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Comments

THE FSLIC ADDITIONAL PREMIUM REQUIREMENT AND ITS TREATMENT UNDER THE INTERNAL REVENUE CODE

The purpose of this paper is to explain a unique and specialized provision, the additional premium requirement of the Federal Savings and Loan Insurance Corporation. This discussion will include a summary of applicable savings and loan association history prior to the enactment of the requirement, a survey of the circumstances which led to the necessity for such a provision, and a review of the litigation which produced a definition of the requirement.

I. EARLY SAVINGS AND LOAN ASSOCIATIONS

The earliest savings and loan associations¹ in the United States were based on the theory of the English "building societies,"² which in turn were the outgrowth of "friendly societies"—small, local cooperative groups whose members made weekly contributions which entitled them and their families to benefits in the event of death, illness, accident, fire, sometimes unemployment, or certain other major calamities.³ The building societies were similar in organization to the friendly societies; their purpose, however, was to provide a medium to invest savings and to obtain loans to finance home building.⁴

The first savings and loan association in the United States, the Oxford Provident Building Association, was organized in 1831 in Frankford, Pennsylvania, on the building society principle: "1) the regular payment by each member, each week, of a small amount of money into a pool; and 2) the lending of the money in the pool to first one and then another of the members until each had acquired his

¹ "Savings and loan association" is used throughout this paper to denote thrift and home financing institutions which are called by a variety of names in the United States: savings and loan association, building and loan association, cooperative bank (in New England), homestead association (in Louisiana), building association, and savings association. *Preface to UNITED STATES SAVINGS AND LOAN LEAGUE, SAVINGS AND LOAN FACT BOOK 69 (1969)* [hereinafter cited as *FACT BOOK*].

² For a history of the building society, see H. BELLMAN, *BRICKS AND MORTALS* (1949).

³ L. KENDALL, *THE SAVINGS AND LOAN BUSINESS* 4 (1962) [hereinafter cited as *KENDALL*].

⁴ T. MARVELL, *THE FEDERAL HOME LOAN BANK BOARD* 6 (1969) [hereinafter cited as *MARVELL*].

home."⁵ The Oxford Provident was followed in 1836 by the Brooklyn Building and Mutual Loan Association. A third savings and loan association was organized in South Carolina in 1843.⁶ Thereafter, the number of savings and loan associations grew rapidly; in 1893, the first comprehensive census by the United States Commissioner of Labor indicated there were 5598 associations.⁷

As the number of savings and loan associations increased, their character changed. Personal participation by the members was superseded by professional management. The terminating association, which dissolved when each member had received a loan, and the serial plan association, which continued through the issuance of successive series of stock, were replaced by the permanent share plan association.⁸ The permanent share plan provided for separate accounts and earnings for shareholders. It attracted a new group of people who saved, not in order to borrow in the future,⁹ but to accumulate capital and earnings for personal purposes. The savings and loan association thus evolved from a group of friends into a permanent, formal business organization.

Prior to 1932, any law under which a savings and loan association operated was state law.¹⁰ A distinction was maintained between the supervision and the regulation of savings and loan associations: supervision involved the inspection or visitation of the association regarding the integrity of accounts and conformity with law; regulation concerned the determination of broad policies and practices. The United States Building and Loan League,¹¹ a voluntary, self-regulating organization of savings and loan associations and other groups interested in the savings and loan industry, and the various state leagues were

⁵ J. EWALT, *A BUSINESS REBORN* 373 (1962) [hereinafter cited as EWALT].

The Oxford Provident was what is known as a terminating society: It was to serve its purpose for the 37 original members and then cease its operations. The only way in which a new person could join was to buy the shares of an original member who wanted to drop out. It actually terminated in 10 years and was succeeded immediately by Oxford Provident No. 2; this was followed by still another, the Oxford Provident No. 3. *Id.* at 373-74.

⁶ KENDALL, *supra* note 3, at 5.

⁷ EWALT, *supra* note 5, at 386. These 5598 associations had a total membership, borrowers and savers, of 1,349,437, with total assets of \$473,137,454. *Id.*

⁸ KENDALL, *supra* note 3, at 5.

⁹ EWALT, *supra* note 5, at 378-79.

¹⁰ In 1931 all of the states except Maryland and South Carolina had some degree of regulation over savings and loan associations. EWALT, *supra* note 5, at 5; KENDALL, *supra* note 3, at 21.

