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What are the special tax problems of banks?

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Banking is a specialized type of business and, as such, has some highly specialized tax problems. Since it is their business, bankers are aware at all times of the cost of money. Perhaps more than any other client, a banker will appreciate a saving in taxes or even a deferral of taxes. In order that you, as auditors for and advisers to bankers, may be better equipped to recognize basic tax problems which may exist with respect to those clients, this article will attempt to point out the areas in which tax problems are most commonly encountered in commercial banks.

Reserve for bad debts

In examining the accounts of any bank it is almost a certainty that you will find that there is a reserve for bad debts. Although most bankers justifiably believe that such a reserve is necessary and claim tax deductions for additions thereto, there are many tax problems connected with this deduction. I would venture to say that this particular reserve has resulted in more rules and less agreement than any other single deduction claimed by banks since 1947.

The foundation of the above opinion lies in the history of this particular item as it relates to banks.

Until 1947 banks, in providing for losses on loans, were subject to the same statutory restrictions as any other corporation. That is, the deductible addition to the reserve for bad debts was limited to an amount which was considered to be reasonable when related to past

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loss experience and the expectation of losses in the current outstanding loans[1].

By the end of World War II the lean years of the thirties were gone but the losses of those years had not been completely forgotten by bankers. However, the years during World War II had shown practically no net losses on loans, and additions to reserves for bad debts were extremely hard to justify based on immediate past experience. In order to be able to provide for possible losses such as those incurred in 1933 (the member banks of the Seventh Federal Reserve District alone had net charge-offs of 6.48% of outstanding loans[2]), the bankers felt that some formula other than measurement by immediate past experience should be allowed to banks in determining a reasonable addition to the reserve for bad debts.

In 1947, the Commissioner of Internal Revenue, recognizing the

1. Section 166, Internal Revenue Code (1954) (Section 23(k) (1) Internal Revenue Code (1939), substantially unchanged).
2. Seventh Federal Reserve District statistics.

problem of the banks with respect to providing for unusual losses, promulgated Mimeograph 6209[3] setting forth a method whereby banks could use a moving average of losses over the preceding 20 years including the taxable year for determining the loss ratio to be applied against eligible outstanding loans at the end of the taxable year involved. The maximum allowable reserve for bad debts was limited to three times the amount determined by applying the loss ratio to eligible loans. The application of the loss ratio to eligible loans determined the tentative addition to the reserve. The maximum allowable deductible addition to the reserve for bad debts for that taxable year was limited to the difference between the reserve, before addition, and the maximum allowable reserve, or the tentative addition, whichever was smaller.

As stated above, Mimeograph 6209 required the use of a 20-year moving average in determining a loss ratio. By the end of 1953 it was apparent that banks were again approaching the same position they were in at the end of World War II. That is, the 20-year period was moving out of the depression years and the average loss ratio was becoming lower each year. In 1954 the Commissioner issued Rev. Rul. 54-148[4] allowing the use of a fixed 20-year period for determination of the loss ratio. The 20-year period could embrace any 20 consecutive years after 1927. Naturally, almost every bank selected for use the 20-year period which produced the highest loss ratio.

One of the first problems to arise in conection with the rulings discussed above was that of determining which loans fell into the category of "eligible loans." Over the years it has been fairly well established that loans which are insured by governmental agencies are not "eligible loans." This, of course, is a logical approach since no loss should be incurred upon such loans. It should be remembered, however, that not all "insured" loans are fully insured and such loans are required to be excluded from "eligible loans" only to the extent that they are insured. Thus, an 80% insured loan constitutes an eligible loan to the extent of the 20% portion which is uninsured.

Another related problem is the method of determination of the loss ratio. Is a bank required to relate total net losses for the 20-year period to the total of year-end balances of eligible loans for the same period or is it required to determine a loss ratio for each year separately and then determine an average of the 20 yearly loss ratios? The latter method certainly is advantageous to banks which experienced great growth during the 20-year period selected for determining the loss ratio to be used.

3. 1947-1 Cumulative Bulletin 26.
4. 1954-1 Cumulative Bulletin 60.

The Commissioner has ruled that either method is acceptable as long as the one selected is consistently used[5]. However, we have learned that, where a bank has selected the method which is least advantageous, the Internal Revenue Service might allow the bank to change to the more advantageous method. Such a change would be considered to be a change in accounting method requiring prior approval by the Service. The application for permission to change accounting method must be filed during the first 90 days of the taxable year in which the change is to become effective.

