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## SYMPOSIUM

### LEGISLATIVE TAX REFORM

#### THE BAD DEBT RESERVES OF FINANCIAL INSTITUTIONS

*The Tax Reform Act of 1969 reduces the amounts deductible by financial institutions as "reasonable" additions to their bad debt reserves and in so doing enacts for the first time a specific statutory provision governing the bad debt reserves of commercial banks. While the latter might be characterized as a positive development, the 1969 legislation places almost total emphasis upon the not unimportant goal of relative "fairness" and similarity of treatment among the various types of financial institutions and vis-à-vis taxpayers in general; however, it appears that very little attention was paid to the level of reserves necessary for the continued safety and soundness of these institutions and the protection of their depositors in times of economic stress.*

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The Federal income taxation of financial institutions<sup>1</sup> is a topic that is usually discussed in terms of fairness, and seldom in terms of financial, business, or even fiscal policy. Congressional consideration of this subject, as part of the Tax Reform Act of 1969<sup>2</sup> (hereinafter referred to as the 1969 Act), is not an exception to this observation. The concept

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1. For the purposes of this article, the term "financial institutions" is meant to include only commercial banks, savings banks, and savings and loan associations.

2. 83 Stat. 487.



that "what is fair is proper" is embodied in and controls the 1969 Act provisions dealing with financial institutions. Those provisions, *inter alia*, bring the bad debt reserves of all banking and mutual savings institutions under statutory formulae for the first time.<sup>3</sup> What is unsettling about the preoccupation with fairness in enacting this tax legislation is the idea that somehow the effective rate at which financial institutions are taxed, vis-à-vis each other as well as other corporations, is of paramount importance. Little regard is given to the effect such a rate, or the tax mechanism by which that rate is set, may have on the financial success, safety, or soundness of the institutions, their savers, and depositors. Even less regard is given to the impact upon their shareholders and the borrowing public.

On three occasions in the past twenty years, in 1951,<sup>4</sup> 1962,<sup>5</sup> and most recently in the 1969 Act,<sup>6</sup> Congress has considered the taxing mechanism concerning financial institutions. After weighing the fairness of the income tax as it then applied to each of the principal statutory categories of such institutions, Congress decided to alter that statutory machinery. Further, the Internal Revenue Service has performed what it apparently thought was preventive maintenance on numerous occasions, particularly in regard to the federal income taxation of commercial banks. It may be questioned whether such attention was needed by both the Congress and the I.R.S. and whether the resulting repairs have been constructive.

This article traces the history of the federal income taxation of financial institutions in general, and the 1969 Act in particular, in an attempt to prescribe a more rational taxing scheme than has existed heretofore. Since the principal focus of Congress, the I.R.S., practitioners, and theorists has been the deductions allowed for additions to the bad debt reserves of these institutions, this article is confined substantially to the consideration of this feature of the taxing scheme as enacted and amended by sections 431 and 432 of the 1969 Act.<sup>7</sup> Considerable attention is given to the possibility of constructing a more lasting statutory mechanism than sections 431 and 432 of the 1969 Act provide.<sup>8</sup>

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3. See Tax Reform Act of 1969, § 431(a), 83 Stat. 616 (codified at INT. REV. CODE of 1954, §§ 585-86); Tax Reform Act of 1969, § 432(a), 83 Stat. 620 (codified at INT. REV. CODE of 1954, § 593(b)).

4. Revenue Act of 1951, ch. 521, § 313, 65 Stat. 490-91.

5. Revenue Act of 1962, § 6, 76 Stat. 977-85.

6. Tax Reform Act of 1969, tit. IV, §§ 431-35, 83 Stat. 616-25.

7. 83 Stat. 616, 620 (codified at INT. REV. CODE of 1954, §§ 585, 593).

8. 83 Stat. 620, 623 (codified at INT. REV. CODE of 1954, §§ 582, 593).



The principal advantage accorded financial institutions under the 1954 Code, both prior and subsequent to enactment of the 1969 Act involves the deductions permitted them for reasonable additions to their bad debt reserves.<sup>9</sup> Section 166(c) of the Code allows any taxpayer on the reserve method of reporting bad debts a deduction for a reasonable addition to a reserve for bad debts "[i]n lieu of any deduction" for wholly and partially worthless bad debts. The language of section 166(c) therefore provides the statutory authority underlying the bad debt reserve deductions allowed both commercial banks and mutual savings institutions. The effect of section 166(c) on financial institutions, however, is that of a reference point. The important question with which the Commissioner of Internal Revenue historically sought to deal and which the Code now actually answers is this: as to both types of institutions, what constitutes the maximum "reasonable addition" to bad debt reserves for such institutions on the reserve method? In the case of commercial banks, the Commissioner, since 1947 by rulings, and now the 1969 legislation,<sup>10</sup> have provided a response to the question. In the case of mutual savings institutions, the Code,<sup>11</sup> at least since 1951, has answered the question. How well this question has been answered is another matter.

### COMMERCIAL BANKS

The term "commercial banks" will be used to describe those financial institutions to which the Commissioner has historically sought to apply particularized nonstatutory bad debt reserve rules in a series of published rulings, beginning with Mimeograph 6209 in 1947.<sup>12</sup> The institutions to which those rulings applied were:

banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts. Such term as used in Mimeograph 6209 and herein does not include mutual savings banks not having

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9. See INT. REV. CODE OF 1954, §§ 166(c), 585(b), 593(b).

10. Tax Reform Act of 1969, tit. IV, § 431(a) (codified at INT. REV. CODE OF 1954, § 585 (b)).

11. INT. REV. CODE OF 1954, § 593(b).

12. Mim. 6209, 1947-2 CUM. BULL. 21; Rev. Rul. 54-148, 1954-1 CUM. BULL. 60; Rev. Rul. 64-51, 1964-2 CUM. BULL. 1003; Rev. Rul. 65-92; 1965-1 CUM. BULL. 112; Rev. Rul. 65-105, 1965-1 CUM. BULL. 116; Rev. Rul. 66-26, 1966-1 CUM. BULL. 41.



capital stock represented by shares, domestic building and loan associations, or cooperative banks without capital stock organized and operated for mutual purposes and without profit.<sup>13</sup>

(Another way of defining the same group of institutions is found in the statutory language of section 585(a)(1) of the Code, *i.e.*, "any bank (as defined in section 581) other than an organization to which section 593 applies) . . . ." <sup>14</sup>

Before commencing a detailed examination of the machinery used since *Mimeograph 6209*<sup>15</sup> to determine what is "a reasonable addition" to the bad debt reserve of a commercial bank, several basic principles need to be stated. First, the bad debt deduction allowed a commercial bank, like that allowed any financial institution, but unlike that permitted mercantile corporations, relates, as a general proposition, only to an item (*i.e.*, money loaned) which has not and will not be included in income when repaid.<sup>16</sup> Second, the measure of reasonable bad debt

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13. Rev. Rul. 54-148, 1954-1 CUM. BULL. 60, 61.