¹¹ The name was changed to the United States Savings and Loan League by resolution at the 47th Annual Convention of the United States Building and Loan League, September, 1939. UNITED STATES SAVINGS AND LOAN LEAGUE, *SAVINGS AND LOAN ANNALS* 1939, at 475 (1940).

responsible for supervision; regulation was exercised exclusively by the legislative bodies through statutory enactment.¹²

II. FEDERAL REGULATION OF SAVINGS AND LOAN ASSOCIATIONS

The federal government did not make any provision for savings and loan associations until the Great Depression. Although their record was good in previous economic crises,¹³ the savings and loan associations came under considerable pressure in late 1930 and early 1931:

. . . unemployment, business failures and the collapse of real estate values had disrupted the usual home credit procedures. Foreclosures increased because of the inability of home owners to refinance their mortgage loans. Disaster overtook financial institutions, with repossessed property becoming a costly frozen asset which produced staggering losses as the depression deepened.¹⁴

Savings and loan associations were thus included in two general emergency relief measures, the Emergency Relief and Construction Act of 1932¹⁵ which set up the Reconstruction Finance Corporation (RFC)¹⁶ and the Home Owners' Loan Act of 1933¹⁷ which provided for the Home Owners' Loan Corporation (HOLC).¹⁸

Savings and loan associations were first eligible for government loans through the RFC. Such loans were made as early as March, 1932, and total borrowing amounted to \$118 million.¹⁹ The HOLC had authority to purchase delinquent home mortgages from savings and loan associations and other lending institutions and to refinance these mortgages over longer terms and at lower interest rates.²⁰ During its active lending life (1933-1936), the HOLC purchased approximately \$770 million of savings and loan mortgages.²¹

More important than the RFC and HOLC were the two permanent organizations formed with specific reference to the needs of the savings

¹² M. BODFISH, *THE DEPRESSION EXPERIENCE OF SAVINGS AND LOAN ASSOCIATIONS IN THE UNITED STATES* 9 (1935).

¹³ The savings and loan associations survived the depressed economy of the 1890's and the panic of 1893 with only minor losses in overall growth and a small number of failures. By 1904, they had regained their pattern of rapid yearly growth. MARVELL, *supra* note 4, at 8; KENDALL, *supra* note 3, at 6.

¹⁴ FACT BOOK, *supra* note 1, at 109.

¹⁵ Ch. 520, 47 Stat. 709.

¹⁶ *Id.* § 1(a).

¹⁷ Ch. 64, 48 Stat. 128.

¹⁸ *Id.* § 4(a).

¹⁹ EWALT, *supra* note 5, at 35-36.

²⁰ MARVELL, *supra* note 4, at 24.

²¹ KENDALL, *supra* note 3, at 7.

and loan industry. The Federal Home Loan Bank Act,²² which created the Federal Home Loan Bank Board (FHLBB) and the several Federal Home Loan Banks, was designed "both to take care of this emergency situation and to function as a permanent institution, thus eliminating, to a large extent, the probability of a recurrence of the present distressing conditions in the small mortgage field."²³

The fundamental purpose of the regional Federal Home Loan Banks is to provide a central reserve credit facility to supplement the resources of the member institutions (the institutions which have subscribed to the stock of a Federal Home Loan Bank). In performing this function, the Banks also serve as sources of secondary liquidity in meeting seasonal or other unanticipated changes in mortgage loan demand or in savings withdrawals.²⁴ The Federal Home Loan Banks obtain funds from three principal sources: members' deposits, sale of their own obligations, and issuance of capital stock to members.²⁵

The issuance of capital stock is the aspect of the Federal Home Loan Bank System relevant to the subsequent adoption of the additional premium requirement. The Federal Home Loan Bank Act provided that the stock subscription for a member institution would be one per centum of its aggregate home mortgage loans.²⁶ It further specified that expenditures by the United States for the purchase of stock would not exceed \$125 million.²⁷ The \$125 million was not a subsidy to the new agency, but rather an advance of government credit to allow it to begin operations, similar to the advance of capital which started the Federal Reserve System.²⁸ The government held the greatest amount of stock in 1945 with an investment of almost \$125 million. By 1948 member-held stock exceeded that of the government.²⁹ Legislation enacted in 1950³⁰ as part of the program to accelerate the retirement of government stock increased the required stockholding to two per centum. By July, 1951, the last of the government-held stock had been retired.³¹

The second permanent organization was the Federal Savings and Loan Insurance Corporation (FSLIC), a government corporation

²² 12 U.S.C. §§ 1421-49 (1971).

