

INTERNAL REVENUE SERVICE
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Date: June 22, 1999

LEGEND:

Bank =

State A =

Year 1 =

\$t =

\$u =

\$v =

\$w =

\$x =

\$y =

Dear:

This is in reply to a letter dated February 17, 1999, and subsequent correspondence, requesting a ruling on behalf of Bank. The requested ruling concerns whether the reduction of Bank's loans outstanding that resulted from the transfer of loans described below requires recapture of Bank's suspended reserves for bad debts.

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FACTS

Bank, a State A chartered mutual savings bank regulated by the State A Department of Banking, was organized in Year 1 and has continuously engaged in the banking business. Bank is primarily engaged in attracting deposits from the general public in Bank's market area and investing these deposits in one- to four-family residential real estate mortgages and loans, consumer loans, and commercial loans. Bank also invests in mortgage-backed securities and other investment securities. Bank qualifies as a bank within the meaning of § 581 of the Internal Revenue Code and as a large bank within the meaning of § 585(c)(2).

Bank used the reserve method of accounting for bad debts allowed by § 593 until that method was repealed for taxable years beginning after 1995. At the close of Bank's last taxable year beginning before 1988 (the close of the base year), the balance of Bank's bad debt reserve was \$t (the pre-1988 reserve), and the amount of its loans outstanding was \$u. Bank's loans outstanding exceeded \$u at the close of each subsequent taxable year until the transfer of loans described below.

As required by the repeal of the § 593 reserve method, Bank changed to the specific charge-off method of accounting for bad debts in its first taxable year beginning after 1995 (the year of change). Under § 593(g), Bank computed a net § 481(a) adjustment for the change. The amount of this adjustment (\$y) was the amount by which Bank's bad debt reserve balance at the close of the year preceding the year of change (\$w) exceeded the amount of its pre-1988 reserve. The amount of this § 481(a) adjustment has been, and will continue to be, included in Bank's income ratably over the 6 years beginning with the year of change. Bank's pre-1988 reserve and Bank's supplemental reserve were suspended and have not been recaptured.

In a year after the year of change, to reduce Bank's State A income tax liability, Bank formed a passive investment company (PIC), as a wholly owned subsidiary of Bank, pursuant to State A law. When Bank formed the PIC, it made an initial capital contribution to the PIC and also transferred loans with an aggregate balance of about \$x to the PIC. Bank represents that these transfers were transactions described in § 351(a) and were not transactions described in § 381(a). The PIC is responsible for the servicing, escrow, collection, foreclosure, refinancing, and restructuring activities related to the loans that it holds.

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Bank is authorized to transfer as much as \$y of loans to the PIC. The PIC is not a bank as defined in § 581.

After forming the PIC, Bank directly held loans with an aggregate balance exceeding \$x. Since then, Bank has continued to accept deposits and make new loans and to be a bank as defined in § 581. As a result of the loan transfer, however, Bank's amount of loans outstanding fell below \$u, the amount of its loans outstanding at the close of the base year, and remained below \$u through the close of the taxable year that included the loan transfer.

LAW

Section 593(f) provides for the termination of the § 593 reserve method. Sections 593(a), (b), (c), and (d) do not apply to any taxable year beginning after December 31, 1995.

Section 593(g)(1) provides that any taxpayer required by § 593(f) to change its method of computing reserves for bad debts will treat the change as a change in method of accounting, initiated by the taxpayer and having been made with the consent of the Commissioner. Pursuant to § 593(g)(1), the net § 481(a) adjustment for the change will be determined by taking into account only applicable excess reserves, ratably over the 6-year period beginning with the first taxable year beginning after December 31, 1995.

Pursuant to § 593(g)(2)(A), the term "applicable excess reserves" means the excess of (i) the balance of the reserves described in § 593(c)(1) (other than the supplemental reserve) as of the close of the taxpayer's last taxable year beginning before January 1, 1996, over (ii) the lesser of (I) the balance of such reserves as of the close of the base year, or (II) the balance of the reserves described in subclause (I), reduced in the same manner as under § 585(b)(2)(B)(ii) on the basis of the taxable years described in clause (i) and this clause (ii).

