DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

December 11, 2001

Number: **200210053**
Release Date: 3/8/2002
CC:PSI:5;
CAM-115962-01
UIL: 167.14-11; 446.04-17

INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR INDUSTRY DIRECTOR, FINANCIAL SERVICES
LMSB:F

FROM: Susan J. Reaman
Chief, Branch 5, Office of Associate Chief Counsel
(Passthroughs and Special Industries), CC:PSI:5

SUBJECT: Denial of consent for change in method of accounting

In accordance with section 8.07(2)(a) of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 43, this Chief Counsel Advice advises you that consent for a change in accounting method has been denied to a taxpayer within your jurisdiction. Pursuant to § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice is not to be cited as precedent.

LEGEND:

Taxpayer =

Bank =

B =

C =

D =

E =

Taxpayer filed a Form 3115, Application for Change in Accounting Method, to request permission to change its treatment of regulatory intangible assets ("supervisory goodwill") from non-depreciable assets to depreciable assets, beginning with the taxable year beginning B ("year of change").

Taxpayer, formerly Bank, acquired in C separate transactions D thrift institutions in earlier taxable years. The acquisitions were approved by the Federal Home Loan Bank Board ("FHLBB"), and each acquisition resulted in the creation of a regulatory intangible asset. The regulatory intangible assets represented the right to include such assets when calculating the regulatory capital of Taxpayer.

The aggregate fair market value of the regulatory intangible assets approximated $E. The regulatory intangible assets generally were referred to as "goodwill" or "excess of cost over fair market value of acquired assets" on Taxpayer's financial statements. Although the regulatory intangible assets were amortized for book purposes, they were never amortized for federal income tax purposes.

Under the proposed method, Taxpayer will depreciate under § 167 of the Internal Revenue Code the tax basis of the regulatory intangible assets acquired during the purchase of various thrift institutions over the useful life of the assets.

Law and Analysis

Taxpayer takes the position that the contractual "right to use" the purchase method of accounting, along with the resultant purchased goodwill, results in an asset on its books properly identified as supervisory goodwill. Taxpayer believes that this supervisory goodwill qualifies as other property for purposes of § 597 of the Code and is a form of financial assistance provided by the Federal Savings and Loan Insurance Corporation ("FSLIC") under § 406(f) of the National Housing Act. And, as such, the asset was properly excluded from income pursuant to § 597(a). Relying on Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993), Taxpayer further believes that it, as a result of the application of § 597, has an ascertainable tax basis in its supervisory goodwill and that this asset, with the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), had a limited useful life. We cannot accept this view based on our analysis as set forth below.

Issue (1): Whether "supervisory goodwill" qualifies as "money or other property" for purposes of § 597 of the Code?

Supervisory goodwill is a creature of regulatory accounting principles although it bears a nexus to the generally accepted accounting principles ("GAAP") asset of "purchased goodwill" that results under the purchase method of accounting upon the acquisition of one corporation by another.

For federal income tax purposes, Taxpayer's acquisitions of the failing thrifts qualified (and were accounted for) as tax-free reorganizations under § 368(a)(1) of the Code. Thus, Taxpayer took a carryover basis in the assets and liabilities from the acquired institutions at their financial book basis and recognized no gain or loss on the acquisitions.

As a general matter, for federal income tax purposes, purchased goodwill is not an acquired asset in a tax-free reorganization. The value otherwise ascribed to purchased goodwill under GAAP (the excess of purchase price (including liabilities assumed) over the fair market value of the assets acquired) is already reflected in the book basis of the assets and liabilities acquired from the failing thrifts. Taxpayer, at the time of its acquisitions of the failing thrifts, correctly did not recognize a separate intangible asset for federal income tax purposes comparable to its regulatory asset of supervisory goodwill that was booked on its acquisitions of the failing thrifts, as that regulatory asset was derived from the GAAP asset of purchased goodwill. Moreover, even where goodwill is recognized as a tax asset, it is not subject to recovery by depreciation or amortization. See United States v. Winstar Corporation, 518 U.S. 839, 849 at n.5 (1996) quoting Newark Morning Ledger Co. v. United States, 507 U.S. 546, 556 (1993), and Winstar, supra at 851, n.7.

