TAX ASPECTS OF GOVERNMENT-ASSISTED ACQUISITIONS OF SAVINGS AND LOAN ASSOCIATIONS (H.R. 1135, H.R. 1326, H.R. 1338 AND H.R. 561)

Scheduled for a Hearing

before the

HOUSE COMMITTEE ON WAYS AND MEANS

on February 11, 1992

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Committee on Ways and Means has scheduled a public hearing on February 11, 1992, on the following four bills, which deal with tax aspects of government-assisted acquisitions of savings and loan associations:

(1) H.R. 1135, introduced on February 27, 1991, by Messrs. Guarini, Moody, Levin (Mich.), Rangel, Gradison, Gibbons, Schulze, Matsui, Thomas (Calif.), Donnelly, Bunning, Sundquist, Chandler, Mrs. Johnson (Conn.), and others;

(2) H.R. 1326, introduced on March 7, 1991, by Mr. Dorgan;

(3) H.R. 1338, introduced on March 7, 1991, by Messrs. Guarini and Moody; and

(4) H.R. 561, introduced on January 18, 1991, by Mr. Donnelly.

This document,[1] prepared by the staff of the Joint Committee on Taxation in connection with the hearing, provides a summary of the bills (Part I), background information concerning present law (Part II), and descriptions of the four bills (Part III).

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[1] This document may be cited as follows: Joint Committee on Taxation, Tax Aspects of Government-Assisted Acquisitions of Savings and Loan Associations (H.R. 1135, H.R 1326, H.R. 1338, and H.R. 561) (JCX-2-92), February 7, 1992.

I. SUMMARY OF THE BILLS

H.R. 1135

Under the bill, any Federal Savings and Loan Insurance Corporation (FSLIC) assistance payable with respect to any loss of principal, capital, or similar amount upon the disposition of any asset would be taken into account for purposes of determining whether a loss is deductible. In addition, any FSLIC assistance payable with respect to any debt would be taken into account for purposes of determining the amount of any bad debt deduction.

In general, the bill would apply to FSLIC financial assistance paid with respect to any asset disposed of on or after January 1, 1991, to which the special rules of the 1981 Act applicable to FSLIC assistance payment apply. However, the bill would not apply to (1) any amount received by a taxpayer to the extent that the IRS had issued prior to January 1, 1991, a ruling or a closing agreement expressly providing that such amount shall not be taken into account in determining the amount of any deductible loss or bad debt deduction or (2) any FSLIC financial assistance provided with respect to deductions or losses recognized prior to the commitment to pay such assistance. Further, the bill provides that the provisions should not be construed as affecting any private contractual rights and remedies that are otherwise available to parties of agreements for the provision of Federal financial assistance.

H.R. 1326

The bill is similar to H.R. 1338. In addition, H.R. 1326 provides that nothing in section 597 of the Internal Revenue Code ("Code") would be construed to exclude from gross income any amount paid by the FSLIC, the FSLIC Resolution Fund, the Resolution Trust Corporation (RTC), or the Federal Deposit Insurance Corporation (FDIC) for the repurchase of an asset or to exclude such amount in determining the amount of any gain or loss under section 1001 of the Code.

The bill would apply to taxable years ending after December 31, 1980. H.R. 1326 does not contain the exceptions to the effective date for (1) taxpayers that had received an IRS ruling or closing agreement, or (2) amounts provided with respect to deductions or losses recognized prior to the commitment to pay such assistance. Finally, H.R. 1326 does not contain a special rule relating to the effect of the bill on any contracts rights of the taxpayer.

H.R. 1338

The bill is the same as H.R. 1135, except that H.R. 1338 would apply to FSLIC financial assistance paid with respect to any asset disposed of on or after January 1, 1981 (rather than on or after January 1, 1991, as under H.R. 1135). All other provisions of H.R. 1338 are the same as those of H.R. 1135, including the general rule, the exceptions to the effective date, and the contracts rights provision.

H.R. 561

The bill would impose a recapture tax equal to the net tax benefits accruing to an affiliated group of corporations by reason of certain acquisitions of a domestic building and loan association. The recapture tax would be imposed if a building and loan association either (1) becomes subject to the jurisdiction of a bankruptcy court or the FSLIC or (2) receives Federal financial assistance (other than assistance pursuant to the acquisition). The bill would apply to acquisitions that occurred after November 10, 1988, and before January 1, 1989, and with respect to which the FSLIC (or its successor) provided money or other property to which section 597 (as in effect before the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)) applied. The amount of any recapture tax would be basically (1) the aggregate reduction in the taxes of the affiliated group from the losses of the domestic building and loan association which were incurred after January 3, 1991, reduced by (2) the amount (if any) required to paid to the FSLIC (or its successor) in respect to the tax reductions pursuant to the agreement for the acquisition. This provision of the bill would apply to taxable years ending after January 3, 1991.