Section 593(g)(3) provides for the recapture of the suspended reserves where the taxpayer ceases to be a § 581 bank. If, during any taxable year beginning after December 31, 1995, a taxpayer to which § 593(g)(1) applied is not a bank (as defined in § 581), § 593(g)(1) will apply to the reserves described in § 593(g)(2)(A)(ii) and the supplemental reserve, except that such reserves will be taken into account ratably over the 6-year period beginning with such taxable year.

Section 593(g)(6) provides for the suspended reserves to be included as § 381(c) items. The balance taken into account by a

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taxpayer under § 593(g)(2)(A)(ii) and the supplemental reserve will be treated as items described in § 381(c).

Section 593(g)(8) gives the Secretary the authority to prescribe any regulations necessary to carry out §§ 593(g) and (e), including regulations providing for the application of these sections in the case of acquisitions, mergers, spinoffs, and other reorganizations. No regulations have been issued under § 593(g)(8).

Section 593(e) provides for the recapture of the suspended reserves upon certain distributions to shareholders. In general, any distribution of property by a taxpayer having a balance described in § 593(g)(2)(A)(ii) to a shareholder with respect to its stock will be treated as made first out of its post-1951 earnings and profits, then out of the balance taken into account under § 593(g)(2)(A)(ii), then out of the supplemental reserve, then out of such other accounts as may be proper.

ANALYSIS

Because of the repeal of the § 593 reserve method, Bank changed to the specific charge-off method of accounting for bad debts in its first taxable year beginning after 1995. Section 593(g) governed this change in accounting method. Accordingly, Bank computed a net § 481(a) adjustment by taking into account only its applicable excess reserves, as defined in § 593(g)(2)(A). Subclause (II) of § 593(g)(2)(A)(ii) had no effect in determining Bank's applicable excess reserves, because the amount of its loans outstanding at the close of the base year was \$u, and its loans outstanding exceeded this amount at the close of each subsequent taxable year while it used the § 593 reserve method. The amount of Bank's applicable excess reserves was the amount by which its reserve balance at the close of the year preceding the year of change exceeded the amount of its pre-1988 reserve. Bank has been including in income the amount of its applicable excess reserves, ratably over the prescribed 6-year period, and will continue to do so. Bank's pre-1988 reserve and its supplemental reserve were suspended and have not been recaptured.

Later, when Bank formed the PIC, it transferred a substantial portion of its loans to the PIC. However, Bank also retained a substantial portion of its loans, and Bank has continued to accept deposits and make new loans and to qualify as a bank under § 581.

Since Bank has not ceased to be a § 581 bank, § 593(g)(3) does not require recapture of the suspended reserves in the

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present case. Nor did Bank's formation of the PIC involve a distribution to shareholders that would require recapture of the suspended reserves under § 593(e). Moreover, assuming that Bank's transfer of loans to the PIC was not a transaction described in § 381(a), § 593(g)(6) does not require Bank's suspended reserves to be treated as § 381(c) items.

For these reasons, and based on the facts and representations submitted, we conclude that the reduction of Bank's loans outstanding that resulted from its transfer of loans to the PIC does not require recapture of its pre-1988 reserve or its supplemental reserve. However, these suspended reserves will remain subject to future recapture by Bank if it ceases to be a § 581 bank or makes a distribution to shareholders that is described in § 593(e).

No opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provisions of the Code. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this ruling should be attached to the federal income tax return of Bank for the taxable year that includes the transfer of loans to the PIC.

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this ruling letter to your authorized representatives.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By:

Sharon Galm
Senior Technician Reviewer, Branch 1

Enclosures:

Copy of this letter
Copy for § 6110 purposes

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