositors. See, e.g., Rev. Proc. 70-20, 1970-2 C.B. 499.

D. However, over time, Congress has reduced the amount of the deduction. Applying the rules in sections 291 and 265 (both described in detail below) concurrently:

1. Bonds acquired before 1983 are not subject to proration.
2. Bonds acquired from 1983 to August 1986 are subject to 20% proration per section 291.
3. Bonds acquired post August 1986 are subject to 100% proration per section 265.

E. **Proration Under Section 291**

1. Section 291, enacted in TEFRA, reduced the amount of the deduction allowable with respect to “financial institution preference items” by 15 percent. The percentage was subsequently increased to 20 percent.
2. Financial institution preference items include:

   Tax-exempt related interest - Section 291(e)(1)(B) provides that interest that is incurred to purchase or carry tax-exempt obligations acquired after 1982 but before August 1986 is a tax preference item. (Note allocation rule-see below.)
4. With respect to such tax-exempt obligations, the amount of the deduction for interest on funds “allocable to” those obligations is reduced by 20-percent. Section 291(a)(3) and (e).
5. Interest “allocable to” such tax-exempt obligations is determined as follows (section 291(e)(1)(B)(ii)):
interest allocable to tax-exempt obligations = adjusted basis of such tax-exempt obligations

interest allocable to total interest deduction = adjusted basis of all assets


F. Proration Under Section 265(b)

1. In the 1986 Act, the former 20-percent disallowance rule was replaced with a 100-percent disallowance rule.


3. This rule applies in concert with (and following the application of) the usual section 265(a)(2) disallowance rule. Section 265(b)(6)(A).

4. Interest allocable to such tax-exempt obligations is determined as follows (section 265(b)(2)):

\[
\frac{\text{interest allocable to tax-exempt obligations}}{\text{total interest deduction}} = \frac{\text{adjusted basis of such tax-exempt obligations}}{\text{adjusted basis of all assets}}
\]
5. Certain “qualified tax-exempt obligations” (“QTOs”) are excepted from the total disallowance rule of section 265(b)(1).
   a. These are certain obligations designated as qualifying under section 265(b)(3) by qualified small issuers.
   b. These obligations, instead, are subject to the section 291 20-percent disallowance rule.

6. See Example #7.

7. Transitional rules
   a. The 100-percent disallowance rule applies to obligations acquired after August 7, 1986, in years after 1986. Thus, for example, an obligation acquired on August 15, 1986 is subject to the 20-percent disallowance rule for 1986, and the 100-percent disallowance rule for years after 1986.
   b. There is an exception for certain acquisitions pursuant to written commitments to purchase tax-exempt obligations.
   c. Note that in certain instances status as an obligation eligible for the 20-percent disallowance rule can be lost, and replaced by status as a obligation subject to the 100 percent disallowance rule. Rev. Rul. 90-44, 1990-1 C.B. 54.
   d. See Example #8.

VII. Foreclosure on Property Securing Loans
    A. Ordinarily, foreclosure on a loan is a taxable event: foreclosure constitutes the closing of the loan transaction and the beginning of a new investment in the acquired property.
    B. The taxable event has two components (see Treas. Reg. § 1.166-6).
       1. First, a bad debt is sustained, equal to the amount of the debt less the foreclosure sale (bid) price. An accrual basis bank that has reported accrued unpaid interest adds that accrued interest to the amount of the debt.
       2. Second, a gain or loss is realized, equal to the amount of the mortgage debt applied to the bid price less the fair market value of the property acquired. Again, the amount of the debt may include accrued interest.
3. Depending on the bid price and the fair market value of the property, the tax consequences of this second component will vary. Community Bank v. Comm’r, 819 F.2d 940 (9th Cir. 1987).

4. See Example #9.

C. Formerly, section 595 provided a special rule applicable to thrift institutions.

1. Section 595 provided that for thrifts foreclosure is not a taxable event. Rather, the mortgage loan investment is carried forward in the property investment.

2. Thus, upon foreclosure, no bad debt deduction is allowed, and no gain or loss is recognized. Section 595(a). This rule was mandatory, not elective.

3. The acquired property has the same character as the debt. Thereafter, the thrift is treated as if it still had the debt. Section 595(b). The thrift’s basis in the indebtedness is carried over as the basis of the property. Section-595(c).


5. Section 595 was repealed by the 1996 Small Business Act for property acquired in years beginning after 1995.

VIII. Combined Thrift-Life Insurance Business

A. Mutual savings banks that operate a life insurance business in a department separate from their banking business pay a combined tax composed of two partial taxes. Section 594.

