# DESCRIPTION OF S. 1828

Relating to

# THE TAX TREATMENT OF THRIFT PARTNERSHIPS

Scheduled for a Joint Hearing

before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

and the

Subcommittee on Housing and Urban Affairs

of the

Senate Committee on Banking

on

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# INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management and the Senate Banking Subcommittee on Housing and Urban Affairs have scheduled a joint hearing on S. 1828 (introduced by Senator Lugar) on February 5, 1982. S. 1828 relates to the tax treatment of thrift partnerships. This document has been prepared by the Staff of the Joint Committee on Taxation in connection with this hearing.

The first part of this document is a summary of the bill. The second part is a description of the bill, including present law, issues, explanation of provisions, and effective date. The third part states the estimated revenue effect.

## I. SUMMARY OF THE BILL

There is no provision in present law specifically dealing with the taxation of partnerships between thrift institutions and non-thrift taxpayers. S. 1828 would amend the portions of the Code relating to the taxation of partnerships to provide special rules for a new type of partnership referred to as a "qualified thrift partnership." Under the bill, qualified thrift institutions could transfer portions of their mortgage portfolios to qualified thrift partnerships and characterize any gain or loss on the sale of the mortgages as an ordinary gain or loss to the partnership. The qualified thrift partnership could then allocate all such ordinary gain or loss to its non-thrift partners. The bill would apply to transactions occurring after December 31, 1981, in taxable years ending after that date.

## II. DESCRIPTION OF THE BILL

### A. Present Law

#### Tax treatment of partnerships

Under present law, a partnership is not itself a taxpaying entity. Rather, a partnership is a conduit for tax purposes. The various items of income, gain, loss, deduction or credit realized by the partnership are taken into account directly by the partners as if such items were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership (sec. 702(b)).

As a general rule, a partner's distributive share of any item of partnership income, gain, loss, deduction or credit must be allocated among the partners according to the partnership agreement (sec. 704(a)). This general rule will not apply, however, and the partner's distributive share of partnership income, gain, loss, deduction or credit must be determined in accordance with each partner's interest in the partnership (taking into account all facts and circumstances), if the partnership agreement makes no provision for the partner's distributive share of such items, or if the partnership agreement's allocation does not have substantial economic effect (sec. 704(b)).

The "substantial economic effect" requirement is designed to assure that all partnership allocations "may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences." Treas. Reg. sec. 1.704-1(b)(2). For example, if all losses on the sale of depreciable partnership property are allocated in one taxable year to partner A who has no such gains individually, and an equal amount of losses of a different character are allocated to partner B in the same taxable year, the special allocation of losses to A will have no substantial economic effect because it will have no effect on A's

ultimate share of partnership economic income or loss. Thus, the special allocation of loss to A would be disallowed. Similarly, where a loss is allocated to a partner but not reflected in that partner's capital account and, under the partnership agreement, liquidating distributions are to be made in accordance with capital accounts, the Tax Court has held that the special loss allocation does not have substantial economic effect.[1/]

Because the characterization of items of partnership income, gain, loss, deduction or credit takes place at the partnership level, the character of any such item generated by the sale of contributed property may differ if the property is disposed of by the partnership after contribution than if the property is disposed of by the partner directly. Whether a sale or exchange is by a partner or the partnership depends upon the facts and circumstances. "In all cases, the substance of the transaction will govern, rather than its form." Treas. Reg. sec. 1.721-1(a). If property is contributed to a partnership and then immediately sold by the partnership in a preplanned transaction, the Internal Revenue Service could argue that the sale by the partnership should be ignored as a sham and the sale treated as if made by the contributing partner with the sale proceeds being contributed to the partnership.[2/]

Tax treatment of thrift institutions

Building and loan associations, cooperative banks, and mutual savings banks compute bad debt deductions under a special set of rules (sec. 593). Under one of these rules, called "the percent of taxable income method," these institutions are allowed a bad debt deduction equal to 40 percent of their taxable income (computed without regard to the bad debt deduction). However, to qualify for the full amount of this deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in certain assets (hereinafter called "qualified assets"). The 40 percent is reduced under a formula to the extent that the percentage of qualified assets is less than the 82- or 72-percent levels. The reduction in the case of building and loan associations and cooperative banks is three-fourths of one percent for each percentage point that the percent of qualified assets is less than 82 percent of all assets. The reduction in the case of mutual savings banks is 1-1/2 percent for each percentage point that the percent of qualified assets is less than 72 percent of all assets. Qualified assets consist of

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1/ See Harris, Jr. v. Commissioner, 61 T.C. 770 (1974); Martin Magaziner, et ux., v. Commissioner, T.C. Memo. 1978-205 (June 5, 1978).

