INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.:TAM-118843-98

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

A =

B =

State A =

State B =

State C =

State D =

State E =

Date A =

Date B =

Year A =

Amount A =

Amount B =

Amount C =

ISSUES: 1. Did the Taxpayer acquire the right to conduct business in State B (State B Branching Rights) with a fair market value basis pursuant to section 597 of the Internal Revenue Code of 1954?

2. In any event, has the Taxpayer properly determined the fair market value of the State B Branching Rights upon their acquisition?

3. In any event, did the Taxpayer abandon the State B Branching Rights in Year A so that a deduction is permitted under section 165(a) of the Code?

CONCLUSIONS: 1. The Taxpayer did not acquire the State B Branching Rights with a fair market value basis pursuant to section 597 of the 1954 Code.

2. In any event, the Taxpayer has not properly determined the fair market value of the State B Branching Rights upon their acquisition.

3. In any event, the Taxpayer did not abandon the State B Branching Rights in Year A so that a deduction is permitted under section 165(a) of the Code.

FACTS:

On Date A, A, a subsidiary of the Taxpayer, acquired three insolvent federal savings and loan associations through supervisory mergers approved by the Federal Home Loan Bank Board (FHLBB). At the time of the transaction, A was headquartered in State A. Two of the acquired savings associations were located in State B and one was located in State C. After the mergers, the acquired institutions ceased to exist as separate entities. Thereafter, the acquired institutions' historic businesses were operated as branches of A in their respective states.

A entered into a number of written agreements for the acquisitions. First, on Date B, A entered into a merger agreement with B to acquire the three merged institutions.[1] The parties agreed to several conditions precedent before the completion of the merger. Among them were: (a) The FHLBB must approve the transaction; and (b) the Federal Savings and Loan Insurance Corporation (FSLIC) must provide a satisfactory assistance agreement.

On Date A, A entered into an Assistance Agreement with the FSLIC in which the agency stated it would provide "indemnification and/or financial assistance" under Title 12 U.S.C. § 1729(f) (section 406(f) of the National Housing Act) for the acquisition of the three insolvent institutions. FSLIC agreed to provide several types of financial assistance, e.g., a cash negative net worth payment and loss protection payments with respect to certain assets. A imposed a number of conditions precedent to its obligations under the Assistance Agreement. Among them were: (a) the FHLBB issue a federal charter to A in substantially the form it requested; (b) a supervisory forbearance letter be issued; and (c) the FHLBB certify that grounds for the merger exist under Title 12 U.S.C. § 1464(d)(6)(A)(i) or (iii). The last paragraph of the agreement stated that restrictions imposed by either FSLIC or the FHLBB on the insolvent institutions would not apply to A.

The liabilities that the Taxpayer assumed in connection with the acquisition of the State B institutions exceeded the fair market value of the assets it received by approximately Amount A. For financial accounting purposes, that amount was treated as the cost of core deposits and goodwill and amortized over various periods. No federal tax deduction, however, was initially claimed for any portion of this amount.

In Year A, A sold its State B branches to two in-state financial institutions. In one sale agreement, A agreed not to compete with the acquirer in State B, or in adjacent counties in State D and State E for a period of three years, except by national or regional advertising not targeted at State B. In the other agreement, A agreed not to compete with the acquirer for a period of two years within a specified Metropolitan Statistical Area within State B.

On its Year A federal income tax return, A reported gain of Amount B from the sale of its State B branches. The adjusted basis for the branches did not include any portion of the excess of liabilities assumed over the fair market value of assets acquired in connection with the acquisition of the State B institutions (Amount A). The examining agent and the Taxpayer do not dispute that Taxpayer's acquisition of the State B institutions was part of a reorganization within the meaning of section 368(a)(1)(G) of the Code and that the assets acquired by the Taxpayer would generally have a carryover basis pursuant to section 362(b). The Taxpayer currently claims, however,

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[1] Under the plan, the two State B institutions were to be merged into B, a State C corporation, prior to the merger with A.

that of Amount A, approximately Amount C reflects the fair market value of State B Branching Rights and that it should be permitted to deduct this amount under section 165(a) because the rights were abandoned in Year A. Taxpayer asserts that the rights were assistance provided to A within the meaning of section 597(a) of the Internal Revenue Code of 1954 and that it thus acquired the rights as tax-exempt income with a fair market value basis.