²³ H.R. REP. No. 1418, 72d Cong., 1st Sess. 4 (1932).

²⁴ FACT BOOK, *supra* note 1, at 109.

²⁵ THE FEDERAL HOME LOAN BANKS, THE FEDERAL HOME LOAN BANK SYSTEM 29 (1961).

²⁶ Ch. 522, § 6(c), 47 Stat. 725 (1932).

²⁷ *Id.* at § 6(f).

²⁸ UNITED STATES BUILDING AND LOAN LEAGUE, BUILDING AND LOAN ANNALS 1932, at 18 (1932).

²⁹ FACT BOOK, *supra* note 1, at 113.

³⁰ Act of June 27, 1950, ch. 369, § 2, 64 Stat. 256.

³¹ FACT BOOK, *supra* note 1, at 113.

created by Title IV of the National Housing Act³² to insure the accounts of savings and loan associations up to \$5000 per investor.³³ The mechanics of Title IV were relatively simple: the payment of insurance premiums of one-fourth of one per centum of the total of accounts plus creditor obligations³⁴ was compulsory for Federal associations and optional for state-chartered associations.³⁵

Title IV was added to the National Housing Act to soften the opposition of the savings and loan industry to other sections of the Act, particularly the provision for home mortgage insurance which the industry felt would allow banks and insurance companies too much leverage in a sphere it considered to be its own.³⁶ The FSLIC was not the panacea for savings and loan industry opposition which the drafters thought it would be. It was widely criticized—generally, as a regulatory measure for an industry whose leaders were opposed to government regulation,³⁷ and specifically, as an inequitable measure, since premiums were based on total accounts although a particular account could only be insured for \$5000.³⁸

However, the benefits of the FSLIC—safety to small savers, attraction of funds which otherwise might be deposited in FDIC-insured institutions, and freedom from the threat of savings account runs³⁹—outweighed the disadvantages, and savings and loan associations slowly began to be protected by the FSLIC.⁴⁰ The FSLIC gained

³² 12 U.S.C. § 1725(a) (1971).

³³ National Housing Act, ch. 847, § 405(a), 48 Stat. 1246 (1934). The present limitation on insurance of savings accounts in insured institutions is \$20,000. 12 U.S.C. § 1728(a) (1971).

³⁴ National Housing Act, ch. 847, § 404(a), 48 Stat. 1246 (1934).

³⁵ 12 U.S.C. § 1726(a) (1971).

³⁶ MARVELL, *supra* note 4, at 27-28.

³⁷ UNITED STATES BUILDING AND LOAN LEAGUE, BUILDING AND LOAN ANNALS 1934, at 602 (1934). The following statement by the Executive Vice-President of the United States Building and Loan League is indicative of savings and loan industry criticism:

I suppose that the credit institutions of the country, regardless of their character, honesty of purpose, and ability of management must submit to substantial regulation to pay for the sins of certain security speculators and some unscrupulous individuals in the commercial banking world. However, I differentiate vigorously between supervision and regulation. Frankly, I am for a maximum of supervision but a minimum of regulation. *Id.*

³⁸ . . . The present construction [of the Act] is, for example, that an association must pay $\frac{1}{4}$ of 1% per year, or \$250 on an account of \$100,000 which may be in the institution, although that account is only insured for \$5,000. In other words, on that particular account the rate of 5% per year is paid on the insurance coverage actually received. It is practically an unheard of proposition in insurance that the premium should be based on anything other than the amount of the insurance. *Id.* at 603.

³⁹ MARVELL, *supra* note 4, at 28.

⁴⁰ Six months after the National Housing Act was passed, only 450 institutions were insured. The most recent available figures indicate that 4438 institutions

(Continued on next page)

additional members when savings and loan industry lobbying resulted in reduction of the insurance premium to one-eighth of one per centum of total accounts plus creditor obligations in 1935⁴¹ and one-twelfth in 1950.⁴²

III. THE ADDITIONAL PREMIUM REQUIREMENT AND THE SECONDARY RESERVE

In 1961, it was determined that while stockholdings of the Federal Home Loan Banks had increased in line with the rapid growth of the member institutions, the reserves of the FSLIC had not.⁴³ Many authorities, including Chairman McMurray, felt that the Federal Home Loan Banks were overcapitalized.⁴⁴ In addition, the Banks had authority to obtain funds by selling their consolidated obligations on the open market.⁴⁵ On the other hand, the ratio of the FSLIC's reserves to potential liability had decreased from 0.843 per cent in 1950 to 0.661 per cent in 1961.⁴⁶ Therefore, the Federal Home Loan Bank Act and Title IV of the National Housing Act were amended to strengthen the FSLIC by building up its reserve funds, without imposing any undue burden on the insured institutions.

