TAX TREATMENT OF THRIFT INSTITUTIONS UNDER H.R. 2494, THE "THRIFT CHARTER CONVERSION TAX ACT OF 1995"

Scheduled for a Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

On October 26, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 25, 1995

JCX-46-95

CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on October 26, 1995, on H.R. 2494 (the "Thrift Charter Conversion Tax Act of 1995"), which was introduced by Chairman Archer, Mr. Leach, and Mrs. Roukema on October 11, 1995. H.R. 2494 addresses certain Federal income tax issues relating to the treatment of thrift institutions raised by proposed banking legislation (H.R. 2363, the "Thrift Charter Conversion Act of 1995," the principal provisions of which are contained in Title II of H.R. 2491, the 1995 budget reconciliation bill as reported by the House Committee on the Budget.[1]) This document,[2] prepared by the staff of the Joint Committee on Taxation, describes present law and background with respect to the treatment of thrift institutions and the provisions contained in H.R. 2494.

Part I of the document provides an overview. Part II provides a description of the treatment of bad debt reserves of thrift institutions under present law, prior law, and the bill, and a discussion of the issues raised by H.R. 2491 and H.R. 2494. Part III provides a description of the tax treatment under present law and under H.R. 2494 of certain special assessments proposed to be levied upon thrift institutions by H.R. 2491.

---

[1] See Title II of H.R. 2491 ("Seven-Year Balanced Budget Reconciliation Act of 1995"), as reported (H. Rept. 104-280, October 17, 1995.)

[2] This document may be cited as follows: Joint Committee on Taxation, Tax Treatment of Thrift Institutions Under H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995" (JCX-46-95), October 25, 1995.

I. OVERVIEW

Thrift institutions (i.e., building and loan associations, mutual savings banks, or cooperative banks) historically have been allowed Federal income tax deductions for bad debts under reserve methods that were more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions, including banks). The thrift bad debt method of present law, contained in section 593 of the Internal Revenue Code, allows a qualified thrift institution to deduct as an addition to its reserve for bad debts an amount equal to the larger of: (1) 8 percent of its taxable income, or (2) the amount determined under the experience method generally applicable to small banks. Under proposed Treasury regulations, the conversion of a thrift institution to a bank requires the institution to recapture all or a portion of its bad debt reserve.

H.R. 2363 (the "Thrift Charter Conversion Act of 1995," the principal provisions of which are contained in Title II of H.R. 2491, the 1995 budget reconciliation bill), contains a provision that would require a Federally-chartered savings and loan institution to become a Federally-chartered bank or State-chartered savings and loan institution. It is understood that the recapture for Federal income tax purposes of a portion of the bad debt reserve of a thrift institution upon the conversion to a Federally-chartered bank would require the institution to record a tax liability for financial accounting purposes that would reduce the regulatory capital of the institution.

H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995," would (1) repeal the special bad debt reserve method of section 593 for all thrift institutions, (2) not require the recapture of a certain portion of the institutions' bad debt reserves, and (3) suspend recapture of the remaining portion of the reserve for each taxable year an institution met a residential loan requirement. The residential loan requirement would be met for a taxable year if the institution made a principal amount of loans secured by certain residential real or church property equal to the average amount of such loans made by that institution during a preceding 6-year period.

In addition, H.R. 2491 would require thrift institutions to pay a special assessment to the Saving Association Insurance Fund ("SAIF"), the insurance fund for deposits in thrift institutions. 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 currently are required to pay annual premiums to the SAIF and BIF, respectively, based on the amount of their insured deposits, but 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, thrift institutions and banks would be subject to the same lower deposit insurance rates generally applicable to banks.

It may be unclear under present law whether the payment of the special assessment under H.R. 2491 would be deductible for the Federal income tax purposes. H.R. 2494 would provide that the special assessment would be deductible when paid.

II. ACCOUNTING FOR BAD DEBTS BY THRIFT INSTITUTIONS

A. Present Law

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, 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,[3] is required to recapture its bad debt reserve.[4] 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)).

---

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

[4] The requirement of the proposed regulations that a thrift institution recapture its bad debt reserves upon a change in the method of its accounting for bad debts is based on Nash v. U.S., 398 U.S. 1 (1970), where the U.S. Supreme Court held that a taxpayer essentially was required to recapture its bad debt reserve when the related accounts receivable were transferred by the taxpayer .

B. Prior Law

Savings and loan associations, cooperative banks and mutual savings banks were tax exempt until the Revenue Act of 1951. While thrift institutions were made taxable as part of that Act, they also were given generous bad debt deductions that effectively kept thrift institutions exempt from income tax. In the Revenue Act of 1962, Congress attempted to end this virtual tax exemption by modifying the bad debt reserve deductions.

