Joint Committee on Taxation
October 31, 1995
JCX- 48-95

H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995"

Scheduled for Markup
by the House Committee on Ways and Means
on November 1, 1995

Introduction

The House Committee on Ways and Means has scheduled a markup of H.R. 2494 (the "Thrift Charter Conversion Tax Act of 1995") on November 1, 1995. H.R. 2494 was introduced by Chairman Archer, Mr. Leach, and Ms. Roukema on October 11, 1995, and the Committee on Ways and Means held a public hearing on H.R. 2494 on October 26, 1995.

Title II of H.R. 2491 (the "Seven-Year Balanced Budget Reconciliation Act of 1995"), as passed by the House of Representatives on October 26, 1995, would require savings and loan institutions to forego their Federal thrift charters and become either State-chartered savings and loan institutions or Federally-chartered banks.

Part I of this document describes present law relating to the tax treatment of bad debt deductions and reserves of bad debt of thrift institutions, the treatment of thrift institutions under Title II of H.R. 2491, and the provisions of H.R. 2494 relating to accounting for bad debts by thrift institutions and treatment of recapture of bad debt reserves. Part II describes present law, H.R. 2491, and H.R. 2494 relating to the treatment of special assessments paid by thrift institutions. Part III describes changes that the Chairman's amendment in the nature of a substitute would make to H.R. 2494, as introduced.

I. Treatment of Bad Debt Deductions and Reserves of Bad Debt of Thrift Institutions

Present Law and Background

Tax treatment of bad debt deductions of savings institutions

Reserve methods of accounting for bad debts of thrift institutions

A taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions are eligible to compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593 of the Internal Revenue Code. To qualify for this reserve method, a thrift institution must meet an asset test, requiring that 60 percent of its assets consist of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage must be computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution uses the reserve method of accounting for bad debts, it must establish and maintain a reserve for bad debts and charge actual losses against the reserve, and is allowed a deduction for annual additions to restore the reserve to its proper balance. Under section 593, a thrift institution annually may elect to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that is also available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of : (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). Pursuant to a provision contained in the Tax Reform Act of 1986 ("1986 Act"), for taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. The base year amount is reduced to the extent that the taxpayer's loan portfolio decreases. Prior to 1988, computing bad debts under a "base year" concept allowed a thrift institution to claim a deduction for bad debts

for an amount at least equal to the institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with an adjusted basis of assets of $500 million or less) only may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. A large commercial bank must use the specific charge-off method. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct actual losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve amount in excess of actual losses is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[1] is required to recapture its bad debt reserve. The percentage of taxable income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institution qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income either ratably over a 6-taxable year period, or under the 4-year recapture method described above.

In addition, a thrift institution may be subject to a form of reserve recapture even if the institution continues to qualify for the percentage of taxable income method. Specifically, if a thrift institution distributes to its shareholders an amount in excess of its post-1951 earnings and profits, such excess will be deemed to be distributed from the institution's bad debt reserve and must be restored to income (sec. 593(e)).

Proposed banking legislation (H.R. 2491)

Treatment of thrift institutions under H.R. 2491

Title II (Chapter 2, subtitle B) of H.R. 2491, which passed the House of

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[1] Prop. Treas. reg. sec. 1.593-13.

Representatives on October 26, 1995 would require savings and loan institutions to forego their Federal thrift charters and become either State-chartered savings and loan institutions or Federally-chartered banks. Under proposed Treasury regulations, if a thrift institution becomes a bank, the institution would be subject to recapture of all or a portion of its bad debt reserve . As described in detail below, it is understood that such recapture would require the institution to immediately record, for financial accounting purposes, a current or deferred tax liability for the amount of recapture taxes for which liabilities previously had not been recorded (generally, with respect to the pre-1988 reserves) regardless of when such recapture taxes are actually paid to the Treasury. It is further understood that the recording of this liability generally would decrease the regulatory capital of the new bank.

Financial accounting treatment of tax reserves of bad debts of thrift institutions

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deductible for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will become liable for tax in a future period when the timing item "reverses" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required for pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was indefinite (i.e., generally, a reversal would only occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year by the 1986 Act increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and it is understood that thrift institutions generally have recorded deferred tax liabilities for these additions. Prior to the 1986 Act, the base year balance of a thrift institution was the reserve balance whenever the institution changed from one bad debt method to another (e.g., from the percentage of taxable income method to the experience method).[2]

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[2] How the establishment of 1987 as a permanent base year changed nature of the bad debt reserves of thrift institutions between pre-1988 years to post-1987 years (which, in turn, changed the financial accounting treatment of such reserves) can be illustrated by the following example:

Assume that a thrift institution ("T") always used the percentage of taxable income ("PTI") method to deduct bad debts through 1986 when its reserve balance was $10,000. Further assume that in 1987, T: (1) has insufficient taxable income to use the PTI method, (2) has actual bad debt losses of $1,000, and (3) under the six-year average formula of the experience method, would be allowed a deduction of $900. Under pre-1986 Act law, T would be allowed a bad debt deduction of $1,000 (rather than $900) in 1987 because $1,000 is the amount necessary to restore the reserve to its base year (PTI) level. Specifically, in 1987, T would charge the year-end

Description of H.R. 2494

Repeal of section 593

H.R. 2494 (hereinafter, the "bill") would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under the bill, thrift institutions that qualify as small banks would be allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks would be required to use the specific charge-off method. Thus, the percentage of taxable income method of accounting for bad debts would no longer be available for any institution.