The 1961 amendment made three major changes pertinent to the topic under discussion. 1) It established a Primary Reserve, to which would be channeled the regular premium of one-twelfth of one per centum of total accounts plus creditor obligations.⁴⁷ 2) It established a Secondary Reserve, to which would be credited an "additional premium" equal to 2 per centum of the members' net account increase, less any amount required for the purchase of Federal Home Loan Bank stock.⁴⁸ This Secondary Reserve would be available to meet the

(Footnote continued from preceding page)

were insured in 1969. FEDERAL HOME LOAN BANK BOARD, SAVINGS AND HOME FINANCING SOURCE BOOK 1969, at 14 (1970) [hereinafter cited as SOURCE BOOK].

⁴¹ Act of May 28, 1935, ch. 150, § 25(a), 49 Stat. 293.

⁴² Act of June 27, 1950, ch. 369, § 7, 64 Stat. 256.

⁴³ S. REP. NO. 778, 87th Cong., 1st Sess. 11 (1961); *Hearings Before Subcomm. on Banking and Currency on H.R. 7108 and H.R. 7109*, 87th Cong., 1st Sess. 10 (1961).

⁴⁴ H.R. REP. NO. 823, 87th Cong., 1st Sess. 5 (1961). The paid-in stock and statutory reserves of the 11 Banks amounted to \$1,138,500,000 as compared with outstanding consolidated obligations of \$955 million. *Id.*

⁴⁵ S. REP. NO. 778, *supra* note 43, at 5.

⁴⁶ *Id.* at 11. In the same period, the assets of insured institutions had increased from \$13,691,000,000 to \$77,984,000,000. SOURCE BOOK, *supra* note 40, at 9.

⁴⁷ Act of September 8, 1961, Pub. L. No. 87-210, § 3, 75 Stat. 482, as amended 12 U.S.C. §§ 1727(a), (b)(1) (1971).

⁴⁸ Act of September 8, 1961, Pub. L. No. 87-210, §§ 3, 6, 75 Stat. 482, as amended 12 U.S.C. §§ 1727(a), (d)(3) (1971).

FSLIC's losses only if the FSLIC's other reserves were insufficient. A pro rata return equal to the FSLIC's yield on investments in U.S. obligations would be credited to the Secondary Reserve.⁴⁹ This amendment also provided several ways in which a savings and loan association could cease making these payments and recover its pro rata share of the Secondary Reserve.⁵⁰ 3) It reduced the required Federal Home Loan Bank stockholding to 1 per centum of the aggregate unpaid loan principal.⁵¹

The Committee Reports indicate that, in terms of the effect on the cash flow of the insured institutions, the additional premium requirement would be "approximately offset" by the reduction in Federal Home Loan Bank stock purchases.⁵² The interrelationship between a savings and loan association's FHLBB and FSLIC requirements before and after the 1961 amendment, and more particularly the possible fungibility of the Federal Home Loan Bank stock and the additional premium payments, are best illustrated by the following chart:

See pages 404 and 405.

⁴⁹ 12 U.S.C. § 1727(e) (1971).

⁵⁰ (1) Payments by a savings and loan association will cease if:

- (a) Its status as an insured institution is terminated. 12 U.S.C. § 1727(f)(i) (1971).
- (b) A conservator, receiver, or other legal custodian is appointed for it. 12 U.S.C. § 1727(f)(ii) (1971).
- (c) FSLIC makes a determination that it has gone into liquidation. 12 U.S.C. § 1727(f)(iii) (1971).
- (d) The aggregate of the Primary and Secondary Reserves equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations but the Primary Reserve alone does not equal or exceed that 2 per centum. (Note that under (d) the savings and loan association's pro rata share of the Secondary Reserve will be used to make such payments.) Act of September 8, 1961, Pub. L. No. 87-210, § 6, 75 Stat. 482, as amended 12 U.S.C. § 1727(g) (1971).