14. INT. REV. CODE of 1954, § 585(a)(1). *Id.* § 581 provides:

For purposes of section 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

*Id.* § 593(a) provides:

This section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit.

In addition, *id.* § 585(a)(2) includes:

(2) any corporation to which paragraph (1) would apply except for the fact that it is a foreign corporation, and in the case of any such foreign corporation this section shall apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

15. 1947-2 CUM. BULL. 26.

16. As the Commissioner recognized in *Mim. 6209*, 1947-2 CUM. BULL. 26 citing *Estate of Maurice S. Saltstein*, 46 B.T.A. 774, 777 (1942), *acquiesced in*, 1942-1 CUM. BULL. 14:

The Tax Court has held that the "use of the reserve for bad debts is not inherently inconsistent with a cash basis where, as here, the reserve is against loss of capital only . . . and contains no element of income which has never been reported."



reserves of financial institutions can either relate to the particular bad debt experience of the institution claiming the deduction, or to a more general, and even industry-wide, experience, or to both. Finally, any fixed, and hence to a degree arbitrary and artificial, measure of bad debt experience must relate either to all loans outstanding at a point in time or to all new loans of the institution during the taxable year, or to both factors. It also should be noted that when limitations are imposed on the extent to which any such formula bad debt reserve deduction may be claimed in a single taxable year (usually expressed in terms of either the portfolio of loans outstanding or new loans), such limitations will relate to the particular taxpayer involved, and hence to the "fairness" of that situation as related to the entire taxing scheme. Experimenting with the mechanism has been tried where the unfairness of the entire scheme has been called into question.

Any historical discussion of the federal income taxation of commercial banks must focus primarily on a 1947 mimeograph of the Commissioner.<sup>17</sup> That mimeograph, like almost every formal consideration of the tax treatment of the bad debt reserves of financial institutions, indicated the importance attached both to the propriety of such reserves, and their measure, and to the fairness of the competitive effects of the rules promulgated. The Commissioner stated as a preamble to this ruling that:

In determining a reasonable annual addition to a reserve for bad debts by a bank *it is believed to be fair and sufficiently accurate* to resort to the average annual bad-debt loss of the bank over a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss.<sup>18</sup>

Mimeograph 6209, while a historic document, represents the genesis of the periodic attempt to apply a standard of fairness to the entire subject of taxation of financial institutions. This is further evidenced by the following:

However, such a reserve cannot be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short

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17. Mim. 6209, 1947-2 CUM. BULL. 26.

18. *Id.* (emphasis added).



period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. *This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the reserve other than such indefinite limitation as might eventually prevail under a moving average method.*<sup>19</sup>

Thus, for example, under Mimeograph 6209, there was an outer limit placed on the accumulated total in the reserve at the end of any year equal to three times the moving average loss rate applied to the particular association's outstanding loans. From the outset, therefore, the Commissioner has paid lip service to logic and "equality" of treatment, but the rules applied have been those of so-called "fairness." The quoted terms are not interchangeable.

The terms of Mimeograph 6209, therefore, are objective and seemingly mathematical, but the philosophy is quasi-legalitarian. Basically, in the case of commercial banks the mimeograph authorized a "special method" of computing an annual addition to the banks' bad debt reserves under which their reserve ceilings were to be computed by reference to a "moving average experience factor" for determining the ratio of losses to loans on the basis of twenty years of experience, including the taxable year.<sup>20</sup> For any year or years within such twenty-year period, during which the commercial bank in question was not in existence, however, the bank was entitled to utilize the average experience of other "similar" banks with respect to the "same kind" of loans. The terms "similar" banks, and the "same kind" of loans, were not defined by the mimeograph. The combined texts of the mimeograph and the 1954 Revenue Ruling<sup>21</sup> produced the following mechanical and arbitrary rules:

[First, the Commissioner] approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average . . . [was] to be determined on a basis of 20 years, including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years.<sup>22</sup>

19. *Id.* (emphasis added).

20. This was the characterization of Mimeograph 6209 given in the Commissioner's pronouncement seventeen years later in Rev. Rul. 65-92, 1965-1 CUM. BULL. 112, 113.

21. Rev. Rul. 54-148, 1954-1 CUM. BULL. 60.

22. Mim. 6209, 1947-2 CUM. BULL. 26, 27.



[Second,] [i]n computing the moving average percentage of actual bad debt losses to loans, the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current taxable year involved. Government insured loans should be eliminated from prior year accounts in computing percentages of past losses, also from the current year loans in computing allowable deductions for additions to the reserve.<sup>23</sup>

[Third,] a newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with 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.<sup>24</sup>

[Fourth,] [i]n lieu of the moving average experience factor provided in paragraph 3 of Mimeograph 6209, which is determined on a basis of 20 years including the taxable year, a bank may use an average experience factor based on any 20 consecutive years of its own experience after the year 1927. Such average experience factor, representing the percentage of bad debt losses to loans for the period selected, applied to loans outstanding at the close of the taxable year, determines the maximum permissible addition to the reserve for the year.<sup>25</sup>

[Fifth,] [c]onsistent with the provisions of Mimeograph 6209 . . . banks which select a 20-year period under [the fourth point] above which extends back into years for which they have no experience of their own will be permitted to fill in such years with similar comparable data.<sup>26</sup>

At this point in time, the significance of Mimeograph 6209 and Revenue Ruling 54-148 is the relative leniency shown by the Commissioner until 1965 in permitting commercial banks to use a 20-year experience period which included the bad debt experience of the Depression. Despite this leniency the banking profession by 1965 was not enamored with the reserve method of accounting for bad debts,<sup>27</sup> perhaps because

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23. *Id.* at 27.

24. *Id.*

25. Rev. Rul. 54-148, 1954-1 CUM. BULL. 60, 61.

26. *Id.* at 61-62.

27. See in this connection Garrison, *Tax Advantages of the Bad Debt Reserve Tech-*



many banks had reached the point where their reserves were equal to three times their loss ratio times loans outstanding. Whether this dissatisfaction stemmed principally from the complications of applying the mimeograph's formula, or from the fact that many banks had reached their reserve ceiling under the mimeograph, the complexities that were inherent in the twenty-year moving average and the competitive inequities which were also present in that formula, even after the Commissioner's attempt in Revenue Ruling 54-148 to remove them, helped cause the formula's ultimate elimination in 1965 in favor of a uniform fixed percentage formula. The question remains, however, whether fairness is really a meaningful criterion for determining the level of the reserves of a financial institution. Asking this question leads to an even more basic inquiry as to whether the taxing scheme, let alone the taxing statute, should contain any formula which seeks to regulate the level of reserves of financial institutions?

