

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Prop. Reg. § 1.1221-1(e), The New Bank One, Prop. Reg. § 1.1363-1(b)(2)

AUTHOR: Carlisle, Linda E.

PANEL: Recent Regulatory and Other Developments

DATE: 10/20/06

COMMITTEE: Banking and Savings Institutions

NOTE: This material was produced in connection with ABA Section of Taxation and Section of Real Property, Probate and Trust Law continuing legal education programs. It represents the statements and views of the author and does not necessarily represent the official policies or positions of the American Bar Association or the ABA Sections of Taxation and Real Property, Probate and Trust Law. The American Bar Association, the Section of Taxation and the Section of Real Property, Probate and Trust Law do not accept responsibility for the accuracy of the information in this paper, nor for any interpretation or application by the reader of the information contained in this paper. This paper is not intended to be, nor should it be construed as constituting, the opinion of, or legal or tax advice with regard to specific case or transaction by the author, the Tax Section, the Real Property, Probate and Trust Law Section or the American Bar Association.

Recent Regulatory Developments:

Prop. Reg. § 1.1221-1(e) – The Scope of Section 1221(a)(4)
The New Bank One – Valuation of Derivatives
Prop. Reg. § 1.1363-1(b)(2) – S Corporation Banks

American Bar Association
Joint Fall CLE Meeting
October 2006

Linda E. Carlisle, White & Case LLP
Phoebe Mix, Internal Revenue Service, Special Counsel
to the Associate Chief Counsel
Clarissa C. Potter, Internal Revenue Service, Senior
Counsel to the Deputy Chief Counsel – Legislation

Table of Contents

- I. Proposed Regulations on Capital Asset Exclusion for Accounts and Notes Receivable
- II. The New Bank One
- III. S Corporations Banks

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Background of Section 1221(a)(4)

- Section 1221 defines a capital asset as all property held by a taxpayer unless specifically excepted.
- Prior to the enactment of section 1221(a)(4) in 1954, accounts or notes receivable held by taxpayers other than dealers in accounts or notes receivable were treated as capital assets.
 - If a taxpayer performed services or sold inventory and received an account or note receivable from the other party, the taxpayer would recognize ordinary income.
 - If the taxpayer disposed of the account or note receivable for less than the amount he or she included in income, however, the taxpayer recognized a capital loss.
 - Thus, if the taxpayer accrued \$100 in income as ordinary income and disposed of the account receivable for \$90, the taxpayer would have \$100 of ordinary income and a \$10 capital loss.

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Background of Section 1221(a)(4) cont'd

- Section 1221(a)(4) was enacted in 1954 to correct this character mismatch problem.
- Section 1221(a)(4) provides that accounts or notes receivable acquired in the ordinary course of trade or business for services rendered, or from the sale of stock in trade, inventory, or property held for sale to customers in the ordinary course of a trade or business are ordinary property.
- The legislative history of section 1221(a)(4) states that any loss incurred upon the disposition of an account of note receivable acquired from the sale of inventory or stock in trade or from the rendering of services is, in effect, a business bad debt for which ordinary loss treatment is appropriate. (H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954)).

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Expansion of Section 1221(a)(4)

- In Burbank Liquidating Corporation v. Commissioner, 39 T.C. 999 (1963), section 1221(a)(4) was applied to notes resulting from loan origination transactions.
- In Burbank, the Tax Court held that mortgage loans originated by a savings and loan association were ordinary assets in the hands of the association under section 1221(a)(4) because they were notes receivable acquired for the service of making loans.
- The Internal Revenue Service acquiesced to the decision in Burbank and relied on Burbank in ruling that loans made by commercial lenders were ordinary assets under section 1221(a)(4) when held by the original lenders. See Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 72-238, 1972-1 C.B. 65 (loans originated by lending institutions were ordinary assets in the lender's hands under section 1221(a)(4)). See also Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul. 80-57, 1980-1 C.B. 157 (loans made by real estate investment trusts were ordinary assets in the lender's hands under section 1221(a)(4)).