In addition, the bill would provide that, for certain purposes, the earnings and profits of a member of a consolidated group would not include any amount excluded from income under section 597 (as in effect before the enactment of FIRREA). Thus, under the bill, a member of a consolidated group that owns stock in a domestic savings and loan generally would not increase the basis of such stock by the amount of any Federal financial assistance excluded from gross income. This provision of the bill would apply to dispositions after January 3, 1991.

II. BACKGROUND AND PRESENT LAW

Background

Prior to the enactment of the FIRREA, the FSLIC insured the deposits of its member thrift institutions and was responsible for the resolution of insolvent member institutions.[2] Pursuant to this responsibility, the FSLIC entered into agreements that obligated it to give assistance, generally in the form of cash or notes, to acquirers of financially troubled thrift institutions. Such assistance was provided in a variety of circumstances. FSLIC frequently agreed to pay acquirers so-called "covered asset loss" assistance in an amount equal to the difference between the book value of "covered assets" and the proceeds received upon disposition, or the value determined on a write-down, of the covered asset. FSLIC also frequently agreed to (1) provide assistance in amounts specifically determined to offset the negative net worth of the acquired thrift institution as of the date of acquisition, (2) guarantee the yield on certain assets, and/or (3) reimburse the thrift institution for certain operating expenses. Many of the agreements contain provisions regarding the allocation, as between FSLIC and the acquirer of the troubled institution, of certain tax benefits.[3]

Special tax rules relating to the acquisition of a financially troubled thrift institution

Prior to their amendment in 1989, special rules governed the tax consequences of an acquisition of a troubled thrift institution. Under these rules, FSLIC financial assistance to the thrift institution was excludible from gross income and did not result in a reduction of the basis of assets held by the institution (sec. 597 as in effect before May 10, 1989). These rules also generally enabled the acquisition of troubled institutions to occur on a tax-free basis, giving the acquirer a carryover basis in the assets of an acquired institution and the ability to utilize tax attributes, including net operating losses, of the acquired institution.

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[2] Under FIRREA, the assets and liabilities of the FSLIC were transferred to the FDIC and the RTC.

[3] See, "Report to the Oversight Board of the Resolution Trust Corporation and the Congress on the 1988/89 Federal Savings and Loan Insurance Corporation Assistance Agreements", September 18, 1990, (the "RTC Report") Vol. I, pp. 47-49.

The special rules were repealed by FIRREA, but remain applicable to acquisitions of thrift institutions before the enactment of FIRREA (sec. 1401 of FIRREA).[4]

Tax treatment of losses

A taxpayer is allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise (sec. 165). The amount of loss attributable to the disposition of an asset generally is determined as the excess of the adjusted basis of the asset over the amount realized upon the disposition (sec. 1001).

Tax treatment of bad debts

Under present law, taxpayers are permitted a deduction for any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless. If a thrift institution holds 60 percent of its assets in so-called "qualifying assets" (generally cash, government obligations, and loans secured by residential real property), the institution is eligible to compute its bad debt deduction under either the specific charge-off method or a reserve method.

Under the specific charge-off method, the bad debt deduction is determined separately with respect to each debt held by the taxpayer. The deduction generally is allowed for the year that the taxpayer can prove that the debt became partially or wholly worthless.

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[4] Under the Technical Corrections and Miscellaneous Revenue Act of 1988 (TAMRA), taxpayers were required to reduce certain tax attributes by one-half of the amount of financial assistance received from the FSLIC or the FDIC pursuant to acquisitions of certain financially troubled depository institutions occurring after December 31, 1988 and prior to the enactment of FIRREA. The following attributes were to be reduced, in the following order: (1) net operating losses, (2) interest with respect to which a deduction is allowable for the taxable year, and (3) recognized built-in losses for the taxable year on the loan portfolio, on marketable securities, and on property acquired pursuant to foreclosure.

TAMRA also provided, in a technical correction to the Tax Reform Act of 1986, that no deduction would be disallowed under any part of section 265 (which denies deductions for certain items allocated to tax-exempt income) by reason of the allocation of the deduction to income exempt from tax under section 597.

Under the reserve method, the taxpayer may deduct annually an addition to its bad debt reserve calculated under either the experience method or the percentage of taxable income method.