LAW AND ANALYSIS:

Issue 1: Section 597

Background

At the time A acquired the three insolvent institutions, section 597(a) of the Internal Revenue Code of 1954 provided that the gross income of a domestic building and loan association did not include any amount of money or other property received from the FSLIC pursuant to section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)), regardless of whether any note or other instrument is issued in exchange therefore. Section 597(b) provided that payments described in section 597(a) cause no reduction in the basis of the assets of the recipient.

Section 597 was first added to the Code effective January 1, 1981. The section was intended to resolve the question of whether financial assistance from FSLIC was either includible in income because of a quid pro quo, or whether the assistance was a non-shareholder contribution to capital within the meaning of United States v. Chicago, B. & Q. RR. Co., 412 U.S. 401 (1973), and would have a zero basis itself under section 362(c) or reduce the basis of other property owned by the taxpayer.[2]

Federal Banking Law

At the time A acquired the three insolvent thrifts, the FHLBB was an independent federal agency and authorized, among other things, to charter federal savings and loan associations "under such rules and regulations as it may prescribe". 12 U.S.C. §§ 1437(b) and 1464(a). This mandate was sufficiently broad for the FHLBB to permit federal associations to operate branches throughout a state, as well as to operate branches in multiple states, without regard to limitations of state law. Independent Bankers Ass'n v. FHLBB, et al., 557 F.Supp. 23 (D. D.C. 1982). Nonetheless, the agency chose to exercise this authority in a restricted manner. For example, the agency would permit federal associations to establish branches only to the extent state law permitted state chartered institutions to establish branches. 12 C.F.R. § 556.5(a)(2).

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[2] H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981).

In 1967 the FHLBB adopted a general policy not to approve the establishment of branch offices by a federal association outside its home state. 32 Fed. Reg. 20630-31 (Dec. 21, 1967). This statement was later amended to say it was the "general policy" not to approve interstate branching. 37 Fed. Reg. 3987 (Feb. 25, 1972). Subsequently, the policy was further modified by the amendment of regulations in 12 C.F.R. § 556.5 on March 30, 1981. Subparagraph (a)(3)(iii) provided that interstate branching could be approved when the establishment of a branch resulted from the acquisition of assets of another institution pursuant to action by the FSLIC to prevent failure of the other institution and the risk to the FSLIC was reduced by maintaining the branch.

The FSLIC was created in Title 12 U.S.C. § 1725(a). The statute refers to formation and operation of the FSLIC under the direction of the FHLBB. The FSLIC was to operate under such bylaws, rules and regulations as the FHLBB might prescribe for purposes of the subchapter, namely, to provide insurance for savings and loan accounts. Under 12 U.S.C. § 1725(c), FSLIC was nonetheless a separate corporate entity authorized to sue and be sued in its own name.

In addition to providing deposit insurance, the FSLIC was authorized to provide assistance from its assets to insolvent savings associations. This assistance included arranging acquisitions, capital contributions, asset purchases, guarantees, assumption of liabilities and loans. 12 U.S.C. § 1729(f). FSLIC was restricted to providing financial assistance.

The FSLIC was not authorized, itself, to grant charter or branching authority to any institution. The FHLBB was not authorized, itself, to provide financial assistance to insolvent institutions under 12 U.S.C. § 1729(f). Nor was the FHLBB authorized to provide financial contributions or assistance to the FSLIC.

<u>Analysis</u>

In 1981, section 597(a) of the Internal Revenue Code of 1954 provided a limited exclusion from income for assistance to aid insolvent financial institutions. First, the exclusion applied solely to savings associations. Second, it applied solely to assistance furnished by the FSLIC. Third, it applied solely to <u>financial</u> assistance authorized by section 406(f) of the National Housing Act (12 U.S.C. 1729(f)).

Under the facts of this case, FSLIC did not agree to provide a charter or license to A to operate within State B. The written agreement between the FSLIC and A does not grant or promise these rights. The only reference in the Assistance Agreement remotely related to this issue is that the obligations of A are conditioned upon it receiving a charter, a supervisory forbearance letter, and a certification letter from the FHLBB. Similarly, the only reference to this issue in the merger agreement between A and B is a condition the FHLBB approve the transaction in its proposed form, and that the FSLIC enter into an acceptable assistance agreement.