Let us next consider the 1965 attempt by the Commissioner to bring uniformity and simplicity to the treatment of commercial banks, and Revenue Ruling 65-92<sup>28</sup> and 65-105,<sup>29</sup> which provided the ground work for the enactment of Code section 585 in 1969. Revenue Ruling 65-92 is an even better example than Mimeograph 6209 of the attempt made to rationalize the federal tax rules applicable to commercial banks in terms of fairness and equality of treatment. The Commissioner states in Revenue Ruling 65-92 that its purpose is "... to provide a uniform percentage for computing annual additions to reserves for bad debts by banks *in order to minimize the large differences in permissible reserves now existing among banks under prior rulings.*"<sup>30</sup> One thought that occurs is that perhaps different banks should be permitted different reserve levels. However, this could be too simple; further reading of Revenue Ruling 65-92 may be advisable. Having stated the purpose of the 1965 ruling, the Commissioner states a reason for new substantive rules.

The Internal Revenue Service has reexamined the above rulings in the light of the experience developed thereunder. *The rulings*

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*nique*, 150 THE BANKERS MAGAZINE, Summer 1967, at 92, 94, in which the author suggests that an important reason why so many banks, *i.e.*, 39 percent (citing Treasury Department's 1963 figures) do not use the reserve method is that, "in the past, the complexities and inequities of I.R.S. Mimeograph 6209 quite likely either discouraged or precluded many banks from adopting it."

28. 1965-1 CUM. BULL. 112.

29. *Id.* at 116.

30. *Id.* at 113 (emphasis added).



*have resulted in large variances in reserves among banks and in reserve ceilings not related to the probability of bad debts on outstanding loans.*

The Service has therefore approved a revised *special method* for use by banks *which is designed to minimize the existing large variances in permissible reserves.*<sup>31</sup>

The substantive rules themselves were as follows: first, a uniform ratio of 2.4 percent of outstanding loans was established as the general measure of the reserve for bad debts of commercial banks; second, a series of "exceptions and limitations" to this rule was established in situations in which the actual reserve of the institution was either less than, or more than, the uniform ratio; and third, the maximum annual reserve addition through use of the 2.4 percent "uniform reserve ratio" was limited to 0.8 percent of loans of the bank outstanding at the end of the taxable year involved.

The last significant public statement by the Commissioner before the 1969 Act on the subject of the bad debt reserves of commercial banks was Revenue Ruling 68-630.<sup>32</sup> Perhaps in terms of a meaningful and workable document to those initiated to the intricacies of the bad debt reserves of banks, Revenue Ruling 68-630 is more significant than its predecessor, Revenue Ruling 65-92, which it seeks to clarify. As a historical document however, Revenue Ruling 68-630 is important only as an attempt to contract the loan base used in applying Revenue Ruling 65-92.

For example, Revenue Ruling 68-630 held, on a prospective-only basis, that a bank's funds on deposit in another bank were not eligible for inclusion in the loan base. Excluded also were loans secured by passbooks and certificates of deposits, unearned discount investments in securities and money market investments. Loans in which the borrower was required to maintain a minimum, average, or compensating balance were not affected however. The ruling further sought to contract the loan base on a prospective basis by excluding any loan outstanding at the end of a taxable year that was "not representative of the bank's

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31. *Id.* (emphasis added).

32. 1968-2 CUM. BULL. 84. *But see* Rev. Rul. 66-26, 1966-1 CUM. BULL. 41 which sought to bring "clarity" to Rev. Rul. 65-92 but is otherwise of relatively minor significance in tracing the history of the Tax Reform Act of 1969, tit. IV, § 431(a) (codified at INT. REV. CODE of 1954, § 585).



ordinary portfolio of outstanding customer loans . . . .”<sup>33</sup> It is well to remember the 1968 Revenue Ruling as an effort by the Commissioner to carve the loan base of the banks down to a size approximately commensurate with the permissible statutory loan base applicable to the mutual savings institutions’ computation under section 593(b) of the 1954 Code. In short, the 1968 effort was a significant step toward a parallel statutory treatment of the two types of institutions based on fairness.

As indicated at the outset, the 1969 Act brought the bad debt reserves of both commercial banks and mutual savings institutions under the specific statutory coverage of the 1954 Code for the first time. The provisions involved are section 593 (dealing with the bad debt reserves of domestic building and loan associations as specifically defined by section 7701(a)(19)), and new section 585 (dealing with the reserves of banks, as particularly defined by section 585(a)). These modified and new provisions of the Code had their technical origin in the House Ways and Means Committee proposals to place both types of institutions on actual bad debt experience.<sup>34</sup> For analytical purposes, however, the best starting point is a proposal made by the Treasury Department to the Senate Finance Committee on September 4, 1969,<sup>35</sup> which would have accepted this result but would have also caused the enactment of a “special tax deduction” for each of the three basic types of financial institutions, commercial banks, mutual savings banks, and savings and loan associations.

The 1969 Act provisions dealing specifically with commercial banks originated in a rather severe approach by the House Ways and Means Committee which would have had the effect of cutting the banks back to their own “experience.” The House Committee approach, which

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33. Rev. Rul. 68-630, 1968-2 CUM. BULL. 84, 87, also provided in this same regard that,

[i]f a loan is entered into or acquired for the purpose (whether or not it is the primary purpose) of enlarging the otherwise available bad debt deduction, it will be presumed that the loan resulting from such transaction is not representative of the bank's ordinary portfolio of outstanding customer loans.

34. See H.R. 13270, 91st Cong., 1st Sess., §§ 441, 442 (1969). See also H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 120-29 (1969).

35. See, Statement of David M. Kennedy, Secretary of the Treasury, in *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 1, at 495 (1969).



was followed by the full House as well, would have limited banks,<sup>36</sup> insofar as their bad debt reserve deductions were concerned, to "the amount called for on the basis of their own experience as indicated by losses for the current year and the 5 preceding years."<sup>37</sup> A transition period was provided but "excess reserves" at the time of enactment would have barred future deductions for additions to the banks' "reserves" until deduction were "justified on the basis of their own experience."<sup>38</sup>

Why did the House cut commercial banks back to actual experience? The House Committee explained its reasons as follows:

By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, present law gives them much more favorable treatment than most other taxpayers. Section 166(c) of the Internal Revenue Code permits business taxpayers to take a deduction for a reasonable addition to a reserve for bad debts. Most taxpayers accumulate a bad-debt reserve equal to the ratio of the average year's losses to *accounts receivable*. The average loss is computed on the basis of losses for the current year and the 5 preceding years.

Commercial banks have the option of establishing their bad-debt reserves on the basis of their actual experience like other taxpayers. However, they generally elect to build up these reserve [sic] on the basis of the industrywide 2.4 percent figure permitted by Revenue Ruling 65-92. *The extent of the favored tax treatment granted to commercial banks by this ruling is shown by the fact that if banks were subject to the same bad-debt reserve rules applying to taxpayers generally, they would on the average be allowed to build up a bad-debt reserve of less than 0.2 percent of outstanding noninsured loans.*<sup>39</sup>

The Senate Finance Committee took a different approach from that of the House and amended the legislation to provide an alternative to the pure experience method. The Finance Committee version was approved by the Senate and would have allowed commercial banks

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36. It should be noted that the House version of the 1969 Act would have defined "banks" to include what it thought to be "institutions which are similarly situated:" small business investment companies and business development corporations created under State law.