As discussed more fully in Winstar, supra, during the years Taxpayer acquired the failing thrifts, the savings and loan industry was in crisis, and the FSLIC lacked the funds necessary to liquidate all of the failing thrifts. Accordingly, the FSLIC arranged mergers between healthy thrifts and failing thrifts. As an inducement for these mergers, the FSLIC allowed the acquiring thrifts to count supervisory goodwill toward regulatory capital reserve requirements set forth in 12 C.F.R. § 563.13 and to amortize the goodwill over as much as 40 years. In 1989, Congress enacted FIRREA which impacted a thrift's ability to count supervisory goodwill towards satisfaction of its capital reserve requirements.

At the time Taxpayer acquired the failing thrifts, § 597 of the Code, as added by § 244 of the Economic Recovery Tax Act of 1981, Pub. L. 97-34 (Aug. 13, 1981) (the "Act"), 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 § 406(f) of the National Housing Act (12 U.S.C. § 1729(f)), regardless of whether any note or other instrument was issued in exchange. Further, § 597(b) provided that no reduction in the basis of assets of a domestic building and loan association shall be made on account of such money or other property received.

Section 246(c) of the Act made § 597 of the Code applicable to payments made on or after January 1, 1981. The use of the word "payments" in § 246(c) of the Act, along with the statutory language of § 597 of the Code and § 406(f) of the National Housing Act, clearly indicates the congressional intent to limit § 597 to forms of financial assistance provided by the FSLIC.

Although the legislative history to § 244 of the Act is somewhat sparse, what legislative history there is also supports a conclusion that § 597 of the Code covers only financial assistance provided by the FSLIC. Section 597, as enacted, appears to have been first added in the version of H.R. 4242 that was passed by the House on July 29, 1981. See 127 Cong. Rec. at H5259 and H5279 (daily ed. July 29, 1981). The legislative history also indicates that this tax provision was initially

agreed to in the Senate as a floor amendment (captioned "Section 604 FSLIC Financial Assistance") on July 23, 1981. See 127 Cong. Rec. at S8287 (daily ed. July 23, 1981).

In support of the Senate amendment, the congressional record reflects that the "amendment would facilitate the infusion of capital to a failing savings and loan, or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events." Id. at S8288. Further, the use of terms such as "payment," "capital infusion," and "repayment" during the legislative process are further indications of a congressional intent to limit § 597 of the Code solely to forms of financial assistance. See, e.g., Letter from Richard T. Pratt (then-Chairman of the FHLBB), 127 Cong. Rec. at S8288. The conference report, moreover, indicates that this amendment was intended to resolve the question of whether financial assistance from the FSLIC was to be included in income or treated as a non-shareholder contribution to capital (with a consequential reduction in the tax basis of assets) by the taxpayer. H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981). See also Staff of the Joint Committee on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Cong; Pub. L. No. 97-34) (1981), at 152 ("to facilitate providing of financial assistance by the FSLIC") and 153 (referring to the FSLIC's "financial assistance program" and the proper treatment under prior law of such "assistance payments" from the FSLIC).

The FSLIC was created in 1934 with the passage of the National Housing Act chiefly to insure deposits made by the public. See Winstar, 518 U.S. at 844. In addition to providing deposit insurance, the FSLIC generally was authorized to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured institution. See §406(f) of the National Housing Act, 12 U.S.C. § 1729(f).

As a result, supervisory goodwill does not resemble any type of financial assistance listed in § 406(f) of the National Housing Act. Rather, the concept of supervisory goodwill was merely part of an accounting regime designed to induce healthy thrifts to acquire failing thrifts. See Winstar, 518 U.S. at 849-856. The nature of supervisory goodwill is one of regulatory forbearance rather than financial assistance.

Further, based on the types of assistance that the FSLIC was authorized to render under § 406(f) of the National Housing Act, the FSLIC assistance given under this provision was intended to increase the capital of an institution so that the institution could meet its obligations to depositors. Supervisory goodwill does not enhance the capital of an institution. Rather, it is the antithesis of capital as it relieves the institution and its shareholders of their obligations to meet otherwise applicable capital requirements. Nothing in the legislative history to § 597 of the Code indicates it was intended to apply to forms of assistance other than financial assistance. Under these circumstances, supervisory goodwill is not assistance within the meaning of § 597.