(2) Payments will cease and the savings and loan association will receive its pro rata share of the Secondary Reserve in cash if the Primary Reserve alone equals or exceeds the 2 per centum. Act of September 8, 1961, Pub. L. No. 87-210, § 6, 75 Stat. 482, as amended 12 U.S.C. § 1727(g) (1971).

⁵¹ 12 U.S.C. § 1426(c)(1) (1971).

⁵² S. REP. No. 778, *supra* note 43, at 1; H.R. REP. No. 823, *supra* note 44, at 2.

<i>Statute</i>	<i>Federal Home Loan Bank Stock</i>	<i>Basic Insurance Premium Primary Reserve</i>	<i>Additional Premium Secondary Reserve</i>
Federal Home Loan Bank Act ch. 522 47 Stat. 725 July 22, 1932	1 per centum of the aggregate of the unpaid principal of home mortgage loans, but not less than \$1500	None	None
National Housing Act ch. 847 48 Stat. 1246 June 27, 1934	Same	One-fourth of 1 per centum of the total amount of all accounts of the insured members plus any creditor obligations	None
Act of May 28, 1935 ch. 150 49 Stat. 293	Same	One-eighth of 1 per centum of the total amount of all accounts of the insured members plus any creditor obligations	None

Act of June 27, 1950 ch. 369 64 Stat. 256	2 per centum of the aggregate of the unpaid principal of home mortgage loans, home-purchase contracts, but not less than \$500	One-twelfth of 1 per centum of the total amount of all accounts of the insured members plus any creditor obligations	None
Act of Sept. 8, 1961 Public Law No. 87-210 75 Stat. 482	1 per centum of the aggregate unpaid loan principal, but not less than \$500	Same	2 per centum of net account increase less an amount equal to any requirement for the purchase of Federal Home Loan Bank stock
Act of Dec. 23, 1969 Public Law No. 91-151 83 Stat. 371	Same	One-twelfth of 1 per centum of the total amount of all accounts of the insured members	Same
Current citation	12 U.S.C. § 1426(c)(1) (1971).	12 U.S.C. § 1727(b)(1) (1971).	12 U.S.C. § 1727(d)(3) (1971).

IV. TAX TREATMENT OF THE ADDITIONAL PREMIUM

The character of the additional premium, and hence its classification for tax purposes, has been a subject of controversy from the date of its enactment. The statute labels it "an additional premium . . . in the nature of a prepayment with respect to future premiums of the institution."⁵³ The Senate Committee Report refers to the premium as a "prepayment on the institution's future regular premium."⁵⁴ It is impossible to differentiate between the language of the statute and of the Committee Report, or to discern any legislative intent regarding its classification. Moreover, conflicting interpretations of the terminology are immediately obvious. The words "additional premium" imply a simple increase in the deductible premiums which a savings and loan association was already required to pay. The word "prepayment" suggests the confusing series of decisions in the prepaid insurance cases, from which a taxpayer might choose the most advantageous tax treatment.⁵⁵ The phrase "prepayment on future premiums" infers the creation of an asset having a life longer than a single taxable year.⁵⁶ Therefore, judicial interpretation was mandatory.

In 1963 several savings and loan associations deducted the additional premiums as ordinary and necessary business expenses⁵⁷ on their tax returns. In a private letter ruling the Internal Revenue Service took the position that the payments in question constituted capital investments which could be deducted only when and to the extent used by the FSLIC to meet losses or to satisfy associations' regular premium obligations.⁵⁸ The private letter ruling was made public by the Internal Revenue Service through a Revenue Ruling

⁵³ 12 U.S.C. § 1727(d)(1) (1971).

⁵⁴ S. REP. NO. 778, *supra* note 43, at 9.

⁵⁵ The cases are discussed in 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.26 (1967). The most significant cases are *Comm'r v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942), which held that prepaid insurance premiums should be prorated over the period of coverage, and *Waldheim Realty & Inv. Co. v. Comm'r*, 245 F.2d 823 (8th Cir. 1957), which held that the premiums could be deducted in the year of payment or could be prorated if the taxpayer preferred to do so.