Under the experience method, the taxpayer's bad debt reserve cannot exceed a percentage of total loans outstanding equal to the average ratio of total bad debts to total debt outstanding in the current and 5 preceding taxable years. The reserve is reduced by the amount of any bad debt actually written-off during a period and increased by any recovery during the period with respect to a debt written off in a prior period. The taxpayer is then allowed a deduction during the period only for the amount (if any) needed to increase the reserve to the appropriate level.

Under the percentage of taxable income method, a thrift institution is allowed a deduction for additions to its loan loss reserve equal to 8 percent of its taxable income (subject to certain adjustments and limitations) for the taxable year.

Treasury Report

In March, 1991, the Treasury Department issued a report (the "Treasury Report") addressing the tax consequences of certain forms of financial assistance provided by the FSLIC pursuant to assistance transactions.[5]

The Treasury Report concludes that assisted institutions should not be allowed to deduct covered capital losses or certain expenses that are reimbursed by the FSLIC or its successors. In general, the Treasury Report reasons that there is no economic loss to be recognized to the extent of FSLIC assistance. Furthermore, the Treasury Report reasons that any loss should not be deductible because it is compensated for by insurance or otherwise within the meaning of the general loss deduction provision of section 165. Similar reasoning is applied for purposes of determining whether acquirers should be allowed bad debt deductions.

The Treasury Report observes that taxpayers may contest this interpretation of the loss provisions. The Treasury Report states that the IRS is prepared to challenge and litigate, if necessary, the deductibility of covered losses and expenses.

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[5] Department of the Treasury, "Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions," March, 1991. This Treasury Report was undertaken as a result of tax issues raised in the earlier RTC Report (footnote 3, supra).

President's budget proposal

The President's fiscal year 1993 budget proposal[6] provides that Federal financial assistance with respect to any loss would be taken into account as compensation for purposes of section 165 of the Code and in determining the worthlessness of any debt. The proposal would apply to financial assistance credited on or after March 4, 1991, with respect to: (1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991; and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for purposes of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991.

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[6] Budget of the United States Government for Fiscal Year 1993, Part Two-8. This proposal is included in section 374 of H.R. 4150 (introduced by Mr. Michel and others on February 4, 1992).

III. DESCRIPTION OF THE BILLS

1. H.R. 1135 (Messrs. Guarini, Moody, Levin, Rangel, Gradison, Gibbons, Schulze, Matsui, Thomas, Donnelly, Bunning, Sundquist, Mrs. Johnson, and others)

In general

Under the bill, any FSLIC assistance payable with respect to any loss of principal, capital, or similar amount upon the disposition of any asset would be taken into account as compensation for such loss under section 165 of the Code. In addition, any FSLIC assistance payable with respect to any debt would be taken into account for purposes of sections 166, 585, or 593 of the Code in determining whether such debt is worthless (or to the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts arising from the worthlessness or partial worthlessness of such debts.

For this purposes, the term "FSLIC assistance" would mean any money or other property provided with respect to a domestic building and loan association by the FSLIC, the FSLIC Resolution Fund, or the RTC, pursuant to section 460(f) of the National Housing Act or section 21A of the Federal Home Loan Bank Act (or under any similar provision of law).

Effective date

In general, the bill would apply to FSLIC financial assistance paid with respect to any asset disposed of on or after January 1, 1991. However, the bill would not apply to: (1) any payment to which the amendments made by section 1401(a)(3) of FIRREA apply (generally, those payments that must be included in the income of the recipient); (2) any amount received by a taxpayer to the extent that the IRS has issued, in writing, to the taxpayer prior to January 1, 1991, an IRS ruling or a closing agreement expressly providing that such amount shall not be taken into account in determining the amount of any loss under section 165 of the Code or in determining the worthlessness or partial worthlessness of an asset for purposes of section 166, 585, or 593 of the Code; and (3) FSLIC financial assistance provided with respect to deductions or losses recognized prior to the commitment to pay such assistance.

Contract rights

The bill would provide that nothing in the bill should be construed as affecting any private contractual rights and remedies that are otherwise available to parties of agreements for the provision of Federal financial assistance.

2. H.R. 1326 (Mr. Dorgan)

Under the bill, any section 597 payment with respect to any loss of principal, capital, or similar amount upon the disposition of any asset would be taken into account as compensation for such loss under section 165 of the Code. In addition, any section 597 payment with respect to any debt would be taken into account for purposes of sections 166, 585, or 593 of the Code in determining whether such debt is worthless (or to the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts arising from the worthlessness or partial worthlessness of such debts.