B. The first partial tax is computed by reference to only the banking part of the thrift.

C. The second partial tax is computed under Subchapter L by reference to the life insurance department.

IX. Taxation of Depositors

A. Interest paid on deposits is taxable. Section 61(a).

B. Dividends paid with respect to stock are taxable. Sections 61(a), 593(e).

C. Losses on deposits in insolvent institutions

1. In general, losses on deposits, incurred when a bank becomes insolvent, are treated as bad debts under section 166.
2. For an individual, except for deposits made in a trade or business, such bad debt losses are treated as short term capital losses. Section 166(d). Deduction of such losses is limited by section 1211 to the extent of $3,000 plus capital gains for the year.

3. For years after 1981, certain losses sustained by certain depositors are allowable as ordinary casualty losses under section 165(c). Section 165(1).
   a. The depositor must not own 1 percent or more of the institution’s stock, be an officer of the institution, or a relative thereof.
   b. The deposit must be in a bank or a thrift (or certain other institutions).

X. **Section 597**

A. Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), federal financial assistance (FFA) can be extended to financially troubled banks and thrift institutions.

1. Without any changes to the tax law, a bank receiving FFA from the federal government was not required to include such assistance in income or to make a downward basis adjustment to its assets.

2. Thus, a taxpayer might receive duplicative tax benefits due to the provision of tax-free financial assistance with no limitation on the deductibility of losses.

B. To prevent such duplicative tax benefits, FIRREA added Code section 597.

1. Section 597 provides the Treasury Department with authority to promulgate regulations on the tax treatment of FFA as long as the regulations do not allow the utilization of “any deduction (or other tax benefit) if such amount was in effect, reimbursed by nontaxable FFA.”

2. The regulations provide that all FFA is ordinary income.
   a. There are limits on how much FFA must be currently included in income.
   b. The FFA income generally can be offset by built-in losses.

C. The regulations also provide that the acquisition of 50% or more of the stock of a troubled financial institution that has received FFA or has been under the control of certain government agencies, including the FDIC, will be treated as a deemed asset sale.
1. The effect of the deemed asset sale generally is to require the acquirer to take a cost basis in the acquired assets, eliminating losses inherent in those assets.

D. 2007-2008 Recession Developments

1. The FDIC has a program to provide financial assistance to financial institutions acquiring distressed banks.
   a. Taxpayers were lobbying the IRS and Congress to provide that section 597 does not apply to such financial assistance.

2. The Treasury Department issued Notice 2008-101, which provides that “no amount furnished by the Department of the Treasury to a financial institution pursuant to the TARP established by the Secretary under EESA will be treated as the provision of Federal financial assistance within the meaning of section 597 of the Code and the regulations thereunder.”

XI. Taxation Of Common Trust Funds

A. “Common trust funds” are pooled funds maintained by a bank in its capacity as trustee, executor, etc. Section 584(a).

B. A common trust fund is not a taxable entity. Section 584(b). It is treated as pass-through entity, similar to a partnership. Trust fund income is computed only for purposes of determining participants’ income. Section 584(d).

C. Taxation of participants

1. Each participant includes in their income a proportionate share of the trust fund’s income or losses, whether or not distributed. Section 584(c).
   a. The IRS will challenge allocations of gain and loss where a common trust fund invests in offsetting positions in foreign currencies, and the investors in the trust fund include tax indifferent parties. Such a “common trust fund straddle tax shelter” is designated as a listed transaction for purposes of the disclosure, registration, and list maintenance requirements of sections 6011, 6111, and 6112. Notice 2003-54, 2003-33 I.R.B. 363.

2. Long term capital gains, short term capital gains, and ordinary gains and losses are treated separately.

3. Each participant is entitled to a proportionate share of tax-exempt income, etc.

4. Withdrawals from common trust funds
a. Upon entry into a fund, the participant purchases unit shares in the fund. The value of those units may fluctuate.

b. Upon withdrawal from the fund, the participant “sells” the units, realizing gain or loss equal to the amount received less the adjusted basis of the shares. Treas. Reg. § 1.584-4(a).

c. The value of the units at the time of withdrawal may reflect undistributed income, already taxed to the participant. To correct for this, the basis of the units is increased by the participant’s share of undistributed income. Treas. Reg. § 1.584-4(b).

In years after 1995, a common trust fund may transfer substantially all of its assets to a RIC (or RICs) in exchange for RIC stock, and then transfer the RIC stock to its participants in exchange for their interests in the fund, without gain being recognized by either the fund or its participants. Section 584(h).