The system set up in 1962 allowed thrift institutions to choose among two alternative formulas: (1) an annual addition to reserves of 60 percent of taxable income (limited to a loss reserve of 6 percent of qualifying real property loans), or (2) a loss reserve of 3 percent of qualifying real property loans plus a percentage of other loans based on experience. Savings and loan associations and cooperative banks were allowed to use these methods only if 82 percent of their assets were invested in residential real estate, liquid assets and certain other assets, but no similar restrictions were applied to mutual savings banks.

The Tax Reform Act of 1969 eliminated the 3-percent method, phased down the percent of taxable income from 60 to 40 percent over 10 years, applied limits on the use of the percentage of taxable income method to mutual savings banks similar to those applicable to savings and loan associations (but with a 72-percent qualifying asset requirement in place of 82 percent), provided that the taxable income percentage was to be phased down gradually if an institution's proportion of qualifying assets fell short of 82 or 72 percent (instead of causing that institution to lose all benefit from the percentage of taxable income method), and made a series of other modifications to the bad debt provisions.

The Economic Recovery Tax Act of 1981 expanded the organizations eligible for these special rules to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations.

The Tax Equity and Fiscal Responsibility Act of 1982 enacted Code section 291 which required that deductions for bad debts by a thrift institution must be reduced by 15 percent of the amount that the institution's bad debt deduction exceeded the amount that would have been allowed under the experience method. The section 291 cut-back percentage was increased to 20 percent by the Deficit Reduction Act of 1984.

The Tax Reform Act of 1986 ("1986 Act") created the present system for accounting for bad debts by limiting the percentage of taxable income method to 8 percent of taxable income for those thrift institutions that met the 60-percent qualifying asset test of present law and repealing the section 291 cutback provision.[5] The 1986 Act also repealed the percentage-of-

---

[5] The 1986 Act changes did not change the effective tax rate applicable to thrift institutions. Before the 1986 Act, the effective tax rate was 31.28 percent, computed as:

(1) 46-percent corporate tax rate times,

(2) 68 percent (100 percent minus 32-percent deduction allowed under 40-percent

eligible loans method for taxable years beginning after 1987. The 1986 Act significantly changed the treatment of accounting for bad debts for other taxpayers by requiring the use of the specific charge-off method for all taxpayers, except thrift institutions and "small banks" (i.e., those with assets of $500 million or less). Small banks were allowed to continue to use the experience method of section 585. The experience method was amended to establish 1987 as a permanent base year for all taxpayers eligible to use the experience method, including thrift institutions.

C. Proposed Banking Legislation (H.R. 2491)

Treatment of thrift institutions under H.R. 2491

H.R. 2363 (the "Thrift Charter Conversion Act of 1995," introduced by Mrs. Roukema, and Messrs. Leach, McCollum, Roth, Baker of Louisiana, Bachus, Vento, Flake, Royce, Lucas, Weller, Metcalf, and Watts of Oklahoma on September 10, 1995, the major provisions of which are contained in H.R. 2491, the 1995 budget reconciliation bill) 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

---

of taxable income method, adjusted for the 20-percent cutback of sec. 291).

After the 1986 Act, the effective tax rate also was 31.28 percent, computed as:
(1) 34-percent corporate tax rate times,
(2) 92 percent (100 percent minus 8-percent deduction allowed under percentage of taxable income method).

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.

D. Description of H.R. 2494

H.R. 2494 (the "Thrift Charter Conversion Tax Act of 1995," introduced by Chairman Archer, Mr. Leach, and Ms. Roukema on October 11, 1995), 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.

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, adjusted for decreases in the taxpayer's loan portfolio) would not be taken into account. However, the balance of these pre-1988 reserves would continue to be subject to the provisions of 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.

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.--The bill would be effective for taxable years beginning after December 31, 1995.

E. Issues Raised by H.R. 2491 and H.R. 2494

Title II of H.R. 2491 (the proposed banking legislation) and H.R. 2494 (the proposed tax legislation) raise and address certain accounting, banking, and tax policy issues. First, H.R. 2491 would require a Federally-chartered savings and loan institution to become either a Federally-chartered bank or a State-chartered savings and loan. If an institution became a bank, absent any accompanying tax legislation, the converting institution would be denied the future benefit of the bad debt reserve method of section 593 and, pursuant to proposed Treasury regulations, would recapture all or a portion (depending on whether the institution would be treated as a small or a large bank) of its bad debt reserve. Thus, H.R. 2491, without any legislative tax relief, would impose a financial burden upon those institutions selecting Federal bank charters rather than State thrift charters. Further, as described in Part C. above, requiring the recapture of all or a portion of an institution's bad debt reserve may require the institution to record a deferred tax liability for such amounts, thereby reducing the regulatory capital of the institution. Taken together, the financial and capital requirements burdens imposed by bad debt reserve recapture may provide an incentive for thrift institutions to become State-chartered savings and loans rather than Federally-chartered banks, thus potentially frustrating Federal banking policy.