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995. For purposes of determining the section 481(a) adjustment of a taxpayer, the balance of the reserve for bad debts with respect to the taxpayer's base year (generally, the balance of the reserve as of the close of the last taxable year beginning before January 1, 1988) would not be taken into account. However, the balance of these pre-1988 reserves would continue to be subject to the provisions of

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1986 reserve of $10,000 for the $1,000 actual loss and then add (and deduct) $1,000 to the reserve so that the balance of the reserve at year end 1987 is once again $10,000. Thus, T's former PTI deductions, which gave rise to the $10,000 reserve balance, generally would not be restored to income under pre-1986 Act law (subject to sec. 593(e)).

Further assume that in 1988, T has sufficient taxable income to be allowed a PTI deduction of $1,500, increasing the balance of the reserve to $11,500 at year-end 1988. Further assume that in 1989, T: (1) again has insufficient taxable income to use the PTI method, (2) has actual bad debts of $2,500, and (3) under the six-year average formula of the experience method would be allowed a deduction of $900. Pursuant to the change made by the 1986 Act, T would be allowed a deduction of $1,000 (i.e., the amount necessary to restore the reserve to its base year (year-end 1987) level.) Specifically, T would charge the year-end 1988 reserve balance of $11,500 for the $2,500 actual loss and then add (and deduct) $1,000 to the reserve to restore the balance to the $10,000 base year amount. Thus, T's post-1987 PTI deduction of $1,500 is restored to income under post-1986 Act law (i.e., T had actually losses of $2,500 in 1989, but only was allowed to deduct $1,000).

present-law section 593(e) (requiring recapture in the case of certain excess distributions to shareholders).

Thus, under the bill, subject to the special rule described below, a thrift institution that would be treated as a large bank generally would be required to recapture its post-1987 additions to its bad debt reserve, whether such additions are made pursuant to the percentage of taxable income method or the experience method. In addition, subject to the special rule described below, a thrift institution that would qualify as a small bank generally only would be required to recapture its post-1987 additions to its bad debt reserve that were attributable to the use of the percentage of taxable income method during such period. If such small bank would later become a large bank, any amount required to be recaptured under present law would be reduced by the amount of the pre-1988 reserve.

Residential loan requirement

Under a special rule, if the taxpayer meets the "residential loan requirement" for any taxable year, the amount of the section 481(a) adjustment otherwise required to be restored to income would be suspended. A taxpayer would meet the residential loan requirement if for any taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than the average of the principal amount of such loans made during the six most recent testing years. A "testing year" means (1) each taxable year ending on or after December 31, 1990, and before January 1, 1996, and (2) each taxable year ending after December 31, 1995, for which the taxpayer met the residential loan requirement. For this purpose, a residential loan would be a loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real and church property and mobile homes). The special rule would continue to apply until the taxpayer recaptured its entire section 481(a) adjustment. The determination of whether a member of a controlled group of corporations meets the residential loan requirement would be made on a controlled group basis. A special rule would provide that a taxpayer that calculates its estimated tax installments on an annualized basis would determine whether it meets the residential loan requirement with respect to each such installment. Treasury regulations are expected to provide rules for the application of the residential loan requirement rules in the case of mergers, acquisitions, and other reorganizations of thrift and other institutions.

Effective Date

This provision of the bill would be effective for taxable years beginning after December 31, 1995.

II. Tax Treatment of Special Assessments

Present Law and Background

Title II (Chapter 1, subtitle B) of H.R. 2491 would require thrift institutions to pay a special assessment to the Saving Association Insurance Fund ("SAIF"). The SAIF generally is the insurance fund for deposits in thrift institutions. The amount of the assessment would be the amount necessary to ensure that the SAIF has reserves of $1.25 for each $100 of insured deposits and the due date of the payment would be the first business day of January 1996. Effective January 1, 1998, the SAIF would be merged with the Bank Insurance Fund ("BIF") (the insurance fund for deposits in banks). Thrift institutions and banks also are required to pay annual premiums to the SAIF and BIF, respectively, based on the amount of their insured deposits. Currently, the premium rate for the SAIF deposits is substantially higher than the premium rate for BIF deposits. After the merger of the SAIF and BIF in 1998, under H.R. 2491, thrift institutions and banks would be subject to the same lower deposit insurance rates generally applicable to banks.