⁵⁶ See Treas. Reg. § 1.461-1(a)(1) (1957):

[I]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. *Id.*

⁵⁷ See INT. REV. CODE OF 1954, § 162(a):

[T]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . . *Id.*

⁵⁸ *FSLIC Prepayments Held Not Deductible as Business Expense by Supreme Court*, 37 LEGAL BULLETIN THE LAW AFFECTING SAVINGS ASSOCIATIONS 205 (1971) [hereinafter cited as *FSLIC Prepayments Held Not Deductible*].

issued in 1966 in anticipation of litigation over deductibility of the premiums.⁵⁰

To date, total litigation on the deductibility of the additional premium has consisted of three cases: *Washington Federal Savings and Loan Association of Miami Beach v. United States*,⁶⁰ *First Federal Savings and Loan Association of St. Joseph v. United States*,⁶¹ both of which allowed the premiums to be deducted as ordinary and necessary business expenses, and *Commissioner of Internal Revenue v. Lincoln Savings and Loan Association*.⁶²

In *Lincoln Savings and Loan Association*, the taxpayer was a cash basis, state-chartered corporation. It had been a member of the Federal Home Loan Bank of San Francisco since 1936 and had been insured by the FSLIC since 1938. In 1963, Lincoln paid an additional premium of \$882,636.86 and claimed a deduction on its income tax return for an ordinary and necessary business expense which is denominated "Federal insurance premiums."⁶³ The Commissioner of Internal Revenue disallowed the deduction and Lincoln appealed to the Tax Court.

The court found the statutory description, "an additional premium in the nature of a prepayment," ambiguous. It concluded that it was neither an additional premium, *i.e.*, a mere increase in the annual premium,⁶⁴ nor a prepayment, at least when compared with the ordinary prepaid insurance premium which provides coverage for some definitely ascertainable period of time.⁶⁵ The court implied that Lincoln could not have been purchasing insurance coverage with

⁵⁰ See Rev. Rul. 66-49, 1966-1 CUM. BULL. 36:

The additional premium prepayments which an insured savings and loan institution is required to pay to the Federal Savings and Loan Insurance Corporation under the provisions of section 404 of the National Housing Act, as amended, are not deductible when paid and may be deducted only when any possibility of their return is precluded. With respect to an accrual basis institution, earnings on such premiums are not includible in the gross income of that institution until such time as the earnings are no longer available for losses of the FSLIC. With respect to a cash basis institution, earnings on such premiums are includible in the gross income of the institution credited therewith only when such earnings are used to pay its obligations or become available to that institution without substantial restriction or limitation. *Id.*

⁶⁰ 304 F. Supp. 1072 (S.D. Fla. 1969), appeal pending in the United States Court of Appeals for the Fifth Circuit. For a comment on the case, see 22 U. FLA. L. REV. 674 (1970).

⁶¹ 288 F. Supp. 477 (W.D. Mo. 1968). For an article written by the attorney for First Federal Savings and Loan Association of St. Joseph, see Erbacher, *Payments by a Cash Basis Federal Savings and Loan Association to the FSLIC: Are They Deductible?*, 35 U. Mo. L. REV. 145 (1970).

⁶² 403 U.S. 345 (1971).

⁶³ *Lincoln Sav. & Loan Ass'n v. Comm'r*, 51 T.C. 82, 93 (1968).

⁶⁴ *Id.* at 94.

⁶⁵ *Id.* at 97.

the additional premiums because of the high expectancy of recovery of the Secondary Reserve.⁶⁶

The Tax Court stressed the capital nature of the payment, offering illustrations such as the following: 1) Rather than being taken directly into income, the payment is credited to a "pool of capital" available to the FSLIC for losses;⁶⁷ 2) The payment does not actually provide insurance coverage in the year it is paid; it results in the acquisition of an asset which will produce benefits in the form of insurance in future years;⁶⁸ 3) The payment is analogous to the purchase of capital stock in a Federal Home Loan Bank, since both are mandatory, based upon the institution's volume of business, and yield nontransferable assets;⁶⁹ 4) The payments were intended by Congress to be a substitute for the investment in the capital stock of the Federal Home Loan Banks, since stock requirements were reduced when the additional premium payments were introduced;⁷⁰ and 5) The payments are capitalized and shown on financial statements as assets, as required by the California Savings and Loan Commissioner and the FHLBB.⁷¹ Predictably, the Tax Court held that the additional premium payment resulted in the creation of an asset in the nature of a capital investment and is therefore a nondeductible capital expenditure.⁷²

In contrast to the lengthy and detailed discussion of the Tax Court, the opinion of the Court of Appeals for the Ninth Circuit,⁷³ reversing the Tax Court, is somewhat abbreviated. The court relied on the *Washington* and *St. Joseph* federal district court decisions and adopted "the cogent arguments in those opinions by reference, without repetition."⁷⁴