H.R. 2494 resolves this issue by forgiving, subject to certain restrictions, recapture with respect to that the portion of the bad debt reserve for which it is understood that deferred tax liabilities have not been recorded for financial accounting purposes. Such forgiveness raises certain tax policy concerns. In general, whenever a taxpayer changes from one method of accounting to another, such change is implemented by way of a section 481(a) adjustment that reflects the cumulative difference between the old and new accounting methods. This adjustment generally is restored to income over a specified period of time so that a taxpayer does not receive a "double deduction" with respect to an item of expense--once under the old method and again under the new method. Restoring the section 481(a) adjustment to income with respect to a repeal of a reserve method of accounting for bad debts ensures that the taxpayer does not receive a double deduction with respect to the same expense--once when the reserve is established and again when the bad debt is actually realized. The opposite of implementing an accounting method change under section 481 of the Internal Revenue Code is the "fresh start" approach, wherein the taxpayer is allowed deductions under both its old and new methods of accounting with no adjustment to reconcile the two methods.

H.R. 2494 effectively allows "fresh start" with respect to the pre-1988 reserves of a thrift institution (subject to the sec. 593(e) limitation) and requires a section 481(a) adjustment with respect to the post-1987 additions to the reserves of the institution (subject to the residential loan requirement). Some would argue that allowing "fresh start" is appropriate with respect to bad debts computed under the percentage of taxable income method of section 593 because such method effectively acted as a permanent incentive for thrift institutions in the residential mortgage business. Conversely, others would argue that fresh start is not appropriate because the benefits of the percentage of taxable income method were never intended to be permanent benefits--pointing to the recapture potential under section 593(e) (relating to certain excess distributions to shareholders). Finally, a third argument could be made that it is appropriate to allow "fresh start" with respect to the pre-1988 portion of the reserve and require recapture for the post-1987 additions to the reserve because the change made by the 1986 Act establishing 1987 as a permanent base year changed the nature of the bad debt deductions of thrift institutions from one of permanency to one of timing.[6] Indeed, the 1986 Act change appears to be the

---

[6] As discussed in Parts A. and B. above, the 1986 Act changed the base year balance to the reserve balance at the close of 1987 taxable year. 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). How the establishment of 1987 as a permanent base year changed the nature of bad debt deductions between pre-1988 years to post-1987 years 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 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 principal reason that accountants changed the treatment of accounting for income taxes with respect to bad debt deductions of thrift institutions for financial accounting purposes.

H.R. 2494 suspends the recapture of post-1987 additions to the bad debt reserve of a thrift institution so long as the institution continues to originate a certain level of loans secured by residential property. The residential loan requirement test is determined with respect to any loans secured by an interest in residential real or church property (including mobile homes not used on a transient basis). Such loans could include conforming and nonconforming[7] home purchase mortgages, home improvement loans, second trusts, mortgage refinancings and home equity loans. This provision raises and addresses certain tax and banking policy issues. The first issue is whether banking policy should be implemented through the Internal Revenue Code. The second issue is whether the residential loan requirement of the bill is appropriately tailored to meet the perceived banking policy goal of ensuring a source of mortgage financing. Specifically, (1) should this benefit be provided permanently or during a limited transition period; and (2) does the provision encompass the appropriate types of loans for the appropriate types of property?

---

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).

[7] A loan generally is "conforming" if it readily acceptable on a secondary market. A loan may be "nonconforming" if it exceeds a certain principal amount, provides for certain variable interest rates, is secured by both a personal residence and other (e.g., farm) property, or is made to an individual who fails to meet certain creditworthiness standards.

III. TAX TREATMENT OF SPECIAL ASSESSMENTS

A. Present Law and Background

Title II 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."[8] 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 special assessments provided in H.R. 2491 is uncertain. On the one hand, if the special assessments are

[8] 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).

viewed as payments necessary to raise SAIF funding to a level appropriate for current needs,[9] 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.[10]

B. Description of H.R. 2494

The bill would provide that the special assessment paid to the SAIF as required by H.R. 2491 would be deductible when paid.

---

[9] 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. The testimony did not discuss the proper Federal income tax accounting treatment for the assessment.

[10] 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.