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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CC:2001-01
January 29, 2001
Attachment 1

ACTION ON DECISION

SUBJECT: Security State Bank v. Commissioner
214 F.3d 1254 (10th Cir. 2000), aff'g 111 T.C. 210 (1998)
T.C. Dkt. No. 15478-96

Issue

Whether a cash method bank that makes short-term loans in the ordinary course of its business is subject to accrual of the stated interest on those loans under section 1281(a)(2) or, in the alternative, under section 1281(a)(1).

Discussion:

Taxpayer was a bank (as defined under section 581) that used the cash receipts and disbursements method of accounting. Taxpayer made a variety of loans to its customers in the ordinary course of its business, including loans with a maturity date of one year or less from the first anniversary of the loan's issue date. The loans at issue provided for a payment of stated interest at maturity. Taxpayer reported the interest on the loans when it was received. The Commissioner argued that the interest should have been included in gross income as it accrued under section 1281(a)(2) or, in the alternative, under section 1281(a)(1).

This issue was one that the Commissioner had previously litigated and lost in Security Bank Minnesota v. Commissioner, 98 T.C. 33 (1992), aff'd, 994 F.2d 432 (8th Cir. 1993). In that case, both the Tax Court and the Eighth Circuit held that section 1281(a)(2) did not apply to loans made in the ordinary course of business, but rather to purchased debt instruments with discount. Finding that the statute was ambiguous, the courts looked to the legislative history of section 1281 and concluded that Congress

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was concerned with obligations purchased at a discount and not loans made by a bank in the ordinary course of its business. The courts further reasoned that the loans at issue did not create the problem section 1281 was intended to address, which the courts noted as the tax deferral resulting from leveraged purchases of short-term discount obligations.

In an Action on Decision (“AOD”) for Security Bank Minnesota, 1995-2 C.B. 2, the Commissioner stated that it was nonacquiescing and that it would continue to litigate this issue outside the Eighth Circuit. Security State Bank was the first case to be litigated outside the Eighth Circuit.

In Security State Bank, both the Tax Court and the Tenth Circuit held that neither section 1281(a)(1) nor section 1281(a)(2) were applicable to short-term loans made in the ordinary course of business. As a result, the courts held that the taxpayer was not required to report accrued interest or original issue discount on these loans as taxable income until the year the interest was actually received. Both courts applied the same reasoning used by the Tax Court and the Eighth Circuit in Security Bank Minnesota. In addition, the Tax Court and the Tenth Circuit also rejected the Commissioner’s alternative argument that, because the stated interest on the loans was original issue discount, the stated interest was subject to section 1281(a)(1). This argument was not raised in Security Bank Minnesota. However, the courts used the same reasoning as that set forth for the section 1281(a)(2) argument to reject the section 1281(a)(1) argument; section 1281 does not apply to loans made in the ordinary course of business.

Although the Commissioner does not agree with the Eighth and Tenth Circuits’ holdings that section 1281 does not apply to loans made in the ordinary course of business, the Commissioner will not continue to litigate this issue in any other circuit if the issue falls strictly within the parameters of the Security Bank Minnesota and Security State Bank opinions. If the issue falls outside of those parameters, for example, because the taxpayer uses an accrual method of accounting or the short-term

obligations are not loans made in the ordinary course of business, the Commissioner may litigate that issue. This AOD, therefore, revises the Security Bank Minnesota AOD.

Recommendation:

Acquiescence

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