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Memorandum

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subject: Acquiring Bank - Sec. 481(a) Issue

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Acquiring Bank =
Failed Bank =
X =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
Amount 12 =
Amount 13 =
Amount 14 =

Amount 15	=
Amount 16	=
Date 1	=
Date 2	=
Year 1	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Reviewing Attorney	=
Assigned Attorney	=

Issue

Whether the Taxpayer's proposed change from erroneously including Section 597 income (as defined below) to correctly excluding Section 597 income constitutes a change in method of accounting requiring an adjustment under section 481(a) of the Internal Revenue Code (the "Code").

Facts

The following facts have been provided by Acquiring Bank (the "Taxpayer"):

In Date 1, the Taxpayer acquired the assets of Failed Bank pursuant to a standard FDIC purchase and assumption agreement. The acquired assets included 100 percent of the common stock of X REIT ("X REIT"). X REIT was not a consolidated subsidiary of the Taxpayer.[1] As such, after the acquisition, X REIT retained basis in its loans equal to Amount 1 of unpaid principal balance ("UPB").[2] The Taxpayer also applied the limitations of section 382(h) to X REIT's loans—i.e., since the Taxpayer acquired X REIT's stock in an ownership change (within the meaning of section 382(g)), built-in losses in those loans were subject to limitation. The Taxpayer continued to treat X REIT as the owner of the loans for purposes of the REIT qualification requirements under section 856 as well.

The Taxpayer allocated Amount 2 in phantom basis to a special account based on its erroneous interpretation of Treas. Reg. § 1.597-3(a). The Taxpayer incorrectly believed that, under § 1.597-3(a), the Taxpayer should be treated as the owner of X REIT's loans that were covered by FDIC loss guarantees. The Taxpayer thus classified those loans as Class II assets under § 1.597-5(c)(3)(ii). At the same time, the Taxpayer treated X

[1] REITs may not file consolidated income tax returns as part of an affiliated group. I.R.C. § 1504(b)(6).

[2]. Treas. Reg. § 1.597-5(b) treats a bank and its consolidated subsidiaries as selling their assets in a deemed asset sale under certain circumstances. Non-consolidated subsidiaries (such as REITs) are not subject to deemed asset sale treatment.

REIT as the owner of the loans for all other Federal income tax purposes, and X REIT continued reporting those loans at their historic cost basis amounts. The Taxpayer also classified the stock of X REIT as a separately purchased Class V asset.

By treating X REIT's loans as Class II assets that the Taxpayer directly acquired from Failed Bank, the Taxpayer erroneously determined that the fair market value of Class I and Class II assets exceeded the purchase price. The Taxpayer thus included Amount 3 in gross income under § 1.597- 5(d)(2)(iii) ("Section 597 income") over a six-year period (taxable years Year 1-Year 6).[3]

The Taxpayer allocated the purchase price among the assets as follows:

Item	Class	Amount (in billions)
Cash	I	Amount 4
Loans & Securities	II	Amount 5
X REIT Loans	II	Amount 6
Other	II	Amount 7
REIT Stock	V	-
Total Assets		Amount 8
Liabilities		Amount 9
Section 597 Income Reported by Taxpayer		Amount 13

The Taxpayer acknowledges that it should have allocated purchase price only to those loans it actually acquired from Failed Bank and its consolidated subsidiaries. The Taxpayer should not have included the fair market value of X REIT's loans in the calculation; instead, it should have allocated purchase price to the X REIT stock. If the Taxpayer had done things correctly, its allocation of the purchase price to Class I and Class II assets would have been Amount 10 (Amount 14 cash, Amount 15 of loans, and Amount 16 of other assets). Because the purchase price (the amount of deposit liabilities assumed) would have exceeded the fair market value of the Class I and II assets acquired, no income inclusion under §1.597-5(d)(2)(iii) would have been required.

[3] Section 1.597-5(c)(3)(ii) provides that the fair market value of an acquired asset covered by a Loss Guarantee is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put. This raises the possibility that the Acquirer's acquisition basis in the asset will equal highest guaranteed value, which, in turn, will exceed Acquirer's actual acquisition cost. Section 1.597-5(d)(2)(iii) accounts for the possibility that the deemed acquisition basis may exceed Acquirer's actual cost by requiring Acquirer to take the difference into income over six years. These rules thus assume that the Acquirer purchased the asset directly, and not indirectly through a non-consolidated entity that is independently continuing to use historic cost basis for the same asset.

Although the Taxpayer created a special account for the Amount 2 phantom basis in the X REIT loans, the Taxpayer did not implement a mechanism to subsequently amortize, depreciate or deduct such phantom basis. The Taxpayer represents that "the Amount 2 of purchase price was used for the sole purposes of measuring the Taxpayer's Section 597 income amount and was thenceforth ignored for all other tax purposes." The Taxpayer acknowledges that it knows of no other theory or position that would permit it to amortize its phantom basis, but rather asserts that such phantom basis would ultimately be deductible upon disposition of its business.