In general, a taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business during the taxable year (sec. 162). However, amounts that give rise to a permanent improvement or betterment must be capitalized rather than deducted currently (sec. 263). Whether an expenditure is deductible under section 162 or must be capitalized under section 263 is often a matter of dispute between the IRS and taxpayers, and has been the subject of significant litigation. Most recently, in INDOPCO v. Commissioner, 503 U.S. 79 (1992), the U.S. Supreme Court noted that the capitalization of expenditures is the norm and that a current "income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."[3] In INDOPCO, the Court distinguished its prior decision in Lincoln Savings v. Commissioner, 403 U.S. 345 (1971), (relating to additional premiums paid by a thrift institution to the Federal Savings and Loan Insurance Corporation) to hold that it is not necessary for an expenditure to give rise to the creation of a separate and distinct asset before such expenditure is capitalized. Rather, the Court held that "although the presence of an incidental future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is important in determining whether the appropriate tax treatment is immediate deduction or capitalization." In INDOPCO, the Supreme Court found that the record supported the lower courts' findings that the investment banking fees in question produced significant benefits extending beyond the tax year in which they were incurred so as to warrant capitalization.

The scope of the INDOPCO decision and its application to the payments of the

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[3] INDOPCO, citing Interstate Transit Lines v. Comm., 319 U.S. 590, 593 (1943); Deputy v. DuPont, 308 U.S. 488, 493 (1940); and New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

special assessments provided in H.R. 2491 may be open to interpretation. On the one hand, if the special assessments are viewed as payments necessary to raise SAIF funding to a level appropriate for current needs,[4] a current deduction arguably would be allowable. If, on the other hand, the special assessments are viewed as current payments that will facilitate the future BIF/SAIF merger (such merger providing the assessed institutions with significant future benefits such as reduced deposit insurance rates), capitalization arguably would be required.[5]

Description of H.R. 2494

The bill would provide that the special assessments paid to the SAIF would be deductible when paid.

Effective Date

This provision of the bill would be effective upon enactment.

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[4] See, e.g., the testimony of the Hon. John D. Hawke, Jr., Undersecretary of the Treasury for Domestic Finance on the SAIF, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services, August 2, 1995, calling for a special assessment at least partially to correct current SAIF weaknesses. This testimony did not discuss the proper Federal income tax accounting treatment for the assessment. However, the testimony of Cynthia G. Beerbower, Deputy Assistant Secretary (Tax Policy) Department of the Treasury, on H.R. 2494 before the House Committee on Ways and Means, October 26, 1995, provides that it is the view of the Treasury Department that the special assessments are deductible under current law.

[5] See, e.g., Private Letter Rulings 9348003 (August 30, 1993) and 9402006 (September 24, 1994), where the IRS required capitalization of certain "exit and entry" fees paid by institutions on the transfer of insured deposits from the SAIF to the BIF. However, these rulings are not dispositive of the proper treatment of the special assessments required under H.R. 2491 because private letter rulings are only applicable to the taxpayers to whom issued and the facts underlying the rulings differ from the facts underlying the special assessments.

III. Changes Made to H.R. 2494 by the Chairman's Amendment in the Nature of a Substitute

The Chairman's amendment in the nature of a substitute ("Chairman's amendment") would make the following changes to H.R. 2494:

1. H.R. 2494, as introduced, suspends the recapture of a portion of a thrift institution's bad debt reserve for each taxable year that the institution meets a "residential loan requirement." Under the bill, as introduced, a taxpayer would meet the residential loan requirement if for any taxable year, the principal amount of loans secured by residential property made by the taxpayer during the year is not less than the average of the principal amount of such loans made during a six-year, upward moving average.

The Chairman's amendment amends the "residential loan requirement" to provide:

(a) that only home purchase and home improvement loans would be taken into account (i.e., refinancings and home equity loans would not be taken into account);
(b) a fixed testing period amount generally based on the average of loans made during the six taxable years preceding 1996. At the election of the taxpayer, the high and low years in this six-year period would not be taken into account in computing this average;
(c) that the testing period amount would be adjusted for inflation; and
(d) that an institution would be deemed to meet the requirement for a taxable year if it met the requirement (absent this special rule) for its prior two taxable years that began after 1995.

In addition, the special estimated tax rule of H.R. 2494 with respect to the recapture of bad debt reserves subject to the residential loan requirement would be deleted. Legislative history will clarify when a loan is deemed "made" by a thrift institution for purposes of the residential loan requirement.

2. H.R. 2494, as introduced, repeals section 593 and makes certain conforming changes to other Code provisions that rely upon, or cross-reference, section 593. The Chairman's amendment would make additional conforming changes. For example, under present law, an institution that computes its bad debt deduction under section 593 (1) is not allowed certain tax credits (sec. 50(d)(1)); and (2) is provided special rules with respect to the foreclosure of property securing its loans (sec. 595). These restrictions and special rules also would be repealed under the Chairman's amendment.

3. The Chairman's amendment clarifies that all or a portion of the supplemental reserves (generally, certain pre-1963 reserves) and reserves for nonqualifying loans of thrift institutions would be treated as pre-1988 reserves.

4. The Chairman's amendment clarifies the treatment of small thrift institutions that would qualify as small banks.

5. The Chairman's amendment amends the provision that provides a deduction for the special assessments to the SAIF by clarifying when such amounts are deductible.