The *Washington* and *St. Joseph* opinions are adverse to the Tax Court's decision in *Lincoln*. Both summarily⁷⁵ dismiss the various

⁶⁶ The Tax Court based its determination of a high expectancy of recovery on two facts: 1) at the time Congress considered the enactment of the additional premium requirement, net insurance losses of the FSLIC had absorbed only 1.1 percent of its gross income; and 2) financial statements of the FSLIC through December 31, 1967, revealed no year in which the net insurance losses of the FSLIC exceeded even its investment income, much less the annual premiums for the year and/or the Primary Reserve. *Id.* at 96.

⁶⁷ *Id.* at 95.

⁶⁸ *Id.* at 98.

⁶⁹ *Id.* at 99-100.

⁷⁰ *Id.* at 100.

⁷¹ *Id.* at 103.

⁷² *Id.* at 102, 107.

⁷³ *Lincoln Sav. & Loan Ass'n v. Comm'r of Internal Revenue*, 422 F.2d 90 (9th Cir. 1970).

⁷⁴ *Id.* at 92.

⁷⁵ "The Court finds this argument unacceptable." *Washington Fed. Sav. & Loan Ass'n of Miami Beach v. United States*, 304 F. Supp. 1072, 1077 (S.D. Fla. (Continued on next page)

capital asset arguments on which the Tax Court grounded the majority of its decision and underscore the insurance elements of the payment. The *Washington* opinion noted that "the only significant difference between the regular premiums and the additional premiums is the fact that there exists a contingent possibility that the additional premiums may some day be recovered."⁷⁶ To show the equivocality of recovery, the court quotes the four refusals by the General Accounting Office to express an opinion on the adequacy of the FSLIC's reserves to meet future losses.⁷⁷ Both courts found that the premiums were compulsory, were paid with respect to insurance coverage, and were based upon the risk of loss.⁷⁸

The Court of Appeals reiterated these insurance aspects. Its sole innovative argument was that under the annual accounting concept of income determination and income tax assessment the payments were a recurring annual expense, the deduction of which should be recognized in the year paid.⁷⁹ The court reversed the Tax Court, holding that the payments were deductible as ordinary and necessary business expenses.⁸⁰

The Government's petition for *certiorari* stated that the *Lincoln* case was important to 2487 savings and loan associations in matters involving over \$19 million in taxes, including a number of protective refund claims.⁸¹ The Supreme Court granted *certiorari*⁸² for this reason.

Although the Supreme Court stated that "the very recital of the facts and of the structure and operation of FSLIC's Reserves . . . itself provides an answer adverse to Lincoln's argument,"⁸³ the Court's resolution of the *Lincoln* case was greatly simplified by the specifically applicable litigation and the resulting opinions in the courts below.

(Footnote continued from preceding page)

1969). "With this interpretation we need not and cannot agree." First Fed. Sav. & Loan Ass'n of St. Joseph v. United States, 288 F. Supp. 477, 484 (W.D. Mo. 1968).

⁷⁶ Washington Fed. Sav. & Loan Ass'n of Miami Beach v. United States, 304 F. Supp. 1072, 1076 (S.D. Fla. 1969).

⁷⁷ *Id.* at 1075. Note that the Tax Court in the *Lincoln* case felt there was a high expectancy of recovery. See n. 66 *supra*.

⁷⁸ Washington Fed. Sav. & Loan Ass'n of Miami Beach v. United States, 304 F. Supp. 1072, 1077 (S.D. Fla. 1969); First Fed. Sav. & Loan Ass'n of St. Joseph v. United States, 288 F. Supp. 477, 484-85 (W.D. Mo. 1968).

⁷⁹ Lincoln Sav. & Loan Ass'n v. Comm'r of Internal Revenue, 422 F.2d 90, 92 (9th Cir. 1970).

⁸⁰ *Id.* at 94.

⁸¹ *Supreme Court to Rule on Deductibility of Payments of Savings and Loan Associations to Secondary Reserve*, 88 BANKING L.J. 562 (1971).

⁸² Comm'r of Internal Revenue v. Lincoln Sav. & Loan Ass'n, 400 U.S. 901 (1970).

⁸³ Comm'r of Internal Revenue v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971).