37. H.R. REP. NO. 91-413, pt. 1, *supra* note 34, at 121.

38. *Id.*

39. H.R. REP. NO. 91-413, pt. 1, *supra* note 34, at 120-21 (emphasis added).



to deduct additions to their bad debt reserves up to 1.8 percent of eligible loans, or the amount called for on the basis of their experience, whichever was the greater.

When the 1969 Act reached the Senate-House Conference Committee, the commercial bank bad debt provision that emerged accepted the 1.8 percent alternative, but only for a six-year period. For taxable years beginning after 1975, the "allowable percentage" will be 1.2 percent, and 0.6 percent for taxable years beginning after 1981 and until 1988. These percentages are to be applied to "eligible loans" of the taxpayer bank at the close of the taxable year involved. The term "eligible loans" is now a statutory word of art defined in section 585(b)(4) of the 1954 Code. For taxable years beginning after December 31, 1987 (by reason of the language of Code section 585(b)(1) (A) and (B)), all commercial banks will be required to utilize the so-called "experience method" which is now specifically described in the code.<sup>40</sup> The "experience method," however, will be of a hypothetical nature for most banks until 1988, if the Treasury's own figures<sup>41</sup> as to the actual percentage of banks' bad debts are accurate.<sup>42</sup>

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40. See INT. REV. CODE of 1954, § 585(b)(3).

41. The Treasury Department submitted a technical memorandum of its positions with respect to the provisions of the 1969 Act under date of September 30, 1969, to the Senate Finance Committee in which it was asserted that the banks' "recent actual experience would appear to entitle them to a reserve of less than 0.2 percent of such loans." See TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270, in *Hearings on H.R. 13270*, *supra* note 35, at 769, 850.

42. INT. REV. CODE of 1954, § 585(b)(2) provides:

(2) PERCENTAGE METHOD.—The amount determined under this paragraph for a taxable year shall be the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the allowable percentage of eligible loans outstanding at such time, except that

(A) If the reserve for losses on loans at the close of the base year is less than the allowable percentage of eligible loans outstanding at such time, the amount determined under this paragraph with respect to the difference shall not exceed one-fifth of such difference.

(B) If the reserve for losses on loans at the close of the base year is not less than the allowable percentage of eligible loans outstanding at such time, the amount determined under this paragraph shall be the amount necessary to increase the balance of the reserve at the close of the taxable year to (i) the allowable percentage of eligible loans outstanding at such time, or (ii) the balance of the reserve at the close of the base year, whichever is greater, but if the amount of eligible loans outstanding at the close of the taxable year is less than the amount of such loans outstanding at the close of the base year, the amount determined under clause (ii) shall be the amount necessary to increase the balance of the reserve at the close of the taxable year to the amount which bears the same ratio to eligible loans outstanding at the close of the taxable year as the balance



The language of section 585 (b) (4) of the 1954 Code and the Treasury Regulations to be promulgated thereunder will have overriding importance for commercial banks in computing their allowable bad debt reserve deduction, either under the percentage method of section 585 (b) (2), or the experience method of section 585 (b) (3). Code section 585 (b) (4) provides:

REGULATIONS; DEFINITION OF ELIGIBLE LOAN, ETC.

—The Secretary or his delegate shall define the terms “loan” and “eligible loan” and prescribe such regulations as may be necessary to carry out the purposes of this section; except that the term “eligible loan” shall not include—

- (A) a loan to a bank (as defined in section 581),
- (B) a loan to a domestic branch of a foreign corporation to which subsection (a) (2) [dealing with foreign banks] applies,
- (C) a loan secured by a deposit (i) in the lending bank, or (ii) in an institution described in subparagraph (A) or (B) if the lending bank has control over the withdrawal of such deposit,
- (D) a loan guaranteed by the United States, a possession or instrumentality thereof, or a state or a political subdivision thereof,
- (E) a loan evidenced by a security as defined in section 165 (g) (2) (C),
- (F) a loan of Federal funds, and
- (G) commercial paper, including short-term promissory notes which may be purchased on the open market.

The first observation about this statutory definition is that its similarity to Revenue Ruling 68-630 is obvious.<sup>43</sup> When proposed regulations are issued, their substantial conformity to the language in Revenue Ruling 68-630 can be expected. Furthermore, even more stringent proposed rules might be anticipated since the 1954 Code merely seeks to block out those loans which are not in any case to be considered “eligible loans.” Finally, the question might be raised in defining what is meant by phrases like “control over the withdrawal of such deposit,” whether section 585 (b) (4) of the 1954 Code will not affect the lending and investment decisions of commercial banks, and thereby have a warping effect on customary banking practice.

Another aspect of the 1969 legislation which merits some discussion is the dual definition of the term “base year” in both section 585 (b)

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of the reserve at the close of the base year bears to the amount of eligible loans outstanding at the close of the base year.

43. 1968-2 CUM. BULL. 84.



(2) of the 1954 Code dealing with the percentage method and section 585(b)(3) dealing with the experience method. In connection with the percentage method formula it is generally provided that

... the term "base year" means: for taxable years beginning before 1976, the last taxable year beginning on or before July 11, 1969, for taxable years beginning after 1975 but before 1982, the last taxable year beginning before 1976, and for taxable years after 1981, the last taxable years beginning before 1982 . . . .<sup>44</sup>

However, for purposes of the experience method which all commercial banks are slated to use after 1987, but which some may use before then,

... the base year shall be the last taxable year before the most recent adoption of the experience method, except that for taxable years beginning after 1987 the base year shall be the last taxable year beginning before 1988.<sup>45</sup>

Aside from the confusion of having two different base years, commercial banks should react adversely to the statutory attempt to use the "base year" under the percentage method to restrict the current deduction in one of two ways. First, if the reserve at the close of the base year is less than the "allowable percentage of eligible loans" outstanding at such time, any current deduction for an addition to a bank's bad debt reserve is whittled down by four-fifths the base year deficiency; this is so even though the application of the "allowable percentage" to its present portfolio of "eligible loans" might require a larger addition on the theory of soundness (assuming the "allowable percentage" is intended as a statutory indication of what is considered a safe and sound level for a bad debt reserve).<sup>46</sup> Second, if the reserve of a bank at the close of the base year is *not* less than "the allowable percentage of eligible loans" outstanding at such time, then the current deduction is again shaved down under section 585(b)(2)(B) of the 1954 Code, as follows: the amount determined under the percentage method shall then be *the greater of* the amount necessary to increase the dollar balance of the reserve at the close of the taxable year *either* to the allowable percentage of eligible loans *or* to the dollar balance of the reserve at the close of the base year, provided however, that if the

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44. INT. REV. CODE of 1954, § 585(b)(2).

45. *Id.* § 585(b)(3).

46. This is quite likely a faulty assumption, as this article seeks to point out.



portfolio of eligible loans has decreased since the base year, the amount allowed as a deduction pursuant to the second alternative shall be reduced proportionately. In other words, in a period of contraction from the base year, the bank will have its current deduction for additions to the reserve pared down even though the present loans and current bad debt experience would seem to justify the higher base year level of reserves be maintained. Despite these disadvantages attaching to the "base year" principle, its effects will be greatly lessened after a bank, showing normal growth, has entered the second and third periods (after 1975 and 1981, respectively), since it will probably be utilizing the "allowable percentage" measure against its eligible loan portfolio at the end of the taxable year.<sup>47</sup> After 1987 all banks will be required to use the "experience method" of section 585(b)(3) of the 1954 Code.