The Commisisoner has also ruled that where a bank is on the reserve method and is using the 20-year moving average method of determining its loss ratio (as opposed to a fixed 20-year period) it may change to the alternative method authorized by Rev. Rul. 54-148 without requesting permission in any taxable year beginning after December 31, 1953[6].

In Mimeograph 6209 it was stated that a newly organized bank or a bank without sufficient years' experience for computing an average would be permitted to substitute the "average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established."

Rev. Rul. 54-148 allows a bank which selects a 20-year period which extends back into years for which it has no experience of its own to fill in such years with similar comparable data.

Rulings cause controversy

The above rulings have caused considerable controversy in the respect that the requirement of "similar comparable data" is difficult to interpret. Many banks, finding themselves in the position of having to employ a substituted ratio, have used the loss experience of all member banks of their particular Federal Reserve District. Although there has been no published sanction by the Internal Revenue Service of this practice, in a recent case involving a Milwaukee bank[7] the Commissioner permitted the use of the loss experience of all member banks of the Seventh Federal Reserve District for the years in which the taxpayer bank had no experience of its own. This method was accepted by the Court.

It is interesting to note that even though the rulings appear to require

5. *Rev. Rul. 54-597*, 1954-2 C.B. 90; *The Boardwalk National Bank of Atlantic City*, 34 T.C. No. 99 (1960).
6. *Rev. Rul 55-3*, 1955-1 C.B. 282.
7. *American State Bank* v. *United States*, 176 F. Supp. 64 (E.D. Wis. 1959), affd. 279 F. (2d) 585 (C.A. 7, 1960).

explicitly that a bank use its own experience where available, some banks have attempted to substitute the experience of other banks for their own. One bank argued that a change in its management resulted in a more liberal loan policy and therefore it should be entitled to a higher loss ratio. The Commissioner contended that this was not permissible and his position was sustained by the Tax Court[8].

Bank mergers create problems, too

In this age of bigger and bigger business, corporate mergers are commonplace and mergers of banks are no exception. Upon merger of two banks, both of which are on the reserve method of treating bad debts, another problem immediately presents itself. Should the loss ratio used by the surviving entity be that of the merged bank, that of the surviving bank, or a combination of the two? If the merger involves two banks of greatly differing size (which is often the case), the combining of loss experience can have an unfavorable effect on the loss ratio.

We are aware of at least one case in which the National Office of the Internal Revenue Service has privately ruled on this question. The ruling was confined to the facts of that particular case and the Service decided not to publish a ruling regarding the question[9]. There is some indication of a strong possibility that the Service still may take the position that a combined experience must be used.

The fact that the ceiling reserve is directly related to eligible loans may cause some problems regarding the deduction for the addition to the reserve for bad debts. For instance, in a year in which the eligible loans of a bank decrease from the eligible loans at the previous year end, it is possible that the bank may not be entitled to a deduction because its reserve exceeds the maximum ceiling. Although it may appear that no deduction is allowable at the time the return is filed, a subsequent examination may result in disallowances which reduce the reserve below the ceiling. In such a case it is not clear whether the fact that no deduction was claimed in the return filed is an "election" not to claim a deduction in that year. As a protective measure it would appear advisable to include in any return in which no deduction for bad debts is claimed a statement to the effect that the bank desires to claim the maximum allowable addition to the reserve for the year. The insertion of such an "election," though possibly not required, should serve to protect the bank's right to a deduction for that year in the event a subsequent examination results in adjustments to the reserve for bad debts.

One other unusual facet of the reserve for bad debts is the requirement that any reserve addition which is claimed by a bank must be entered on the books of the bank. Unlike many items which may be deducted for tax purposes without any entries being made on the books, the bad debt deduction must be covered by adequate reserves on the books. Thus, in reviewing a bank's tax returns we should make sure that adequate reserves exist on the books to cover the bad debt deduction claimed.

Aside from the problems discussed above with respect to reserves for bad debts, it should be noted that this also is an area in which some limited tax planning may be effective. The deduction allowed for additions to a reserve for bad debts is the only deduction I know of which is not required to be claimed in the year in which it first becomes allowable. Because of this a bank may defer claiming the deduction if it does not appear that it will be most advantageous. For instance, it would not be wise to claim such a large deduction that taxable income would be reduced below $25,000. If that were done, part of the deduction would be producing only a 30% tax benefit. Although the extent to which this planning tool may be used is limited, it should be borne in mind when reviewing the tax status of banking clients.

Another planning area exists in a bank's ability to control somewhat the amount of eligible loans at year end. It is possible for a bank to purchase loans from another bank and thus increase its eligible loans at year end. Of course, most banks would not purchase loans merely to increase the bad debt deduction, but if a purchase of loans is anticipated for good business purposes, it would be desirable to make such a purchase prior to year end.