Moreover, both the statutory language and the legislative history of § 597 of the Code limit application of § 597 to financial assistance provided by the FSLIC. Under Title 12 of the United States Code, the regulatory forbearance that Taxpayer claims created supervisory goodwill was not provided by the FSLIC.

Generally, the clear meaning of a statute will control its application unless it is established that congressional intent would require a different result. Congress clearly differentiated between the FHLBB and the FSLIC for purposes of applying various contemporaneously enacted provisions of the Internal Revenue Code. Compare §§ 243 and 244 of the Act (in which Congress spoke only to actions by the FSLIC) with § 241 of the Act (in which Congress spoke to actions by either the FHLBB or the FSLIC). The FSLIC, although working with the FHLBB in such matters, was a separate corporation for tax purposes. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Further, the FSLIC had no authority to allow supervisory goodwill to be counted toward regulatory capital requirements under the rules of the FHLBB. Given the clear statutory reference in § 597 of the Code, we cannot expand the meaning of the FSLIC to encompass actions of the FHLBB.

We do not agree that because the FSLIC and the FHLBB have been treated as indistinguishable for purposes of determining a breach of contract with respect to the use of supervisory goodwill to meet regulatory capital requirements, the same result applies here. We note that the Supreme Court in Winstar, supra, did not hold that supervisory goodwill was provided by the FSLIC under § 406(f) of the National Housing Act within the meaning of § 597 of the Code.

We also do not agree that § 597 of the Code extends to the "right to use" supervisory goodwill to meet regulatory capital requirements and that the FSLIC, on Taxpayer's behalf, obtained that "right" from the FHLBB and then conveyed it to Taxpayer in connection with the acquisitions of the failing thrifts. For the reasons set forth above, we conclude that the "right to use" supervisory goodwill is not assistance provided by the FSLIC under § 597.

Issue (2): Whether Taxpayer properly established a tax basis in the book asset identified as supervisory goodwill?

For federal income tax purposes, a taxpayer's basis in property is generally established by reference to the taxpayer's cost. See § 1012 of the Code. The taxpayer's cost is usually measured by the amount the taxpayer paid (in cash or kind) for the property. See § 1.1012-1(a) of the regulations. When a taxpayer incurs no cost in connection with the acquisition of the property, the taxpayer's basis in that property may be established under other provisions of the Code. However, absent the application of a special provision that provides for the tax-free receipt of property, a taxpayer generally must include the fair market value of the property received in income in order to obtain a tax basis in such property. See, e.g., § 1.61- 2(d) of the regulations; Strong v. Commissioner, 91 T.C. 627 (1988). Thus, generally, when a taxpayer acquires property without incurring any cost, the

amount of the taxpayer's basis in that property is equal to the amount included in income (that is, the property's fair market value).

Taxpayer Has No Tax Basis in Supervisory Goodwill

For federal income tax purposes, Taxpayer's acquisitions of the failing thrifts qualified as tax-free reorganizations under § 368(a)(1) of the Code. Special basis rules apply in connection with assets and liabilities acquired by means of tax-free reorganizations. Under these rules, for federal income tax purposes, a taxpayer (such as Taxpayer) generally steps into the shoes of the transferor corporation (such as the failing thrifts acquired by Taxpayer) with respect to basis. See § 362(b). Because supervisory goodwill was not a pre-existing asset on the books of the failing thrifts acquired by Taxpayer, Taxpayer could not obtain a carryover basis in that asset. See also §§ 357(a) and 1032(a).

As Taxpayer could not obtain a carryover basis for supervisory goodwill under § 362(b) of the Code, Taxpayer must identify a fresh source from which basis can be obtained. Taxpayer takes the position that § 597 applies to provide a tax-free source of income from which this fresh basis can be said to derive. For the reasons set forth above under Issue 1, § 597 is not applicable to the acquisition of supervisory goodwill by Taxpayer. Consequently, Taxpayer was not entitled to exclude the value of supervisory goodwill from gross income under § 597(a). As Taxpayer did not separately pay for the purported asset and did not include the fair market value of that asset in gross income, Taxpayer cannot now claim that Taxpayer had a tax basis in that asset. See § 1.61-2(d) of the regulations; Strong v. Commissioner, supra.