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Expansion of Section 1221(a)(4) (cont'd)

- In Federal National Mortgage Association (“FNMA”) v. Commissioner, 100 T.C. 541 (1993), the Tax Court expanded on its ruling in Burbank and held that mortgage loans acquired in the secondary market by FNMA were ordinary assets in the hands of FNMA under section 1221(a)(4).
 - In FNMA, the court concluded that although the hedging transactions entered into by FNMA did not come within any of the stated exceptions to capital asset treatment in section 1221, the hedging transactions would receive ordinary treatment if they were integrally related to assets that were described in section 1221.
 - Thus, in order to conclude that hedging transactions with respect to the mortgages held by FNMA gave rise to ordinary income and loss, the court was required to conclude that the mortgages were ordinary property under section 1221.

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Expansion of Section 1221(a)(4) (cont'd)

- The Internal Revenue Service argued that although the making of loans may be a service, (as in Burbank Liquidating) the acquisition of mortgages by FNMA on the secondary market is not a service to the mortgage issuer.
- The court stated that the difference between an originating lender and FNMA was not determinative and that issue was whether FNMA was providing a service in acquiring mortgages.

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Expansion of Section 1221(a)(4) (cont'd)

- The court noted that FNMA's operations were restricted by statute and regulations to provide stability to the secondary market for home mortgages and provide liquidity for originating lenders, allowing them to extend further loans.
- The court also stated that the operations of FNMA supported the view that FNMA was providing a service in exchange for the mortgages – benefiting both mortgage issuers by increasing bank lending and the mortgage lending business and the members thereof.
- Given FNMA's mandated purpose, the restrictions on its activities, and its actual operation the court concluded that FNMA's purchase of mortgages was designed to enhance the efficiency of the secondary mortgage market. Accordingly, the court concluded that the mortgages acquired by FNMA on the secondary market were acquired for rendering services and therefore were ordinary property under section 1221(a)(4).

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

The Proposed Regulations

- In the preamble to the proposed regulation, the Treasury Department notes that, historically, a lending transaction was sometimes thought of as rendering a service to the borrower. See Rev. Rul. 70-540, 1970-2 C.B. 101; Rev. Rul. 69-188, 1969-1 C.B. 54; Rev. Rul. 68-6, 1968-1 C.B. 325 (each discussing the treatment of fees charged by a lender for making loans as “service fees” versus interest).
- Nevertheless, the Treasury Department states that the characterization of loan origination as a service does not justify the application of section 1221(a)(4) to notes acquired by origination. The application of section 1221(a)(4) to such loans strains the language of the statute because the notes are not issued by the borrower solely or even predominantly for services rendered, but rather are issued to the lender in exchange for money.
- The Treasury Department further states that the acquisition of notes or mortgages using consideration other than services or section 1221(a)(1) property generally does not create the potential for character mismatch that concerned Congress when it enacted section 1221(a)(4), and therefore the expansion of section 1221(a)(4) (e.g., by Burbank and FNMA) cannot be reconciled with Congress’ stated purpose in enacting the statute.

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

The Proposed Regulations

- The proposed regulation provide that:
 - An account or note receivable is not described in section 1221(a)(4) if, in exchange for the account or note receivable, the taxpayer provides more than de minimis consideration other than services or property described in section 1221(a) (i.e., money), or if the note or account receivable is not issued by the party acquiring the services or property described in section 1221(a).
 - A note is not acquired for services within the meaning of section 1221(a)(4) on the grounds that the taxpayer's act of acquiring (including originating) the account or note receivable constitutes or includes the provision of a service or services to: (i) the issuer of the account or note; (ii) the secondary market in which the accounts or notes receivable may trade; or (iii) the participants in that market.

I. Proposed Regulation § 1.1221-1(e) – Limiting the Scope of Section 1221(a)(4)

Issues

- Why is the Internal Revenue Service changing 40 years of settled law regarding loan originations?
- Why did the Internal Revenue Service issue regulations rather than a revenue ruling?
- Why are the regulations only in proposed form, rather than in proposed and temporary form?
- What effect would the proposed regulations have on the consumer lending industry.
- Are taxpayers who originate loans “securities dealers” within the meaning of section 475?
 - Is mark-to-market accounting a satisfactory way to achieve ordinary treatment for gains and losses?
 - Would mark-to-market accounting create timing mismatches for the finance industry?