X REIT liquidated in a tax-free transaction on Date 2. The Taxpayer has explained that it had no intention of initiating a liquidation of X REIT when the Taxpayer had acquired the X REIT shares in Date 1.

By the end of Year 6, the Taxpayer had taken into account all of its Amount 3 of Section 597 income but had not, nor has it since, recovered any portion of the Amount 2 of phantom basis erroneously assigned to loans held by X REIT. The reason for this is twofold: (1) X REIT already possessed an historic cost basis in the REIT loans and was accounting for all its activity, and (2) there is no provision in the Code that allows a taxpayer to amortize basis in assets that the taxpayer has never acquired.

The Taxpayer filed a protective claim for the taxable year Year 4 with respect to the erroneously reported Section 597 income for that year. Furthermore, the statute of limitations for filing refund claims for the taxable years Year 5 and Year 6 is still open. Section 6511(c). However, the statute of limitations for filing refund claims for the taxable years Year 1 through Year 3 has expired.

The Taxpayer has requested that Exam agree to a negative section 481(a) adjustment in the approximate amount of Amount 11 for the tax year Year 5, which is currently under examination.[4]

Legal Analysis

A change in accounting method is a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A "material item" is any item involving the proper time for the inclusion of the item in income or the taking of a deduction. Id. In determining whether timing is involved, the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982). When looking at the lifetime income effect of a taxpayer's practice, the courts consider both pieces of the practice to determine whether

[4] In its protective claim filed for the tax year Year 4, the Taxpayer represents that "[b]eginning Year 1 and ending Year 6, [it] recognized all of the Amount 3 of section 597 gain into income in approximately equal one-sixth amounts." Thus, the requested taxpayer-favorable sec. 481(a) adjustment for Year 5 is approximately Amount 11 (or Amount 12 X 5 years – Year 1 through Year 5).

it distorts lifetime taxable income. Humphrey, Farrington & McClain v. Commissioner, T.C. Memo. 2013-23. If the practice merely changes the taxable year in which the income is reported and does not permanently affect lifetime income, the practice is a change in method of accounting.

Treas. Reg. § 1.446-1(e)(2)(ii)(b) sets forth several adjustments that will not be considered a change in accounting method, including the following:

> (1) A correction of mathematical or posting errors, or errors in computation of tax liability (such as errors in computation of foreign tax credit, net operating loss, percentage depletion or investment credit);
>
> (2) An adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction (i.e., corrections of items that are deducted as interest or salary but which are in fact payments of dividends, and of items that are deducted as business expenses but which are in fact personal expenses);
>
> (3) An adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset; and
>
> (4) A change in the treatment resulting from a change in the underlying facts.

To the extent a taxpayer's change constitutes a change in method of accounting, rather than an error, a section 481(a) adjustment is appropriate.

Section 165(a) provides that a taxpayer is entitled to deduct a loss sustained during the taxable year and not compensated by insurance or otherwise.

Section 165(b) provides that the basis for determining the amount of any loss shall be the adjusted basis provided in section 1011 for determining loss from the sale or other disposition of property.

Section 1011 provides that the adjusted basis for determining gain or loss from the sale or other disposition of property, *whenever acquired*, shall be the basis (determined under section 1012 or other applicable Code provision), adjusted as provided by section 1016. (emphasis added).

Treas. Reg. § 1.1012-1(a) provides in relevant part that "[i]n general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property."

In the instant case, the Taxpayer maintains that its erroneous inclusion of Section 597 income does not alter its lifetime taxable income, and therefore a section 481(a) adjustment – decreasing the Taxpayer's taxable income for prior Section 597 income inclusions – is appropriate. Specifically, the Taxpayer maintains that this income

inclusion will be offset by the phantom basis because such basis is deductible upon the Taxpayer's disposition of its banking business. The Taxpayer believes that its fact pattern presents a question of *timing difference* as opposed to *permanent difference.*

Contrary to the Taxpayer's assertions, upon disposition of its banking business, it will not be able to claim a loss in the amount of the erroneously-included Section 597 income. The Taxpayer did not acquire a cost basis in the loans of X REIT because it did not directly acquire those loans. Further, there is no authority for the proposition that a taxpayer, by erroneously including income, obtains basis in property that it did not acquire.