It is evident from the foregoing that the area of reserve for bad debts in a bank certainly has many problems. In making an examination of a bank, we should attempt to determine whether the client is taking full advantage of the reserve method of providing for bad debt losses. Even though there are problems connected with the use of the reserve for bad debts, it will normally be advantageous for a bank to use such a method. If a bank is not using the reserve method, a review of its net losses during the years after 1927 should be made to determine how much tax benefit could be obtained through adoption of the reserve method. If it is determined that the adoption of the reserve method is desirable, then permission must be obtained for such adoption. Such permission must be requested from the Internal Revenue Service within the first 90 days of the taxable year in which the change is to be effective.

Discounts on purchased mortgages

There are in existence today many mortgages which were taken by the original mortgagee at interest rates less than the current acceptable rate of interest. Frequently banks will purchase such mortgages from the holder thereof at substantial discounts from the face value or unpaid principal of the mortgage. Such discount is intended to adjust the effective rate of interest earned on the investment.

The treatment accorded such discounts as to when they are reported as income (for both book purposes and tax purposes) may vary from bank to bank, depending largely upon whether a bank reports on the cash basis or on the accrual basis. However, there may be differences even between banks which employ the same general accounting method.

In the case of a bank reporting on the cash basis, such discount might be reported as income on the books as payments on the mortgage are received. On the other hand, some cash basis banks might report the discount as income only after the entire purchase price of the obligation had been recovered. For tax purposes either bank would be required to report income as payments are received by the bank.

Dissimilarities in reporting for book purposes may also be noted between two banks which report on the accrual basis. Bank A may accrue the discount as income ratably over the life of the obligation. This treatment implies that the discount is merely an adjustment of interest and should accrue only as other interest accrues. Bank B may report the entire discount as income upon the date of purchase of a mortgage at a discount. The argument used in this case is that the discount is a commission to the bank which will be collected whether the mortgage is paid in full the next day or at the maturity date.

The position that the Internal Revenue Service may take in the case of an accrual basis bank is hard to predict. There are a number of cases and rulings which hold that the discount should be reported for tax purposes ratably over the life of the obligation[10]. On the other hand, an agent might contend that such discount must be reported as taxable income at the time that an obligation is purchased at a discount. He, too, would have precedent on which to rely[11].

10. *S.M. 3820*, IV-2 C.B. 32; *I.T. 1650*, II-1 C.B. 48; *Motors Securities Co., Inc.*, 11 T.C.M. 1074 (1952).
11. *Columbia State Savings Bank*, 41 F. (2d) 923 (C.C.A.7, 1930) affirming 15 B.T.A. 219; *Bonded Mortgage Company of Baltimore*, 70 F. (2d) 341 (C.C.A.4, 1934) affirming 27 B.T.A. 965.

Although the above discussion would lead one to believe that almost any method of reporting for tax purposes *may* be acceptable, care should be exercised in making recommendations to clients with respect to this item. Any change in the method of reporting might be considered to be a change in accounting method for tax purposes rather than a correction of an erroneous method of reporting. The problems attendant thereto might be greater than the problems eliminated by the change.

Security transactions

All commercial banks will have a great portion of their total assets invested in either municipal or United States government obligations. This area is not so much one in which there is a tax problem but one offering definite possibilities for extremely effective tax planning.

Section 582(c) of the Internal Revenue Code of 1954 states:

> ". . . in the case of a bank, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset."

The above provision in the law recognizes the fact that a bank must keep substantial portions of its total assets invested in securities and that losses incurred in security transactions should not be subjected to the normal restrictions on losses from the sale of capital assets since securities held by a bank are actually property used in its trade or business.

Because most of the securities held by a bank are readily marketable and the selling price readily determinable, a bank is in the position of being able to control bond losses and gains. By carefully selecting which issues are to be sold, a bank can arrange to realize gains in its portfolio in one year and losses in the next. Since net gains in security transactions will be taxable as capital gains and net losses deductible as ordinary losses, the tax advantage of proper planning is obvious.

The provision regarding bond losses may also be used to control taxable income in years when bond prices are low and yields high. By selling off low yield issues and reinvesting in high yield issues, the bank can incur deductible losses, increase its income from investments, and not materially affect the maturity value of its portfolio. In taking advantage of this particular plan, a bank should be careful not to run afoul of the wash sale provision of Section 1091 of the Internal Revenue Code. This provision disallows as a deduction the loss on any security sold if a substantially identical security is acquired within 30 days before or after the loss is incurred. "Substantially identical" securities, however, are rather rare since a difference in any material feature (interest rate, maturity date, or refunding feature) may result in a security not being substantially identical[12].