For this purposes, the term "section 597 payment" would mean any assistance provided after December 31, 1980, if section 597 of the Code (as in effect with respect to such assistance) excluded such assistance from gross income. Such term would not include payments to which the amendments made by section 1401(a)(3) of FIRREA apply (generally, those payments that must be included in the income of the recipient).

Further, the bill would provide that nothing in section 597 of the Code should be construed to exclude from gross income any amount paid by the FSLIC, the FSLIC Resolution Fund, the RTC, or the FDIC for the repurchase of an asset or to exclude such amount in determining gain or loss under section 1001 of the Code.

The bill would apply to taxable years ending after December 31, 1980.

3. H.R. 1338 (Messrs. Guarini and Moody)

In general

Under the bill, any FSLIC assistance payable with respect to any loss of principal, capital, or similar amount upon the disposition of any asset would be taken into account as compensation for such loss under section 165 of the Code. In addition, any FSLIC assistance payable with respect to any debt would be taken into account for purposes of sections 166, 585, or 593 of the Code in determining whether such debt is worthless (or to the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts arising from the worthlessness or partial worthlessness of such debts.

For this purposes, the term "FSLIC assistance" would mean any money or other property provided with respect to a domestic building and loan association by the FSLIC, the FSLIC Resolution Fund, or the RTC, pursuant to section 460(f)

of the National Housing Act or section 21A of the Federal Home Loan Bank Act (or under any similar provision of law).

Effective date

In general, the bill would apply to FSLIC financial assistance paid with respect to any asset disposed of on or after January 1, 1981. However, the bill would not apply to: (1) any payment to which the amendments made by section 1401(a)(3) of FIRREA apply (generally, those payments that must be included in the income of the recipient); (2) any amount received by a taxpayer to the extent that the IRS has issued, in writing, to the taxpayer prior to January 1, 1991, an IRS ruling or a closing agreement expressly providing that such amount shall not be taken into account in determining the amount of any loss under section 165 of the Code or in determining the worthlessness or partial worthlessness of an asset for purposes of section 166, 585, or 593 of the Code; and (3) FSLIC financial assistance provided with respect to deductions or losses recognized prior to the commitment to pay such assistance.

Contract rights

The bill would also provide that nothing in the bill should be construed as affecting any private contractual rights and remedies that are otherwise available to parties of agreements for the provision of Federal financial assistance.

4. H.R. 561 (Mr. Donnelly)

Recapture of certain tax benefits

The bill would impose a recapture tax if a domestic building and loan association became a member of an affiliated group by reason of certain acquisitions and, after January 3, 1991, became subject to a recapture event. A building and loan association would be subject to a recapture event if it either (1) becomes subject to the jurisdiction of a court in a title 11 or similar case (as defined in section 368(a)(3) of the Code), or (2) receives Federal financial assistance (other than assistance pursuant to the acquisition). The bill would apply to acquisitions that occurred after November 10, 1988, and before January 1, 1989, and with respect to which the FSLIC (or its successor) provided money or other property to which section 597 (as in effect before the enactment of FIRREA) applied.

The amount of recapture tax would be (1) the aggregate reduction in the tax imposed on the members of the affiliated group by reasons of losses of the domestic building and loan association which were incurred after January 3, 1991, and

which offset income of other members of the group which were neither domestic building and loan associations nor banks, reduced by (2) the amount (if any) required to paid to the FSLIC (or its successor) in respect to the tax reductions pursuant to the agreement for the acquisition. The recapture tax would be imposed on the common parent of the group for the taxable year in which the domestic building and loan association becomes subject to the recapture event. The recapture tax would not be treated as a tax for purposes of determining the amount of any allowable credit or the amount of any minimum tax liability.

This provision of the bill would apply to taxable years ending after January 3, 1991.

Treatment of assistance in determining earnings and profits

In addition, the bill would provide a special rule for purposes of determining the adjusted tax basis of the stock of a subsidiary of an affiliated group of corporations filing a consolidated tax return. Under the special rule, earnings and profit would not include any amount excluded from income under section 597 (as in effect before the enactment of FIRREA). Thus, under the bill, a member of a consolidated group that owns stock in a domestic savings and loan generally would not increase the basis of such stock by the amount of any Federal financial assistance excluded from gross income.

This provision of the bill would apply to dispositions after January 3, 1991. For this purpose, any event resulting in the inclusion of an excess loss account would be treated as a disposition.