The Taxpayer argues that because the Assistance Agreement was conditioned upon the FHLBB granting A a charter with multi-state branching rights, the State B Branching Rights must have been assistance provided by FSLIC under section 406(f) of the National Housing Act. It claims this position is further supported by the FHLBB's resolution dated Date A. One paragraph of the resolution states:

> RESOLVED FURTHER, That the Bank Board, as operating head of the FSLIC, hereby determines that pursuant to section 406(f) of the National Housing Act ... that (1) <u>financial</u> assistance by the FSLIC is necessary ... and (2) the amount of such assistance ... would not exceed the amount that would be reasonably necessary to save the cost of liquidating ... through receiverships accompanied by the payment of insurance of accounts. (Emphasis added.)

We do not agree with the Taxpayer's analysis for several reasons. First, the Assistance Agreement does not grant the State B Branching Rights. Second, the FSLIC did not have authority to grant such rights. Third, the FHLBB recognizes in its resolution that section 406(f) of the National Housing Act addresses <u>financial</u> assistance by FSLIC, only. Elsewhere in the resolution the FHLBB exercises its own authority to grant A a charter with the branching rights.

Although the Taxpayer seems to argue that FSLIC and the FHLBB are one and the same, this is not the case under federal law generally, and is not the case for federal tax law. As noted above, the FSLIC and the FHLBB are separate federal entities with different purposes and assets. The fact the FSLIC may be subject to the control or supervision of the FHLBB does not mean they are a single corporate entity. <u>See</u> <u>Moline Properties, Inc. v. Commissioner</u>, 319 U.S. 436 (1943); <u>Burr Creamery Corp. v. Commissioner</u>, 62 F.2d 407 (9th Cir. 1932), <u>cert. denied</u>, 289 U.S. 730 (1933). These entities were created by federal statute, Congress was aware they were separate, and Congress chose to limit section 597 to financial assistance from FSLIC. We have no legislative history or other information that Congress intended the statute to resolve issues concerning the exercise of authority of the FHLBB. We have no guidance from Congress explaining how to expand the interpretation of the statute to encompass transactions not explicitly described.

We note that in the year of the merger, the FHLBB promulgated a regulation that included its authority to permit multi-state branching rights in a supervisory acquisition.[3] The authority for the entire regulation is listed as 12 U.S.C. §§ 1464 and 1729 (section

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[3] 12 C.F.R. § 556.5(a)(3)(ii).

406 of the National Housing Act as codified). This statement of authority does not compel agreement with the Taxpayer's position. There are a number of subparagraphs in section 1729 dealing with various powers of the FSLIC and the FHLBB. We cannot conclude from the broad citation that the FHLBB thought that section 1729(f) was the particular authority for it to permit multi-state branching rights under the regulation. To the contrary, the FHLBB's own statements in its resolution, above, leads to the conclusion that the agency considered section 1729(f) (section 406(f)) to refer solely to financial assistance rather than to various charter or license rights. This conclusion is further supported by the manner in which the FSLIC and the FHLBB computed the cost of the assistance package offered to A. Nowhere in the memorandum from the FSLIC to the FHLBB recommending the A transaction as the least cost resolution was there any mention of the State B Branching Rights as part of the cost of the assistance package.

For all the reasons outlined above, we conclude that the grant of either a charter or a license to operate a savings association or branches does not specifically fall within the criteria of section 597. The FSLIC had no authority to grant a charter or license under section 406(f) of the National Housing Act. The charter or State B Branching Rights were not financial assistance.

Issue 2: Fair Market Value

Even if section 597 of the 1954 Code did apply to give Taxpayer a fair market value basis in the State B Branching Rights upon their acquisition, Taxpayer's methodology for determining that fair market value basis is seriously flawed.

Taxpayer essentially argues that the liabilities it assumed in connection with the acquisition of the State B institutions exceeded the fair market value of the assets it acquired by approximately Amount A and that some Amount C of this "premium" represents the value of the branching rights.