II. The New Bank One – Valuation of Derivatives

Background

- At issue in Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), was whether First National Bank of Chicago (“FNBC”) (acquired by Bank One) properly valued interest rate swaps at fair market value for purposes of applying mark-to-market accounting under section 475 of the Internal Revenue Code.
- FNBC valued the swap portfolios as of December 31 of each year on the basis of the mid-market values of the swaps on December 20 of that year. FNBC used a valuation model called the Devon derivatives software system to arrive at the mid-market values but made numerous adjustments to the Devon values (for administrative costs or credit risk) to reflect “fair value” for GAAP purposes.
- The Internal Revenue Service concluded that the taxpayer’s method did not clearly reflect income and applied its own valuation method, which called for mid-market values with no adjustments for credit risk, other than the credit risk implicit adjustment implicit in the discount rate, or administrative costs because they were de minimis and/or unsubstantiated.
- FNBC argued that its valuation of the interest rate swaps was consistent with industry practice whereas the IRS argued that FNBC’s valuation method undervalued the interest rate swaps.

II. The New Bank One – Valuation of Derivatives

Background cont'd

- Judge Laro of the Tax Court held that the mark-to-market rule was subject to the “clear reflection of income” standard in section 446, and ruled that the taxpayer’s method did not clearly reflect income. In particular, Judge Laro determined that there was a difference between fair market value and fair value and held that the taxpayer was required to value the swaps at “fair market value,” rather than “fair value.” Judge Laro also held that the Commissioner’s method did not clearly reflect income and directed the parties to submit computations consistent with the opinion.
- A year later, the parties submitted new valuation computations to the court based on Judge Laro’s valuation method. Judge Laro accepted the Commissioner’s valuation in its entirety. The taxpayer appealed.
- In 2005, the IRS issued a notice of proposed regulations under section 475 relating to the valuation of derivatives.

II. The New Bank One – Valuation of Derivatives

The New Bank One

- In Bank One v. Commissioner, Nos. 05-3730 and 05-3742 (7th Cir. Aug. 9, 2006), J.P. Morgan Chase, Bank One's successor in interest, argued that the Tax Court lacked the authority to impose its own accounting method.
 - Furthermore, the taxpayer argued that its valuation method needed only to be reasonable, rather than to clearly reflect income, because it conformed to generally accepted accounting principles ("GAAP").
 - Finally, the taxpayer argued that the differences Judge Laro found between "fair value" and "fair market value" were illusory, since Congress intended to conform financial accounting and tax standards in enacting section 475.

II. The New Bank One – Valuation of Derivatives

The New Bank One cont'd

- Judge Manion of the Seventh Circuit held that there was no clear error in the Tax Court's holding that the taxpayer's method did not clearly reflect income.
 - However, section 446(b) also provides that "where the taxpayer's method does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."
 - Judge Manion held that the Commissioner's interpretation of the Code may not be set aside unless such interpretation is "arbitrary or unlawful."
- As a result, the Tax Court's holding that the taxpayer's method did not clearly reflect income was affirmed, but the case was vacated and remanded to determine whether: (1) the Commissioner's method was arbitrary or unlawful; and (2) if not arbitrary or unlawful, whether the Commissioner's method should be adopted or corrected.

II. The New Bank One – Valuation of Derivatives

Analysis

- Under what circumstances might the Commissioner's method be considered "arbitrary and unlawful"?
- Judge Manion noted that "more timely rulemaking might have prevented or at least facilitated resolution of this present dispute."
 - Prop. Reg. § 1.475(a)-4 provides a safe harbor for valuation of derivatives under section 475. The safe harbor generally provides that if a taxpayer uses an eligible method on its primary financial statement, the taxpayer may elect to use the value reported on its primary financial statement, subject to certain limitations. Those limitations are: (1) dealers may not use bid or ask valuations; (2) no item of income or expense can be accounted for in current realization and then in the mark; and (3) no valuation adjustment may be double counted, either directly or indirectly.
 - Taxpayers would be required to keep records showing that the same values used on the financials were used on the tax return, that all marked-to-market positions were included in the safe harbor, and that nothing required to be included was excluded.

II. The New Bank One – Valuation of Derivatives

Analysis cont'd

- The taxpayer's method of valuation would not meet the requirements of the safe harbor.
- Although the taxpayer's method conformed to GAAP, the valuations were made as of December 20 of each year, adjusted for any payments made or received between December 20 and year end. Under the safe harbor, the valuation must be made as of the last business day of the tax year.