Taxpayer Has No Tax Basis in the "Right to Use" Goodwill

Even assuming that Taxpayer received an asset from the regulators that is recognizable for federal income tax purposes, this asset can only be the "right to use" purchased goodwill to meet regulatory capital requirements. Further, for federal income tax purposes, this right is considered "other property" and any tax basis attributable to the acquisition of this right would be determined under rules applicable to the receipt of property. See § 1012 of the Code.

As a general matter, the creation of rights under governmental regulatory and licensing arrangements ("property rights") will usually not result in the recognition of gross income to the recipient of those property rights. See, e.g., Rev. Rul. 92-16, 1992-1 C.B. 15 (holding that the issuance of emission allowance by the Environmental Protection Agency does not result in gross income to the taxpayer (a utility) that receives it). Moreover, not even the excess of the fair market value of the property right over the cost of acquisition of that right will be income. See, e.g., Rev. Rul. 67-135, 1967-1 C.B. 20 (holding that the excess of the fair market value over the cost of a lease obtained by a taxpayer in a lottery conducted by the United States Bureau of Land Management is not includable in gross income).

Even where a tax basis in such a property right is properly determined under § 1012 of the Code, that basis is generally limited to the taxpayer's cost of acquiring the property right (not the fair market value of the right itself). The Service's position with respect to the proper determination of any tax basis to be accorded to the acquisition of these types of property rights has been implicitly adopted by a number of courts in cases holding that taxpayers' bases in similar property rights were the respective taxpayers' costs of obtaining those rights. See, e.g., Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951); Nicolazzi v. Commissioner, 79 T.C. 109 (1982), aff'd per curiam, 722 F.2d 324 (6th Cir. 1983); Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803 (1959). Thus, as Taxpayer incurred no additional cost in order to obtain the "right to use" purchased goodwill for regulatory purposes, its cost basis in such an asset would be zero.

Issue (3): Whether Taxpayer is entitled to claim a deduction for depreciation of supervisory goodwill under § 167 of the Code?

Section 167(a) of the Code provides, as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or of property held for the production of income.

Section 167(c)(1) of the Code generally provides that the basis on which exhaustion, wear and tear, and obsolescence are allowed shall be the adjusted basis provided in § 1011, for the purpose of determining the gain on the sale or other disposition of the property. Section 1.167(g)-1 of the regulations provides that the basis upon which the allowance for depreciation is computed with respect to any property shall be the adjusted basis provided in § 1011 for the purpose of determining gain on the sale or other disposition of the property. Section 1.1011-1 provides the adjusted basis for determining gain or loss from the disposition of property is the cost or other basis prescribed in § 1012 or other applicable provisions of subtitle A of the Code.

Section 1.167(a)-1(a) of the regulations provides that the allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan, so that the aggregate of the amounts set aside will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of that property. The allowance shall not reflect amounts representing a mere reduction in market value.

Section 1.167(a)-1(b) of the regulations provides that the estimated useful life of an asset is not necessarily the useful life inherent in the asset but the period over which the asset may reasonably be expected to be useful to the taxpayer in its trade or business or in the production of the taxpayer's income. This period shall be determined by reference to the taxpayer's experience with similar property taking into account present conditions and probable future developments.

Section 1.167(a)-3 of the regulations provides that an intangible asset that is known from experience or other factors to be of use in the business or the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, may be the subject of a depreciation allowance. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance for depreciation will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Section 1.167(a)-10 of the regulations provides that the period for depreciation shall begin when the asset is placed in service and shall end when the asset is retired from service.

In order to claim a depreciation deduction under § 167 of the Code, a taxpayer is required to: (1) have a determinable tax basis in the asset; (2) use the asset in the taxpayer’s trade or business, or hold the asset for the production of income; and (3) have a useful life determinable with reasonable accuracy.

For the reasons set forth above under Issue 2, Taxpayer does not have a tax basis in the claimed intangible asset regardless of whether that asset is considered to be the regulatory asset of supervisory goodwill or merely the "right to use" such supervisory goodwill to meet regulatory capital requirements. Without a tax basis in that intangible asset, even if we were to conclude that such asset was a depreciable asset, Taxpayer's depreciable basis would be zero pursuant to § 167(c)(1) of the Code and § 1.167(g)-1 of the regulations. Thus, the amount of the depreciation deduction that would be allowable in any taxable year would be zero.