Preceding a capitulation which repeats much of the Tax Court's rationale, the Court noted:

What is important and controlling, we feel, is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense. . . .⁸⁴

The Supreme Court reversed the Court of Appeals, concluding that Lincoln's payment made in 1963 was not deductible under section 162(a).⁸⁵

Ironically, by the time the Supreme Court considered the *Lincoln* case, the question of the possibility of any recovery of the additional premium, which was so important to the lower court decisions, no longer lay "in the realm of pure speculation."⁸⁶ In 1969 as a consequence of an amendment eliminating creditor obligations in measuring the adequacy of the reserves,⁸⁷ the aggregate of the FSLIC's Primary and Secondary Reserves reached the 2 per centum level at which payments by a savings and loan association to the FSLIC cease.⁸⁸ Beginning in 1970 the Secondary Reserve was used to fulfill the premium obligations of savings and loan associations.⁸⁹ The Supreme Court adverted to this situation⁹⁰ but did not include it in its rationale.

V. CONCLUSION

Although the opinion of the Court of Appeals in the *Lincoln* case was itself technically inadequate, it did provide some insight into the non-technical aspects of the additional premium requirement. First, it noted that it was a "unique and specialized statutory provision having a tax impact only on one particular segment of the economy."⁹¹ Second, it called attention to the "hybrid" characteristics of the premium. And third, it concluded that "the tax impact of the payment must depend upon whether it is more like a capital investment or a

⁸⁴ *Id.*

⁸⁵ *Id.* at 359. For a brief statement of the post-decision tax aspects, see *FSLIC Prepayments Held Not Deductible*, *supra* note 58, at 205-06.

⁸⁶ *Washington Fed. Sav. & Loan Ass'n of Miami Beach v. United States*, 304 F. Supp. 1072, 1076 (S.D. Fla. 1969).

⁸⁷ 12 U.S.C. § 1727(b)(2) (1971).

⁸⁸ See n.50(1)(d) *supra*.

⁸⁹ *FSLIC Prepayments Held Not Deductible*, *supra* note 58, at 206.

⁹⁰ *Comm'r of Internal Revenue v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 351 n.7 (1971).

⁹¹ *Lincoln Sav. & Loan Ass'n v. Comm'r of Internal Revenue*, 422 F.2d 90, 91 (9th Cir. 1970).

business expense."⁹² *i.e.*, agreeing that there was a fine line of distinction to be drawn.

The Supreme Court has now decided that the payment is more like a capital investment. The next chapter in the additional premium litigation may be the question of the taxability of the application of amounts from the Secondary Reserve to regular annual premium requirements.⁹³ It is hoped that Congress will enact clarifying legislation to avoid further excessive litigation regarding a very specialized statutory provision.

Katherine Randall Bowden

TRANSCENDENTAL MEDITATION AND THE CRIMINAL JUSTICE SYSTEM

It has long been fashionable, both in this country and abroad, to attack as corrupt and inefficient the staid political and economic institutions upon which an industrial society is built. And in this age of the computerized, Madison Avenue megalopolis, sacred cows can be slaughtered wholesale by anyone with enough money or influence to command a headline. A prime candidate for attack has been our criminal justice system.¹ Recently, dissatisfaction has centered around the glaring inadequacies of our penal institutions, considered by most to be the weakest link in the system's chain. Unfortunately, responsive measures taken by those in positions of authority, as evidenced by the killings at San Quentin and Attica,² have served to crystallize rather than dissolve this dissent.

Closer to home, the condition of Kentucky jails has been publicly deplored. A recent state and federally financed study of Kentucky's

⁹² *Id.* at 92.

⁹³ See *FSLIC Prepayments Held Not Deductible*, *supra* note 58, at 206:

The earnings on prepayments, to the extent that earnings are realized by any association (regardless of whether the association has or has not deducted prepayment premiums), by being applied to the association's regular annual premium liability, will give rise to taxable income. However, the problem of allocation between the principal amount of the prepayments and the earnings thereon whenever amounts from the Secondary Reserve are refunded or applied to regular annual premiums still remains uncertain. *Id.*

¹ The strength of this attack is reflected by the counteroffensive it has spawned. Persistent legislative and administrative drives to restore "law and order," the D.C. crime bill and the controversy surrounding President Nixon's insistence on appointing only "strict constructionists" to the Supreme Court, all may be viewed as reactions to the struggle being waged against our legal and judicial institutions.

² The Courier-Journal, September 14, 1971, § A, at 1, col. 1.