This methodology ignores a host of other possible benefits Taxpayer derived from the acquisitions that would explain why Taxpayer would agree to assume liabilities exceeding the fair market value of acquired assets. The methodology ignores, for example, the assets and liabilities of the State C institution acquired as part of the same transaction and any value attributable to the right to do business in State C. Taxpayer's position conflicts with that of the industry taken in the Winstar litigation. In United States v. Winstar Corp., 116 S. Ct. 2432 (1996), the Supreme Court found that in order to minimize the amount of financial assistance that would have to be provided as a result of the savings and loan association crisis, federal regulators provided solvent, acquiring institutions such as the Taxpayer with favorable regulatory accounting treatment. These institutions were permitted to take into account supervisory goodwill in meeting their capital requirements, thus increasing the institutions' ability to lend. Moreover, the relatively slow amortization of this asset improved the institutions' balance sheets. The industry has taken the position, with success, that this favorable accounting treatment is a valuable contract right.

Issue 3: Abandonment

Finally, even if Taxpayer could establish that it held an asset in the nature of State B Branching Rights and its basis in such an asset, Taxpayer has not produced facts showing that it is entitled to an abandonment loss deduction.

Section 165(a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

Treas. Reg. § 1.165-1(b) of the Income Tax Regulations provides that to be deductible a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Treas. Reg. § 1.165-2(a) of the Regulations provides that a loss incurred in a business and arising from the sudden termination of the usefulness in such business of any nondepreciable property, in a case where such business is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year is which the loss is actually sustained.

Taxpayer claims to have abandoned the State B Branching Rights in Year A, the year in which it sold the last of its State B branches. A taxpayer claiming an abandonment loss must show (1) an intent to abandon property and (2) an overt act of abandonment. Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220, 225 (1972), acq., 1973-2 C.B. 2.

The overt act of abandonment must communicate to a third party the taxpayer's intent to abandon the property in question. For example, in Echols v. Commissioner, 935 F.2d 703 (5th Cir. 1991), a taxpayer claiming to have abandoned a partnership interest had tendered the interest to other partners and stated that he would not make any further contributions to the partnership. The court concluded that the overt act requirement had been met. By contrast, in Corra Resources, Ltd. v. Commissioner, 945 F.2d 224 (7th Cir. 1991), the court held that a taxpayer claiming to have abandoned a mineral lease failed to adequately communicate that intent.[4] In support of its holding, the court explained that "[i]ntra-corporate affairs. . . do not generate signs visible to outside observers." Thus, internal communications within the taxpayer's organization did not suffice as overt acts. The court also explained that although there may have

[4] As authority for the overt act requirement, the court cited Treas. Reg. §1.165-1(d)(1) and its requirement that losses be "evidenced by closed and completed transactions and . . . fixed by identifiable events."

been no established method of abandoning the type of interest the taxpayer held, the taxpayer could have communicated its intent to any one of a number of parties, such as the transferor of the mineral interest, the company hired to conduct mining, or the company hired to manage the taxpayer's interest.

In this case, irrespective of whether Taxpayer possessed the intent (in Year A) to abandon its right to conduct business in State B, it has not shown that it unambiguously communicated that intent to any third party. Thus, the overt act requirement has not been met. Correspondence internal to the Taxpayer, such as board resolutions, do not suffice. Moreover, the noncompete agreement that was part of the sale of the Taxpayer's last State B branch was limited both in terms of its duration and its geographic scope. Under the agreement, Taxpayer and related parties are precluded from competing for a period of two years within a given Statistical Area.[5] In short, the intent communicated by Taxpayer in Year A was to preserve its right to conduct business in State B, subject to a narrowly-drawn noncompete covenant.

Taxpayer's status is similar to that of the taxpayer in International Educational Publishing Co. v. Commissioner, 79 F.2d 343 (3d Cir. 1935). In that case, the taxpayer purchased the right to use certain educational materials in correspondence courses in Japan. After investigating the Japanese market, however, the taxpayer determined that a Japanese business was not feasible. The taxpayer charged off the cost of the franchise on its books and claimed a loss deduction for federal income tax purposes. The Service disallowed the deduction and was affirmed by the courts. The appellate court commented, "The petitioner neither canceled nor surrendered its contract with the International Textbook Company to develop the territorial Rights in Japan. It could at any time resume activities in that country if it deemed the conditions favorable."

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[5] Even this limited agreement not to compete provides an exclusion that permits the Taxpayer to acquire institutions within the noncompete area (although in that event the buyer is given an option to purchase the acquired institution from the Taxpayer).