Even assuming that Taxpayer had established a tax basis in the claimed intangible asset (regardless of whether that asset is considered to be the regulatory asset of supervisory goodwill or merely the "right to use" such supervisory goodwill to meet regulatory capital requirements), that asset is not depreciable under § 167 of the Code. For GAAP, Taxpayer’s acquisitions of the failing thrifts were accounted for under the purchase method for business combinations. The amount by which the fair market value of the liabilities assumed by Taxpayer (the "acquisition price") exceeded the fair market value of the assets received by Taxpayer as a result of the acquisitions was recognized on Taxpayer's books as purchased goodwill. For regulatory purposes, this purchased goodwill corresponded to Taxpayer's regulatory asset identified as supervisory goodwill.

If the acquisitions of the failing thrifts created tax basis as Taxpayer alleges, then the calculation of the excess acquisition costs would be consistent with the residual method of determining tax accounting goodwill. See, e.g., Banc One v. Commissioner, 84 T.C. 476 (1985), aff'd, 815 F.2d 75 (6th Cir. 1986). In order to be depreciable, an identified asset requires a determination of value (basis) and a reasonably determinable useful life. Newark Morning Ledger Co. v. United States,

507 U.S. 546 (1993). These two requirements are to be met based on information available as of the transaction date. See Banc One, supra.

At most, Taxpayer received a "right to use" supervisory goodwill to meet regulatory capital requirements. Even assuming that such a right resulted in a recognizable asset for federal income tax purposes at the time of acquisition, this right is not clearly severable from the residual tax asset of goodwill. The mere fact that enactment of FIRREA eliminated Taxpayer's right to use its supervisory goodwill for regulatory purposes does not establish that its tax asset now also has a separately ascertainable value and a reasonably determinable useful life. Taxpayer has failed to substantiate that the fair market value of the right to use supervisory goodwill is equal to the residual amount. Likewise, the remaining useful life determined by the Taxpayer is for the right to use and not necessarily for the residual amount. Therefore, Taxpayer has failed to distinguish the right to use supervisory goodwill from nondepreciable goodwill.

Further, most of the value assigned to the regulatory/book asset of supervisory goodwill was likely derived from loans and other assets that had declined in value because of rising interest rates. See Winstar, 518 U.S. at 851-52. For federal income tax purposes, because Taxpayer took the loans and other assets (from which the regulatory/book asset of supervisory goodwill was derived) at their historic (that is, unreduced) book values, tax basis was properly reflected directly in these loans and other assets, rather than indirectly in a separately booked tax asset comparable to supervisory goodwill. Even if Taxpayer had tax basis in supervisory goodwill, such basis would be the fair market value of the right to use the supervisory goodwill toward regulatory capital requirements, not the full amount of the regulatory forbearance claimed by Taxpayer. While supervisory goodwill was used to meet regulatory capital requirements, the value is not equivalent to its capital cost and does not have a dollar for dollar value. See California Federal Bank v. United States, 43 Fed. Cl. 445, 449 (1999), aff'd in part and vacated in part, 245 F.3d 1342 (2001). Thus, Taxpayer has failed to substantiate the basis in its right to use supervisory goodwill.

Consequently, Taxpayer has not met its burden of separately identifying, valuing, and lifing the right to use as required by the Supreme Court in Newark Morning Ledger, supra, in order for such right to be subject to a depreciation deduction under § 167 of the Code. Even assuming that the asset recognizable for federal income tax purposes is the regulatory asset of supervisory goodwill, Taxpayer also has not met its burden of separately valuing and lifing such asset as required by the Supreme Court in Newark Morning Ledger, supra. Therefore, the claimed intangible asset (regardless of whether that asset is considered to be the regulatory asset of supervisory goodwill or merely the "right to use" such supervisory goodwill to meet regulatory capital requirements) is not depreciable under § 167 and Taxpayer is not entitled to a deduction for depreciation or amortization under § 167 for this asset.

Conclusion

For the reasons set forth above, Taxpayer's requested change in method of accounting with respect to its supervisory goodwill (regulatory intangible assets) has been denied.

If you have any questions on this matter, do not hesitate to call (202) 622-3040.

Susan J. Reaman