III. Prop. Reg. § 1363-1(b)(2) – S Corporation Banks

Background

- Section 1361(b)(2) describes corporations that are ineligible to elect S corporation status. Prior to 1996, banks generally were ineligible to elect S corporation status.
- In 1996 Congress revised section 1361(b)(2) to allow banks to elect S corporation status if they did not use the reserve method of accounting for bad debts under section 585.
- Section 1363(b), which pre-dates the 1996 legislation allowing banks to be S corporations, provides that subject to certain exceptions, the taxable income of an S corporation is computed in the same manner as for an individual.
 - One exception is that section 291, relating to corporate preference items, applies to an S corporation (or any predecessor) that was a C corporation for any of the three immediately preceding tax years.
 - Sections 291(a)(3) and 291(e)(1)(B) apply only to banks and provide a bank's deduction for interest on debt incurred or continued to purchase or carry "qualified tax-exempt obligations" is reduced by 20%.
- Reg. § 1.1361-4(a)(3) provides that all special tax rules applicable to banks also apply to S corporation banks "except as other published guidance may apply section 265(b) and 291(a)(3) and 291(e)(1)(B).

III. Prop. Reg. § 1363-1(b)(2) – S Corporation Banks

Background cont'd

- Since banks, as defined in section 581, must be corporations, section 1363(b) can be read to mean that special rules in the Code that are applicable only to banks (and thus applicable only to corporations) do not apply to S corporation banks except as specifically provided in section 1363(b). Reg. § 1.1361-4(a)(3) appears to take a contrary view, that section 1363(b) does not preclude the application to S corporation banks of the special rules in the Code that are applicable only to banks.
- Many S corporation banks have taken the position that the bank interest deduction rules in section 291 do not apply to S corporation banks beyond the three-year period after conversion from a C corporation to an S corporation.
- In 2005, it was reported that the Internal Revenue Service was auditing S corporation banks for compliance with the rules under section 291 and was taking the position that the bank interest deduction rules under section 291 apply to all S corporation banks without limitation.

III. Prop. Reg. § 1363-1(b)(2) – S Corporation Banks

The Proposed Regulations

- On August 24, 2006, the Internal Revenue Service published proposed regulations under section 1363 clarifying the application of section 1363(b) to S corporation banks.
- The Proposed Regulations are proposed to be effective for tax years beginning on or after August 24, 2006.
- The proposed regulations provide that the general rule of section 1363(b) (*i.e.*, that the taxable income of S corporations is computed in the same manner as for individuals) does not prevent the special rules in the Internal Revenue Code applicable to banks from applying to S corporation banks. Thus, the only special rule for banks that does not apply to S corporation banks is the reserve method for bad debts under section 585.
- The proposed regulations further provide that the special rule applying section 291 to S corporations during the three-year period following a conversion from C corporation status to S corporation status does not prevent the provisions of section 291 relating to banks from applying to S corporation banks beyond such three-year period.

III. Prop. Reg. § 1363-1(b)(2) – S Corporation Banks

The Proposed Regulations cont'd

- The preamble to the proposed regulations explains that when Congress allowed banks to elect S corporation status it did not intend to deny them the benefits, or shield them from the burdens, that ordinarily apply to banks.
- The preamble states that applying the special bank rules to S corporation banks is consistent with Reg. § 1.1361-4(a)(3).
- The preamble also states that applying the special bank rules to S corporation banks is consistent with the requirement that S corporation banks not use the reserve method of accounting under section 585. If the special bank rules in the Code did not apply to S corporation banks (except as provided in section 1363(b)), it would not be necessary to deny use of the reserve method to S corporation banks.
- The preamble also states that section 1363(b)(4) makes section 291 applicable to S corporations during the three-year period after a conversion from C corporation status to S corporation status, but does not preclude the application of section 291 to S corporations in any other situations.

III. Prop. Reg. § 1363-1(b)(2) – S Corporation Banks

Issues

- Why did the Internal Revenue Service issue regulations rather than a revenue ruling?
- Why are the regulations only in proposed form, rather than in proposed and temporary form?
- Are the proposed regulations a change in the position of the Internal Revenue Service?