### SAVINGS INSTITUTIONS

The term "savings institutions" will be used throughout the remainder of this article to refer to those financial institutions which are not commercial banks. This category includes building and loan associations,<sup>48</sup> mutual savings banks, and cooperative banks.<sup>49</sup> These institutions are sometimes referred to collectively as "mutual" institutions, as most such organizations are owned by the savings account holders. Nearly half the states permit the formation of so-called "permanent stock associations," however, which have capital stock outstanding. Because the latter institutions are subject to taxation in the same manner as their depositor-owned counterparts, any further discussion of this distinction is beyond the scope of this article.

### *Historical Background*

During the first half of the nineteenth century, a new type of financial organization appeared on the American scene in the form of the mutual savings bank. These institutions were conceived and developed largely as a means of encouraging low-income individuals to develop habits of personal thrift, and of assisting them in attaining

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47. See INT. REV. CODE of 1954, § 585(b)(2)(B)(i).

48. Although the modern terminology is "savings and loan association," the Internal Revenue Code continues to use the traditional term, apparently for the sake of statutory consistency. See *id.* § 7701(a)(19) for the definition of a "domestic building and loan association."

49. The term "cooperative bank" is defined at *id.* § 7701(a)(32) in a manner paralleling the definition of "domestic building and loan association." *Id.* § 7701(a)(19).



a measure of financial independence. At approximately the same time, another form of financial institution appeared, the building and loan association. These institutions amassed the small periodic deposits of their members to create a fund which would form a basis for loans to members for the purchase of a home. It was anticipated that each participating member eventually would be able to attain home ownership. Both the mutual savings bank and the building and loan association more closely resembled non-profit, self-help organizations than commercial banks, since the latter institutions were profit-oriented from the beginning.

Upon enactment of the first Federal income tax during the Civil War, preferential treatment was extended to savings institutions and their depositors.<sup>50</sup> Subsequently, Congress granted these institutions full exemption from taxation in the Tariff Act of 1894.<sup>51</sup> This approach of complete exemption from taxation was adopted in the earliest form of the modern income tax in 1913,<sup>52</sup> and was continued through all successive revenue revisions up to and including adoption of the Internal Revenue Code of 1939.<sup>53</sup> This approach to the taxation of savings institutions was theoretically abrogated in 1951 when they were first subjected to the income tax.

### *Revenue Act of 1951*

As mutual savings banks and savings and loan associations first became subject to the income tax under the Revenue Act of 1951 (hereinafter referred to as the 1951 Act),<sup>54</sup> an ambivalent Congressional attitude toward these institutions began to develop. On the one hand, it was felt that the principal of tax equity demanded that all able to do

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50. See Act of July 1, 1862, ch. 119, § 82, 12 Stat. 470; Act of March 3, 1863, ch. 74, § 11, 12 Stat. 713, 723; Act of March 3, 1865, ch. 78, § 1, 13 Stat. 469, 479; Act of March 2, 1867, ch. 169, § 13, 14 Stat. 471, 477; Act of July 14, 1870, ch. 255, § 15, 16 Stat. 260.

51. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556-57, as amended by Jt. Res. 18, 53d Cong., 3rd Sess., 28 Stat. 971 (1895).

52. Revenue Act of Oct. 3, 1913, ch. 16, § 11(G)(a), 38 Stat. 172.

53. Revenue Act of 1916, ch. 463, § 11(a), 39 Stat. 766; Revenue Act of 1918, ch. 18, § 231(2), 40 Stat. 1076; Revenue Act of 1921, ch. 136, § 231(2), 42 Stat. 246; Revenue Act of 1924, ch. 234, § 231(2), 43 Stat. 282; Revenue Act of 1926, ch. 27, § 231(2), 44 Stat. 39; Revenue Act of 1928, ch. 852, § 103(2), 45 Stat. 812; Revenue Act of 1932, ch. 209, § 103(2), 47 Stat. 193; Revenue Act of 1934, ch. 277, § 101(2), 48 Stat. 700; Revenue Act of 1936, ch. 690, § 101(2), 49 Stat. 1673; Revenue Act of 1938, ch. 289, § 101(2), 52 Stat. 480; INT. REV. CODE of 1939, §§ 101(2), 101(4).

54. Ch. 521, 65 Stat. 452.



so should bear a fair share of federal expenditures, particularly in view of the increasing defense outlays encountered during the Korean War. The evolution of these organizations from small, self-contained groups of individuals doing business with one another, to large enterprises relatively independent of their members, was viewed as ample justification for re-examining their tax-exempt status.<sup>55</sup> On the other hand, Congress acknowledged the important part played by such institutions in the financing of residential construction, an item of high national priority. Accordingly, the Senate urged, in eliminating the tax exemption of these institutions, that bad debt reserve allowances be more liberal than those allowed commercial banks.<sup>56</sup>

In this setting, the 1951 Act served primarily as a harbinger of things to come. After deliberating over suggestions that savings institutions be subject to taxation in the same manner as other corporations, with deductions for additions to their bad debt reserves on a scale commensurate with that extended to commercial banks, Congress eventually adopted a much less drastic approach: savings institutions were technically removed from tax-exempt status, but were allowed a bad debt reserve deduction equal to 100 percent of taxable income, subject to ceiling limitations on reserve accumulation.

The principles underlying the 1951 Act were important in two respects: the Act effected a basic change in philosophy, from one of total tax exemption to one of restrained taxation; and the method of achieving mitigation (*i.e.*, provision for a statutory formula for the addition to the bad debt reserve of such institutions) has continued to the present time.

The 1951 Act repealed Section 101(2) of the Internal Revenue Code of 1939,<sup>57</sup> thus terminating the total exemption of savings institutions, and subjecting them to the full scope of corporate taxation. This change, however, was largely offset by the amendment made to section 23(k)(1) of the 1939 Code, relating to the deduction for bad debts.<sup>58</sup> This section provided:

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55. S. REP. No. 781, pt. 2, 82d Cong., 1st Sess. 27 (1951).

56. The House bill contained no reference to the tax exemption of savings institutions. The bill, as reported by the Senate Finance Committee, removed the exemption and contemplated that the Commissioner of Internal Revenue would issue administrative guidelines relating to the determination of reasonable additions to a bad debt reserve, taking into account the special characteristics of these institutions. *See id.* at 27-28.

57. Revenue Act of 1951, ch. 521, § 313(a), 65 Stat. 490.

58. *Id.* § 313(e), 65 Stat. 490-91.



In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts shall be determined with due regard to the amount of taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of (A) the amount of its net income for the taxable year, computed without regard to this subsection, or (B) the amount by which 12 per centum of the total deposits or withdrawable accounts of its depositors at the close of such year exceed the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.<sup>59</sup>

Upon enactment of the 1954 Code, this provision was continued as section 593.