The courts have held that taxpayers may not report gain or loss with respect to assets that they do not own. In Miller v. Commissioner, T.C. Memo. 1975-110, the Tax Court stated, "[a] taxpayer has a basis only in property in which he has an ownership interest." Moreover, as noted previously, a REIT cannot be a member of a consolidated group. See also Cochran v. United States, 62 F. Supp. 872, 875 (Ct. Cl. 1945) (where a taxpayer contributed the entire corpus of a trust in which he and his wife were equal beneficiaries, he could only deduct one-half of a loss arising from the worthlessness of the stock because he did not own the other half); Dunne v. Commissioner, 75 F.2d 255, 256 (2d Cir. 1935) (Taxpayer not entitled to a loss in connection with margin trading accounts that were closed out where the accounts were opened for the taxpayer by a third party who guaranteed the account and actually incurred the loss); Barber v. Commissioner, 152 F.2d 930, 933 (2d Cir. 1946) (Taxpayer not entitled to a deduction when stock sold at a loss because his right to share in profits generated by the stock of another does not entitle him to a loss); Draper v. Commissioner, 15 T.C. 135, 136 (1950) (Parents could not claim a casualty loss for the jewelry and clothing of their adult daughter).

In support of its position, the Taxpayer cites to FSA 200048012. In this FSA, the IRS sought to recompute a bank's purchase price allocation related to its acquisition of a failed bank. The agent determined that the purchasing bank allocated too much of the purchase price to depreciable assets (core deposits) and too little to nonamortizable assets (goodwill). The IRS proposed a section 481(a) adjustment to disallow the depreciation attributable to the bank's excess allocation of purchase price to depreciable assets for years closed by the statute of limitations on assessment. In the FSA, the IRS concluded that the taxpayer's excess allocation to depreciable assets affects when, not whether, the taxpayer's cost will be deducted. By allocating the portion of the cost as a depreciable asset, the taxpayer was deducting the cost of the asset through depreciation deductions over the useful life of the asset. If the taxpayer had treated the asset as a nondepreciable asset (i.e., goodwill), it would have deducted its cost at the time of disposition. Thus, the IRS held that the reallocation of purchase price among the assets constituted a change in timing of cost recovery and therefore a change in method of accounting. Accordingly, in that case, a section 481(a) adjustment was appropriate.

The fact pattern in FSA 200048012 is distinguishable from that of the instant case. While the taxpayer in the FSA always had a right to recover the costs allocated to the assets in question, the instant Taxpayer has no right to recover the cost misallocated to the asset it has never owned. In the FSA, the IRS proposed a section 481(a) adjustment, because a reallocation of a portion of the taxpayer's purchase price for the failed bank from depreciable assets to nondepreciable assets affected the timing of deduction (i.e., when the taxpayer would recover the costs that it paid for the assets). The taxpayer in the FSA actually acquired both the depreciable assets (core deposits) and nonamortizable assets (goodwill) from the failed bank. While the FSA concerned a reallocation of the purchase price among assets that the taxpayer actually acquired, the instant case concerns an erroneous allocation of the purchase price to an asset that the taxpayer did not acquire. Thus, unlike the FSA, the instant case presents a question of *whether*, not *when*, the Taxpayer is entitled to recover any amount allocated to X REIT loans.

Finally, the fact that, upon X REIT's subsequent liquidation, the Taxpayer acquired some portion of the X REIT loans does not change the above result. Under § 1.597-5(d)(2)(iii), the event giving rise to an income inclusion occurred in Year 1. The fact that the income inclusion is spread over six years does not change the fact that the income determination was made in Year 1, when X REIT was an entity separate and apart from (and could not file a consolidated income tax return with) the Taxpayer. Upon acquisition of a portion of X REIT's loans in a tax-free liquidation, the Taxpayer is entitled to a carryover basis in those loans under section 334(b). There is no provision that would allow the Taxpayer to take X REIT's loans with a basis greater than a carryover basis because the Taxpayer did not recognize gain pursuant to the REIT's Year 3 liquidation. Section 334(b).

A review of the long-term, lifetime effect on taxable income reveals that the Taxpayer's erroneous inclusion of Section 597 income results in a change to the Taxpayer's lifetime taxable income. The Taxpayer acknowledges that it did not implement a mechanism to subsequently amortize, depreciate or deduct its phantom basis and that such basis was used for the sole purposes of measuring the Taxpayer's Section 597 income amount and was ignored for all other tax purposes. Likewise, there is no mechanism by which the Taxpayer may deduct the cost of its phantom basis in an asset it did not acquire. Upon disposition of its banking business, the Taxpayer will not be entitled to a loss stemming from its erroneously included Section 597 income. In fact, X REIT, an entity separate and apart from the Taxpayer, continued to report the loans at their cost basis amounts and account for the loans as the owner. Moreover, the amount of basis that the Taxpayer should have allocated to its basis in X REIT stock is not equal and offsetting to the amount of Section 597 income. The Taxpayer's reported Section 597 income is an error, not a material item, so that a section 481(a) adjustment is inappropriate.

If you wish to discuss this matter, please call Reviewing Attorney or Assigned Attorney.

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