2/ See, Court Holding Co. v. Commissioner, 324 U.S. 331 (1945).

(1) cash; (2) obligations of the United States or of a State or a political subdivision thereof not including obligations the interest on which is excludable from gross income under section 103; (3) certain certificates of deposit in, or obligations of, a corporation specifically authorized by State law to insure the deposits or share accounts of member associations; (4) loans secured by a deposit or share of a member; (5) certain loans secured by certain residential or church real property; and (6) other assets described in section 7701(a)(19)(C).

Section 582, which applies to all organizations described in section 593 and also applies to banks (sec. 585) and small business investment companies (sec. 586), provides that gains and losses on the sale or exchange of evidences of indebtedness are ordinary gain or loss.

Section 7701(a)(19) defines a "domestic building and loan association" generally as an insured institution, the business of which is to acquire the savings of the public and invest in loans, at least 60 percent of the total assets of which at the close of any taxable year (or at the election of the taxpayer the average assets outstanding during the taxable year) consists of qualified assets.

B. Issues

The principal issues are, where a qualified thrift institutions transfers to qualified thrift partnerships portions of their mortgage portfolios, (1) whether any gain or loss on the sale of those mortgages should be characterized as ordinary gain or loss to the partnership, and (2) whether all such ordinary gain or loss may be allocated entierely to non-thrift partners.[3/]

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3/ It is understood that the bill is intended to permit the creation of partnerships in transactions similar to the following example. Assume that A, a qualified thrift institution, contributes below-market-rate mortgages on personal residences with a face value (and tax basis) of $1 million and a fair market value of $600,000 to a qualified thrift partnership, AB. B, an investor, contributes cash to AB equal to the difference between the face value of the contributed mortgages and their fair market value, or $400,000. Even though A contributes property worth only $600,000, A and B would agree that A's capital account would be $1 million. The purpose of AB is to sell the contributed mortgages and to reinvest the proceeds along with the cash contributed by B in market-rate residential mortgages.

Footnote 3/ continued

Shortly after the creation of the partnership, AB would sell the contributed mortgages for their fair market value of $600,000 and realize a loss of $400,000. Under the bill, the loss would be deemed to be the partnership loss even though the sale of the contributed mortgages was contemplated or arranged prior to the contribution of the mortgages to the partnership.

The partnership agreement would provide that the entire amount of the loss would be allocated to B and would reduce B's capital account from $400,000 to $0. Under the bill, this allocation could not be challenged by the Internal Revenue Service as not having substantial economic effect. Under the bill, the loss to AB would be an ordinary loss. Thus, B would be entitled to an ordinary loss for tax purposes of $400,000.

The bill would provide that, if A is a building and loan association, A would be deemed to own a share of the underlying mortgages of the partnership equal to the proportion that A's capital account bears to the total capital accounts of all partners for purposes of qualifying as a domestic building and loan association (under sec. 7701(a)(19)) and for purposes of computing A's bad debt deduction (under sec. 593).

Under the partnership agreement, the cash flow of the partnership (e.g., the monthly payments on the market-rate mortgages) would be allocated as follows: first, to A such that A would be given a rate of return somewhat greater than the rate of return that A was receiving on the contributed mortgages (e.g., 1-1/2 percentage points greater than the rate on the contributed mortgages); second, to B in an amount necessary to provide B with a return on his investment and restore B's capital account to its original amount; and, third, to A and B as they deterine to the extent to any remaining cash flow. As a result of the arrangement, the qualified thrift institution would increase its rate of return on its mortgages (e.g. by 1-1/2 percentage points) and B would have deferred taxable income from the year of investment until subsequent years.