An inevitable, however undesirable, result of holding a large portfolio of securities is that some may become worthless. Section 582(a) of the Internal Revenue Code of 1954 provides that losses on worthless securities (as defined in Section 165(g) (2) (c)) held by a bank are treated as bad debt losses. Other taxpayers are required to treat such losses as being from the disposal of capital assets. Here again, the different nature of the reasons of a bank for investing in securities is recognized.

Bond premiums and discounts

Because of the relatively rapid shifts in demand for money, a bank will rarely acquire bonds for investment at face value. Depending on whether yields are currently high or low, a bank will acquire bonds at a discount or at a premium. The treatment of such discounts and premiums for book purposes may differ substantially from the required treatment for tax purposes.

Quite often banks will buy short-term, noninterest-bearing securities which are issued on a discount basis. The Internal Revenue Code[13] requires that, where the maturity date is less than one year from issue, the difference between purchase price and sale price or maturity value on such securities be reported as ordinary income at date of maturity or earlier sale.

Interest-bearing securities which are purchased at a discount are treated differently from short-term, noninterest-bearing securities. Depending on the length of time the security is held, the discount which is realized at maturity or sale is treated as long-term or short-term capital gain. Since many banks will accumulate such discounts ratably over the life of the security for book purposes, care should be taken to adjust this item of income in the tax return. The foregoing applies to securities which were not originally issued at a discount. In the case of securities originally issued at a discount, Section 1232 of the Internal Revenue

12. *Rev. Rul. 58-211*, 1958-1 C.B. 529; *Rev. Rul. 58-210*, 1958-1 C.B. 523.
13. Section 454(b), Internal Revenue Code (1954).

Code of 1954 specifically requires that the portion of the gain on sale representing recovery of original issue discount be reported as gain from the sale or exchange of property which is not a capital asset.

Premiums paid for bonds are treated differently depending on whether the interest received on the security is taxable or nontaxable.

Premium on taxable bonds may be deducted ratably over the life of the bond if the taxpayer so elects[14]. Deduction of such discount should be recommended since it is deductible at ordinary income rates, whereas if it remains as cost of the security at disposal, it may be deductible only at capital gain rates.

Premium on tax-exempt municipal securities may not be deducted for tax purposes since the income therefrom is not taxable. However, such premium must be amortized in computing adjusted basis of the security at disposal.

Purchases of F.N.M.A. stock

Banks quite often will sell mortgages to the Federal National Mortgage Association. In order to be allowed to do this, the bank will be required to purchase certain amounts of F.N.M.A. stock. Most banks also dispose of this stock since its dividend yield is usually low in relation to its cost.

Until recently the loss incurred by banks in disposing of such stock has been deductible only as a capital loss. Thus, in order to utilize such losses for tax purposes, the bank had to realize capital gains and offset the loss, thereby realizing only a 25% benefit.

Because of the fact that banks were required to purchase F.N.M.A. stock and thereby incurred losses, it has long been argued that such losses should be fully deductible. In September of 1960, the President signed into law a bill which allows banks to deduct the difference between the price paid for F.N.M.A. stock and the market value of such stock on the date of purchase[15].

Depreciation

Many banks still follow the conservative policy of charging to expense all additions to furniture, fixtures, and equipment. Care should be taken to see that proper records are maintained with respect to these assets so that depreciation may be claimed and allowed for tax purposes. Some banks also do not claim accelerated depreciation, which is author-

14. Section 171, Internal Revenue Code (1954).
15. P.L. 86-779 signed September 14, 1960, creating present Section 162(d), Internal Revenue Code (1954) effective January 1, 1960.

ized. The claiming of depreciation computed under one of the methods of accelerated depreciation as well as additional first-year depreciation authorized by Section 179 of the Internal Revenue Code should be recommended in most cases.

Dividends on Federal Reserve Bank stock

Member banks of the Federal Reserve System are required to own stock in the Federal Reserve Bank. How many shares must be owned depends on the size of the member bank. The Internal Revenue Code[16] provides that dividends received on such stock which was acquired prior to March 28, 1942, are completely exempt from taxation. In preparing or reviewing a tax return of a bank, this exemption should be borne in mind.

For the audit and management services staff

As stated earlier, the tax problems of banks are highly specialized. It is important that members of the audit and management services staff be able to *detect* a tax problem which may exist in a particular bank. The *solution* to the problem can probably best be handled by the tax personnel assigned to the engagement. If this article can help to bring such problems to light, then its purpose will have been served.

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16. Regulations Section 1.103-2.