Thus, the allowable bad debt deduction for the designated savings institutions could be any amount selected by the institution up to 100 percent of taxable income, provided the total reserve, including the addition for the current year, did not exceed a largely theoretical ceiling of twelve percent of total deposits as of the close of the year. During the 1950's, the unprecedented growth in savings produced an ever increasing ceiling on the allowable bad debt reserves of these institutions. As a result, most savings institutions were able to take deductions equal to the full amount of taxable income and thereby continue to enjoy virtual exemption from taxation.

The 1951 Act<sup>60</sup> amended section 23(r) of the 1939 Code to provide that savings institutions could deduct amounts paid or credited to the accounts of depositors and other account holders as dividends on their deposits or withdrawable accounts. This provision was reenacted without substantial change as section 591 of the 1954 Code.

### *Revenue Act of 1962*

In 1961, Congress undertook a thorough reexamination of the taxation of savings institutions instituted under the 1951 Act. This process

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59. *Id.*

60. Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 491.



culminated in the Revenue Act of 1962 (hereinafter referred to as the 1962 Act),<sup>61</sup> in which Congress again attempted to strike a balance between the production of tax revenues from such institutions, and allowance of a bad debt reserve sufficient to insure their continued solvency. This legislation provided an intricate pattern of taxation, with special provisions in the following areas:

- More restrictive deductions for additions to bad debt reserves, under three alternative computations;
- A modified deduction for payment of dividends or interest to savers on their savings accounts;
- Statutory rules deferring recognition of gain or loss on foreclosures and subsequent dispositions of property acquired by virtue of loan defaults; and
- A new definition of the term “domestic building and loan association,” based upon the character of the investments of such institutions.

As described below, these statutory rules are largely interrelated.

#### *Bad Debt Reserve Allowances*

The 1962 Act continued the approach adopted in 1951 by basing the unique treatment of savings institutions upon the deduction allowable for additions to a reserve for bad debts. Initially, three separate categories of reserves were distinguished, requiring such institutions to isolate the proportion of their total reserves relating to (1) “nonqualifying” loans, or those other than loans secured by an interest in improved real property, (2) “qualifying real property loans,” and (3) reserves accumulated during 1952-1962, designated as “supplemental” loan reserves.<sup>62</sup>

Similarly, additions to the reserve for losses on bad debts allowable for years ending after 1962 were broken down into the reserve for losses on nonqualifying loans, and the reserve for losses on qualifying real property loans. Three alternative methods were available for computing a reasonable addition to the latter reserve. Thus, savings institutions were allowed a deduction equal to “a reasonable addition to the reserve for losses on nonqualifying loans,”<sup>63</sup> plus an addition to the reserve for

61. 76 Stat. 960.

62. Revenue Act of 1962, § 6, 76 Stat. 977, 979 (codified at INT. REV. CODE of 1954, § 593(c)(1)).

63. INT. REV. CODE of 1954, § 593(b)(1)(A).



losses on qualifying real property loans computed under either the percentage-of-taxable-income method (sometimes called the "sixty-percent" method), the percentage-of-real-property-loans method (sometimes called the "three-percent" method), or the customary experience method utilized by other taxpayers.<sup>64</sup>

The percentage-of-taxable-income method represented a variation on and contraction of the 100 percent bad debt allowance provided for savings institutions under the 1951 Act. Under this method, the taxpayer would be allowed a deduction for an addition to the reserve for losses on qualifying real property loans in an amount which, when added to the "reasonable" addition to the nonqualifying loan reserve, equaled sixty percent of taxable income for the year. The total amount deductible under the percentage-of-taxable-income method could not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to six percent of the amount of such loans outstanding at that time.<sup>65</sup>

The second alternative, the percentage-of-real-property-loans method, allowed the institution to deduct the amount necessary to increase the balance of the reserve for losses on qualifying real property loans to an amount equal to three percent of such loans outstanding as of the close of the year. An additional deduction was allowable under this method to institutions which had been engaged in business as a thrift institution for ten years or less; this extra deduction amounted to two percent of the amount of qualifying real property loans up to \$4 million, reduced by the balance, if any, of the taxpayer's supplemental (*i.e.* 1952-62) reserve for losses on loans.<sup>66</sup>

Finally, an institution could rely upon its actual loss experience to compute a reasonable addition to the reserve for losses on qualifying real property loans under section 166(c) of the 1954 Code in the same manner as any business organization.<sup>67</sup>

In no event could the addition to the reserve for losses on qualifying real property loans be greater than the larger of (A) the amount computed under the experience method, determined under section 166(c), or (B) an amount which, when combined with the amount added to the reserve for losses on nonqualifying loans, raises the total surplus, undivided profits, and reserves at the beginning of the year to twelve per-

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64. *Id.* § 593(b). *Cf. id.* § 166(c).

65. *Id.* § 593(b)(2).

66. *Id.* § 593(b)(3).

67. *Id.* § 593(b)(4).



cent of the total deposits as of the close of the year.<sup>68</sup> Thus, with this modification, the twelve percent ceiling first imposed under the 1951 legislation survived under the 1962 Act.

### *Definitional rules*

The 1962 Act also amended section 7701(a)(19) of the Code, which defines the term "domestic building and loan association." Prior to 1962 the definition was framed in simple terms:

The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all the business of which is confined to making loans to members.<sup>69</sup>

This definition was enacted as part of the 1951 Act as section 3797(a)(19) of the 1939 Code, and was reenacted without change as section 7701(a)(19) of the 1954 Code. The addition of this provision to the 1939 Code in 1951 was intended as a clarifying amendment, and was not meant to change the meaning of the term.<sup>70</sup>

The 1962 Act added three new aspects to this definition. First, a supervisory test was added,<sup>71</sup> whereby such an institution must be an "insured institution" within the meaning of section 401(a) of the National Housing Act,<sup>72</sup> or be subject to supervision and examination by state or Federal authorities. Second, a business operations test<sup>73</sup> was imposed whereby substantially all of the business of the institution must consist of acquiring the savings of the public and investing in designated types of loans. Finally, detailed guidelines were set forth for the permissible assets held by qualifying institutions. In this latter connection, ninety percent of the total assets of the association must consist of cash, governmental obligations, real property loans, passbook loans, and property obtained upon foreclosure of such loans.<sup>74</sup> Two additional asset

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68. *Id.* § 593(b)(1).

69. Revenue Act of 1951, § 313(i), 65 Stat. 491.

70. S. REP. NO. 781, pt. 2, *supra* note 55, at 28.

71. INT. REV. CODE OF 1954, § 7701(a)(19)(A).

72. 12 U.S.C. § 1724(a) (1964).

