

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) *Computation of tax.* In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following), chapter 1 of the Code, with respect to life insurance companies.

§ 1.595-1 Treatment of foreclosed property by certain creditors.

(a) *Nonrecognition of gain or loss on the acquisition of security property by certain creditors—(1) In general.* Section 595(a) provides that in the case of a creditor which is an organization described in section 593(a) (that is, a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless for purposes of section 166 (relating to bad debts), as the result of a transaction by which such creditor bids in at foreclosure, or reduces to ownership or possession by agreement or process of law, any property (whether real or personal, tangible or intan-

gible) which was security for the payment of any indebtedness (whether or not a qualifying real property loan as defined in section 593(e)(1)). The treatment provided by section 595(a) is mandatory (regardless of whether such creditor utilizes the specific deduction or reserve method of accounting for bad debts) if, for the taxable year in which the property is bid in at foreclosure, or reduced to ownership or possession by agreement or process of law, the creditor is an organization described in section 593(a), even though the creditor subsequently becomes an organization not described in section 593(a). For definition of the terms *domestic building and loan association* and *cooperative bank* for taxable years beginning after October 16, 1962, see paragraphs (19) and (32), respectively, of section 7701(a).

(2) *Effective date.* Section 595 applies to any transaction (described in subparagraph (1) of this paragraph) occurring after December 31, 1962, except that such section does not apply to any such transaction in which the taxable event determined without regard to section 595 (that is, the sale or exchange to the creditor of the security property by reason of the default or anticipated default of the debtor) occurred before January 1, 1963.

(b) *Rules for determining when security property is reduced to ownership or possession by agreement or process of law—*

(1) *Ownership or possession.* For purposes of this section, security property shall be considered as reduced to ownership or possession by agreement or process of law on the earliest date on which the creditor, by reason of the default or anticipated default of the debtor:

(i) Acquires, by agreement or process of law, a title to, or a right or interest in, the security property which under local law is indefeasible and which the creditor can validly dispose of apart from the indebtedness which the property secures, or

(ii) Acquires, by agreement or process of law, an enforceable right to direct the use to which the security property shall be put, including, in the case of real property, whether or not the property shall continue to be occupied

by the debtor who has defaulted (regardless of whether such creditor has obtained indefeasible title to the property), or

(iii) Sells or otherwise disposes of the security property or any interest therein.

(2) *Agreement or process of law.* The reduction of security property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the debtor (including a conveyance directly to the Federal Housing Commissioner) and abandonment to the creditor. The reduction of security property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(c) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. On January 31, 1963, X, a creditor which is an organization described in section 593(a), purchases at a foreclosure sale residential real property which was security for a debt owing to X, and with respect to which the debtor has defaulted. Under local law, there is a 1-year statutory redemption period (during which period the debtor is entitled to remain in possession) so that X must wait until February 1, 1964, to obtain indefeasible title to the property. No gain or loss is recognized by reason of the purchase at the foreclosure sale on January 31, 1963. However, the date on which the security property is considered as reduced to ownership or possession by agreement or process of law is February 1, 1964. If, under local law, there were no statutory redemption period so that X obtained indefeasible title to the security property at the foreclosure sale, the date on which the security property would be considered as so reduced is January 31, 1963. Furthermore, with respect to either of the preceding situations, if the foreclosure sale had occurred on November 1, 1962 (instead of on January 31, 1963), section 595 would not apply to the transaction since the taxable event in respect of such transaction occurred prior to January 1, 1963.

Example 2. The facts are the same as in example 1, except that instead of purchasing the property at a foreclosure sale, X, pursuant to the provisions of local law, enters upon the security property on January 31, 1963, and acquires an enforceable right to direct whether the property shall continue to be occupied by the debtor. X does not obtain indefeasible title to the property until February 1, 1964. The date on which the security property is considered as reduced to ownership or possession by agreement or process of law is January 31, 1963.

(d) *Basis of acquired property.* Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as *acquired property*) shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law. For purposes of determining the adjusted basis of the indebtedness for which the acquired property was security, there shall be included the amount of any unpaid interest with respect to such indebtedness, but only to the extent that it has been included in gross income. The basis of the acquired property, as determined under this paragraph, shall be adjusted in accordance with the rules provided in paragraph (e) of this section.