## C. Explanation of Provisions

The bill defines a new type of partnership, the "qualified thrift partnership," and provides special rules for the taxation of its partners.

### Computation of partnership's taxable income-- gains or loss on sale or exchange

Section 2(a) of the bill would amend the rule relating to computation of a partnership's taxable income and partnership elections (sec. 703) to provide that the character of any gain or loss on the sale or exchange by a qualified thrift partnership of loans secured by an interest in residential or church real property (i.e., property described in sec. 7701(a)(19)(C)(c), hereafter "residential mortgage loans"), would be determined as if the residential mortgage loans had been sold or exchanged by the contributing qualified thrift institution and not by the partnership. Since, under present law (sec. 582), the gain or loss incurred on the sale or exchange of evidences of indebtedness by most "qualified thrift institutions" (defined below) is ordinary gain or loss, the effect of section 2(a) of the bill would be to provide that gains or losses recognized by qualified thrift partnerships on the sale or exchange of residential mortgage loans would be ordinary gains or losses.

### Partnership allocations

Section 2(b) of the bill would amend the requirement that partnership allocations must have substantial economic effect (sec. 704(b))2)) and the general rule on the allocation of items incurred with respect to contributed property (sec. 704(c)(1)) to provide that qualified thrift partnership agreements could allocate all of the gain or loss recognized on the sale or exchange of residential or church loans contributed to it by a qualified thrift institution partner to nonqualified thrift institution partners regardless of whether or not the allocation has substantial economic effect.

### Nonrecognition of gain or loss

Section 2(c) of the bill would amend the rule providing nonrecognition of gain or loss on the contribution of property to a partnership in exchange for an interest in the partnership (sec. 721) to provide that contributions of residential mortgage loans by a qualified thrift institution to a qualified thrift partnership followed by the sale by the partnership of such residential mortgage loans is to be treated as a sale of such assets by the partnership and not the contributing partner.

Definitions

Section 2(d) of the bill would amend the definition of domestic building and loan association (sec. 7701(a)(19)) to provide that, for purposes of the 60-percent test of section 7701(a)(19) and the 82-percent test of section 593, a domestic building and loan association partner, but not any other sort of qualified thrift institution partner, would be deemed to own a share of the assets of qualified thrift partnership in proportion to its percentage interest in partnership capital.

Finally, section 2(e) of the bill would define "qualified thrift partnership" and "qualified thrift institution." Under the bill, a qualified thrift partnership would be a partnership which met four tests. First, at least one partner of the qualified thrift partnership would have to be a qualified thrift institution. Second, 95 percent of the assets of the qualified thrift partnership would have to be either residential mortgage loans or cash. In the case of (1) any contribution to a qualified thrift partnership of property which was not a residential mortgage loan or (2) the proceeds from the sale of a residential mortgage loan, the partnership would be treated as having met the 95-percent requirement if such contributions or sale proceeds were used to acquire residential mortgage loans within a one-year period after receipt. Third, all contributions by nonqualified thrift institution partners would have to be in cash. Fourth, the primary purpose of the qualified thrift partnership would have to be to invest in residential mortgage loans.

Under the bill, a qualified thrift institution would be defined as (1) a mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution charactered and supervised as a savings and loan or similar institution under Federal or State law or (2) a credit union, the deposits or accounts of which are guaranteed under State law or insured under Federal or State law in a manner similar to a savings and loan institution.

D. Effective Date

The provisions of this bill would apply to transfers, sales and exchanges after December 31, 1981, in taxable years ending after that date.

## III. REVENUE EFFECT

The total face value of residential mortgages currently earning interest at a rate below the prevailing market rate and held by qualified thrift institutions is almost $600 billion. The market value of these mortgages probably is less than $450

billion; therefore, the discount probably is more than $150 billion. If all of these mortgages were to be contributed to the qualified thrift partnerships, non-thrift partners could reduce their taxable income by the $150 billion. However, because this amount represents a significant proportion of all corporate and individual taxable income, it is unlikely that all of these mortgages will be contributed. If one-half of the mortgages are contributed, the revenue loss, beginning in 1982 and probably occurring over several years, would be approximately $30 billion.