73. INT. REV. CODE OF 1954, § 7701(a)(19)(B).

74. *Id.* § 7701(a)(19)(C). These "ninety-percent" assets were made subject to additional restrictions assuring that designated percentages would be invested in a specified manner. Thus § 7701(a)(19)(D) provided that, of such assets, (i) at least eighty percent must consist of qualifying nonrealty assets plus loans relating to residential or



requirements were superimposed upon this ninety-percent test.<sup>75</sup> Not more than eighteen percent of the total assets of the institution as of the close of the year could consist of assets other than (a) qualifying nonrealty assets<sup>76</sup> and (b) loans relating to residential or church realty. Similarly, not more than thirty-six percent of total assets could consist of assets other than (a) qualifying nonrealty assets, and (b) loans relating to residential property of one-to-four-family units. This thirty-six percent test was partially relaxed; an institution could have up to forty-one percent of its total assets in the types of assets proscribed by the thirty-six-percent test without losing its categorization as a "domestic building and loan association." For each percentage point in excess of thirty-six percent, however, the bad debt deduction under the percentage of taxable income method was reduced by one-twelfth of the amount otherwise allowable.<sup>77</sup>

### *Foreclosures and Subsequent Dispositions*

Under prior law, uncertainty existed regarding recognition of gain or loss on foreclosure, and subsequent disposition of property acquired in respect of the defaulted loans. The 1962 Act added section 595 to the Code to provide that no gain or loss should be recognized by an institution which acquires ownership or possession of mortgaged security by bidding in at a foreclosure sale or otherwise. Furthermore, the tax characteristics of the acquired property in the hands of the institution would be the same as those of indebtedness. This approach respects the actual economic relationships, treating the transaction as if the loan had remained outstanding. The amount realized upon subsequent disposition of the property is treated as a partial or total payment on the debt, and any loss resulting thereby is treated as a bad debt loss. The results occasionally reached under the 1951 legislation, where-

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church real property, and (ii) at least sixty percent must consist of qualifying nonrealty assets plus loans relating to residential property of one-to-four-family units. These restrictions overlapped to a certain extent the eighteen percent and thirty-six percent tests and have been termed "superfluous" by one treatise. See *FEDERAL INCOME TAXATION OF BANKS AND FINANCIAL INSTITUTIONS* ¶ 19.02 (M. Wakely ed. 1968).

75. INT. REV. CODE OF 1954, § 7701(a)(19)(E).

76. Such qualifying nonrealty items include cash, governmental obligations, deposit insurance company securities, property used in the institution's business, and passbook loans. See *Treas. Reg.* §§ 301.7701-13(d)(2)-6.

77. INT. REV. CODE OF 1954, §§ 593(b)(5); 7701(a)(19).



by dispositions of foreclosed property at a loss would give rise to a nondeductible capital loss, are thereby corrected.<sup>78</sup>

### *Dividends Paid on Deposits*

Under the 1962 Act, section 591 of the 1954 Code was amended to make it clear that the deduction allowable to thrift institutions for their payments to depositors was allowable to a savings and loan association which failed to meet the prerequisite definitional test in section 7701(a) (19) of the 1954 Code. Section 6(f) of the 1962 Act extended this deduction to those formerly covered, and to "other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law."<sup>79</sup>

The 1962 Act also introduced special provisions regarding savings and loan institutions which, rather than being organized on a mutual basis, have shares of capital stock outstanding which are not withdrawable shares. Such institutions are taxed in the same general manner as the more common mutual savings institutions. Special rules, however, are provided in section 593(f) of the 1954 Code for distributions by such nonmutual institutions which are not deductible under section 591.

The effect of these special rules is to require that, before distributions may be considered as made out of either the reserve for losses on qualifying real property loans, or out of the supplemental reserve, the amount required to be charged by the stock institution must be included in its gross income. Thus, the amount charged to either of these reserves, and included in income, is the amount of the distribution to the stockholder "grossed-up" by the appropriate amount of tax. This assures that any distribution out of the amounts charged to these privileged reserves, which amount was not previously taxed to the institution, will be subjected to the regular corporate income tax at the time of distribution.<sup>80</sup>

### *Historical Perspective*

The 1962 Act made dramatic inroads into the tax privileges enjoyed by savings institutions under the 1951 Act. For the first time, most such institutions began to pay corporate income tax in significant amounts.<sup>81</sup> They did not, however, become subject to taxation on the

78. See H.R. REP. NO. 1447, 87th Cong., 2d Sess. 36-37 (1962); S. REP. NO. 1881, 87th Cong., 2d Sess. 47-48 (1962).

79. 76 Stat. 984.

80. See S. REP. NO. 1881, *supra* note 78 at 47.

81. See Figure 1, *infra* at 839.



same total basis as other corporations, nor was their treatment in terms of effective rates of tax on a par with the treatment afforded commercial banking institutions. Against this backdrop appeared the Tax Reform Act of 1969, which took another significant step toward taxation of these institutions on a parity with their less inhibited commercial counterparts.

### *Tax Reform Act of 1969*

#### *Treasury Proposals*

The legislative reexamination of the taxation of savings institutions in 1969 began with the Treasury Department *Tax Reform Studies and Proposals*, prepared during the last years of the Johnson Administration.<sup>82</sup>

These studies and proposals, consisting of four volumes totaling over 800 pages, were developed pursuant to the Revenue and Expenditure Control Act of 1968,<sup>83</sup> and were formally released to the public on February 5, 1969. They constituted a comprehensive examination of the federal tax structure, with specific recommendations for reform in a number of areas. The importance of this document with respect to savings institutions is demonstrated by the fact that, in some form, virtually every proposal on this topic forwarded by the Treasury was eventually adopted in the 1969 Act.

*Repeal of the Percentage-of-Real-Property-Loans Method.* In its study, the Treasury briefly reviewed the background and history of savings institutions through the Revenue Acts of 1951 and 1962. A distinct pattern among the various types of savings institutions with respect to the alternative method selected under section 593(b) of the 1954 Code for computing the allowable bad debt deduction was observed. The "percentage-of-real-property-loans" method (or "three percent method") of computing bad debt deductions<sup>84</sup> was more advantageous than the alternative methods in situations where an institution had a significant increase in real estate loans in relation to its taxable income. This method was likewise advantageous where the institution had a significant part of its net income from tax exempt sources (e.g. municipal bonds); because such income is not "taxable income," it is

82. UNITED STATES TREASURY DEPARTMENT, *TAX REFORM STUDIES AND PROPOSALS*, (Committee Print: Joint Publication of the House Ways and Means Comm. and the Senate Finance Comm., 91st Cong., 1st Sess. 1969).

83. Tit. I, § 110, 82 Stat. 270.

84. INT. REV. CODE OF 1954, § 593(b) (3).



not included in the base against which the percentage of income method is applied. Because of the somewhat greater investment flexibility available to mutual savings banks, these institutions were in a much better position to control the composition of their investment portfolios, and to exploit both of these situations. Such institutions could effect an increase in their outstanding real estate loans merely by liquidating other investments and reinvesting in qualified loans. On the other hand, savings and loan associations were effectively restrained by the investment standards of section 7701(a)(19) of the 1954 Code.