(e) *Characteristics of acquired property—(1) Depreciation; decline in fair market value.* Section 595(b) provides, in part, that for purposes of section 166 (relating to bad debts) acquired property shall be considered as property having the same characteristics as the indebtedness for which such property was security. Thus, no deduction for

exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed to a creditor with respect to acquired property. However, if, at any time, the adjusted basis of the acquired property exceeds the fair market value of such property (determined by proper appraisal and without regard to any outstanding right of redemption), and the creditor can establish (in the same manner as worthlessness in whole or in part is established for purposes of section 166) that an amount equal to any portion of such excess will not be collected with respect to the indebtedness for which such property was security, the creditor may treat such portion, under the provisions of section 166, as a worthless debt. In such case, the basis of the acquired property shall be reduced by the amount treated as a worthless debt.

(2) *Example.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, a creditor which is an organization described in section 593(a), makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. In 1963, A defaults in his payments on a debt owed to X which is secured by residential real property. X reduces the property to ownership or possession by agreement or process of law by bidding it in at a foreclosure sale for \$23,000. The adjusted basis of the indebtedness at the date of acquisition of the property (increased for costs of acquisition) is \$25,000, and this amount becomes the basis of the acquired property. X obtains a deficiency judgment against A for \$2,000. Later in 1963, a proper appraisal enables X to establish that the fair market value of the property is \$18,000. X is also able to establish (under the rules of section 166 and the regulations thereunder) that due to A's poor financial condition only \$1,000 can be collected on the outstanding deficiency judgment. For the year 1963, X may charge its bad debt reserve for \$6,000, computed as follows:

Basis of acquired property	\$25,000
Less: Fair market value of acquired property	18,000
Excess	7,000
Less: Collectible portion of deficiency judgment ...	1,000
Portion of excess treated as worthless debt	6,000

(3) *Capital improvements made after date of acquisition not treated as acquired property.* Except as provided in subparagraph (4) of this paragraph, the term *acquired property* does not include

capital improvements made after the date of (acquisition within the meaning of paragraph (d) of this section) of the property. Thus, the applicable deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed, if otherwise allowable, for improvements which are made by the creditor with respect to acquired property and which are properly chargeable to the capital account. If the creditor sells or otherwise disposes of the acquired property with such capital improvements, any amount realized by reason of such sale or other disposition shall be allocated in proportion to the respective fair market values of the acquired property and such capital improvements. The portion of the amount realized which is allocable to the acquired property shall be treated in accordance with the rules prescribed in subparagraph (6) of this paragraph. The portion of the amount realized which is allocable to such capital improvements shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to section 595.

(4) *Treatment of minor capital improvements as acquired property.* A creditor may treat any minor capital improvements which it makes to a particular acquired property after the date of acquisition (within the meaning of paragraph (d) of this section) in the same manner as the acquired property, provided such creditor treats all minor capital improvements with respect to that particular acquired property in such manner. For purposes of section 595, a capital improvement shall be considered as *minor* only if the cost of such improvement does not exceed \$3,000.

(5) *Records for capital improvements.* For purposes of subparagraphs (3) and (4) of this paragraph, the creditor must maintain such records as are necessary to clearly reflect, with respect to each particular acquired property, the cost of each capital improvement and whether the taxpayer treated minor capital improvements with respect to such property in the same manner as the acquired property.

(6) *Amounts realized with respect to acquired property.* Section 595(b) provides,

in part, that any amount realized with respect to acquired property shall be treated as a payment on account of the indebtedness for which such property was security, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to bad debts) apply. An amount realized with respect to acquired property means an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor (including amounts received under an insurance contract with the Federal Housing Administration or a guarantee by the Veterans' Administration), and collections on a deficiency judgment obtained against the debtor (other than amounts treated as interest under applicable local law). Amounts realized with respect to acquired property include amounts which otherwise would be treated in the manner prescribed in section 351 (relating to transfer to a corporation controlled by transferor), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 453 (relating to installment method), section 1031 (relating to exchange of property held for productive use or for investment), or section 1033 (relating to involuntary conversions). For purposes of section 595(b), if a corporation distributes acquired property in a distribution to which section 311 (relating to taxability of corporation on distribution) or section 336 (relating to nonrecognition of gain or loss to a corporation on distribution of its property in partial or complete liquidation) applies, the fair market value of the acquired property at the time of the distribution shall be treated as an amount realized with respect to such property. However, no amount shall be considered realized by reason of the distribution or transfer of acquired property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, and in the case of such a distribution or transfer the acquired property shall be treated by the distributee or transferee as having the same characteristics as it had in the hands of the distributor or transferor at the time of such distribution

or transfer. The following rules shall apply to amounts realized with respect to acquired property:

(i) Any amount realized shall be applied against and reduce the adjusted basis of the acquired property, and to the extent that such amount exceeds the adjusted basis, it shall, in the case of a creditor using the specific deduction method of accounting for bad debts, be included in gross income as ordinary income, or, in the case of a creditor using the reserve method of accounting for bad debts, be credited to the appropriate bad debt reserve (that is, the reserve for losses on qualifying real property loans or the reserve for losses on nonqualifying loans). Any amounts credited during the taxable year to a reserve for bad debts pursuant to this subdivision shall not be considered as a part of the addition under section 593 for such year, but shall be included in the balance of the reserve for purposes of computing such addition to the reserve for such taxable year. Thus, for example, an amount credited to the reserve for losses on qualifying real property loans during a taxable year shall not be considered as a part of the addition to such reserve computed under the percentage of taxable income method. However, the amount of such credit shall be included in the balance of such reserve for the purpose of determining the amount necessary to increase the balance of such reserve (as of the close of such taxable year) to an amount equal to 3 percent of qualifying real property loans and for the purpose of determining whether such balance exceeds 6 percent of such loans.

(ii) If an amount realized on the sale or other disposition of the acquired property is insufficient to restore to the creditor the adjusted basis of the property, the difference between such adjusted basis and such amount realized shall be treated as a bad debt to which the provisions of section 166 apply. If the creditor subsequently realizes an additional amount with respect to the original indebtedness or the acquired property, such additional amount shall be treated as the recovery of a bad debt.

(7) *Treatment of rents, similar amounts, and expenses.* Section 595 does not

change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property. (See, however, subparagraph (1) of this paragraph for treatment of depreciation, etc.) Thus, for example, if the acquired property is a governmental obligation within the meaning of section 103 (relating to interest on certain governmental obligations), interest payments received by the creditor with respect to such obligation would not be included in gross income.

(8) *Examples.* The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example 1 (i) Facts. X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts. On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness \$20,000 principal and \$700 interest. X has previously included the \$700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling \$500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of \$400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses until October 1, 1964, at which time X sells the acquired property for \$22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., \$20,000 principal plus \$700 interest)	\$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
	20,800
Adjusted basis of acquired property at sale	20,800
Less: Portion of \$22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans (\$22,000 minus \$20,800)	1,200

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the \$1,200 portion of the sales proceeds would be treated as ordinary income.

Example 2 (i) Facts. The facts are the same as in example 1 except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) *Treatment of rents and expenses.* X includes in gross income the total rent receipts of \$400 and deducts (if otherwise allowable) the expenses of \$500.

(iii) *Treatment of sales proceeds.* As the result of the sale of the acquired property, X credits \$1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, i.e., \$20,000 principal plus \$700 interest)	\$20,700
Less: Portion of \$22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans (\$22,000 minus \$20,700)	1,300

(iv) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the \$1,300 portion of the sales proceeds would be treated as ordinary income.

Example 3 (i) Facts. The facts are the same in example 1 except that X sells the acquired property for \$15,000.

(ii) *Treatment of rents, expenses, and sales proceeds.* X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., \$20,000 principal plus \$700 interest)	\$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of \$15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
	5,800
Amount charged to reserve for losses on qualifying real property loans	5,800

(iii) *Creditor using specific deduction method.* If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of \$5,800 would be allowed as a specific bad debt deduction.

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