For these reasons, the Treasury proposed that the three percent method of computing additions to a reserve for bad debts be eliminated as a generally available alternative for mutual savings banks and savings and loan institutions alike, even though the latter group made only limited use of this method. The three-percent method would, under this proposal, have continued to be available to a "new company" as defined in section 593(b)(3)(B) of the 1954 Code.<sup>85</sup>

It is significant to note that this Treasury study, which is generally conceded to have gone far beyond the eventual 1969 legislation in most areas of tax reform, recommended no other changes in the substance of the bad debt provisions for savings institutions. In particular, no recommendation was made with respect to lowering the basic sixty-percent figure contained in the percentage-of-taxable-income method. Aside from the above-mentioned practices of mutual savings banks, the Treasury in fact acknowledged that most savings and loan associations "are currently paying taxes in the manner generally anticipated by the Congress under the tax formula adopted in 1962."<sup>86</sup> The Treasury pointed out that, because the earnings of savings and loan associations for 1963 were lower than those utilized in the revenue projections upon which the 1962 legislation was based, the amount of tax actually paid by these institutions in 1963 was less than the payment estimated. The tax collected, however, "reflected that the formula adopted by Congress was working in the manner anticipated."<sup>87</sup> Thus, the Tax Reform Studies and Proposals of the Treasury contemplated that savings institutions would compute their reserve for bad debts on the basis of actual experience or, subject to certain limitations, on the sixty-percent-of-taxable-income method.

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85. UNITED STATES TREASURY DEPT., *supra* note 82, at 265.

86. *Id.* at 264.

87. *Id.*



*Investment Standards.* As previously discussed, savings and loan associations are entitled to use the preferential bad debt provisions only upon meeting a comprehensive set of investment standards, as set forth in section 7701(a)(19) of the 1954 Code. These standards were created to insure that these tax benefits would be extended only to those savings and loan associations which were primarily engaged in the business of home mortgage financing. Therefore, at least eighty-two percent of the assets of a savings and loan association must be in cash, governmental obligations, mortgages on residential real estate, and certain related assets. Failure to meet this and related tests would result in complete loss of the special tax benefits available to savings institutions. Mutual savings banks, as previously noted, were not subject to this type of investment restriction.

For this reason, the Treasury suggested that it would be appropriate to require mutual savings banks, as a condition to receiving the same tax privileges extended to savings and loan associations, to meet investment standards similar to those imposed upon such associations. Realizing that identical standards could not properly be imposed in view of the greater investment flexibility afforded mutual savings banks, the Treasury also took note of recent efforts to increase the investment flexibility of savings and loan associations. Continuation of rigid investment standards in the savings and loan taxation provisions would defeat any action of regulatory authorities permitting increased savings and loan investment flexibility. Consequently, the Treasury suggested the development of a system of investment standards, applicable to both types of savings institutions, which would precondition their favorable tax treatment, in a flexible manner, to the extent of their investment in mortgage funds for residential housing. Such a provision would assure that the policy underlying the preferential treatment of these institutions would not be subverted in application.

Accordingly, the Treasury recommended that the allowable deduction for the addition to reserve for bad debts under the sixty percent method would be proportionately reduced below sixty percent of taxable income from investments, to the extent the institution's investment in residential real estate fell below a specified level. The figure of eighty-five percent was selected as the amount of assets, other than certain liquid assets (e.g., cash, demand deposits, governmental securities), and assets used in the trade or business, which would have to consist of loans upon



residential real estate.<sup>88</sup> The sixty percent maximum allowable deduction would be reduced by two percentage points for every percentage point by which such assets fell below the required eighty-five percent.

*Perfecting Changes in the Percentage-of-Taxable-Income Method.* To correct technical problems arising under the percentage of taxable income method, the Treasury recommended two modifications aimed at refining the application of this method.

1. Capital gains. Under Section 593(b)(2) of the 1954 Code the sixty percent figure was applied against taxable income, with no adjustment to reflect the preferential rate at which capital gains are taxed. Thus, capital gains gave rise to a bad debt deduction in an amount equal to that generated by an equivalent amount of ordinary income, even though capital gains were taxed at approximately half the normal corporate rate. The following example summarizes the effect of these interacting factors:

As a consequence of this rule, for an institution on the 60 percent method and in the 48 percent corporate tax bracket, each one dollar of capital gains gives rise to a 60 percent deduction for a tax saving of 28.8 cents. On the other hand, the dollar of capital gains is only taxed at a 25 percent rate. The net effect is as if the institution paid no tax on capital gains, and in addition the presence of each dollar of capital gains decreased the tax on other income by 3.8 cents.<sup>89</sup>

Because capital gains were taxed at about one-half the normal rate, the Treasury proposed that one-half of capital gain income be eliminated from the measuring base. This, it was claimed, would restore the correct relationship between the tax on these gains and the value of the bad debt reserve deduction.

2. Investment Income. As noted above, the base for applying the sixty percent formula was simply "taxable income." Just as capital gains were included in full, so were amounts received as income from various services rendered by the institution. Such service income might be realized from the sale of mutual fund shares, travelers' checks and money

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88. Some thought was also given to excluding tax-exempt bonds from the category of liquid assets which is excluded in applying the eighty-five percent test under the investment standard described above, on grounds that this tax-exempt income distorts the balance of these various interrelated tests; however, this issue was not further pursued, probably because tax-exempt bonds do not constitute a major asset category for savings institutions. *Id.* at 267.

89. *Id.*



orders, and the performance of other services unrelated to the investments which give rise to potential bad debts. To prevent this functional anomaly, the Treasury proposed that the base against which the sixty percent figure is to be applied should be limited to only investment income. Appropriate rules were provided for allocating expenses between investment income and service income. Furthermore, it was suggested that an exception be provided for a minimum amount of income from services.<sup>90</sup>

### *House of Representatives*

The Tax Reform Bill<sup>91</sup> drafted by the Ways and Means Committee of the House of Representatives (hereinafter referred to as the House bill) incorporated in slightly different form most of the earlier Treasury proposals.<sup>92</sup> Moreover, the provisions of the House bill dealing with the bad debt reserves of saving institutions served as the backbone of the eventual Act; the amendments made by the Senate and the Conference Committee with respect to this topic were largely technical in nature. Accordingly, the House bill will be described in detail, with subsequent versions of the legislation discussed only insofar as they represent a departure from the House bill.

*Percentage-of-Real-Property-Loans Method (Three-Percent Method).* The House Ways and Means Committee agreed with the earlier Treasury findings that the bad debt reserve provisions governing mutual savings banks were unduly generous in allowing those institutions to pay an effective rate of tax much lower than that of corporations in general. The Committee concurred particularly in the view that many mutual savings banks had improperly utilized the three percent method to avoid substantially all Federal income tax.<sup>93</sup> The manner in which this was accomplished has been amply described above. Accordingly, the House bill provided for the repeal of the three percent method, to assure that the intent of Congress would no longer be subverted in this manner. Under the House amendments, therefore, mutual savings banks

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90. *Id.* at 269.

91. H.R. 13270, 91st Cong., 1st Sess. (1969).

92. It should be noted that the committee bill was reported out under a "closed rule," which precluded amendments being introduced on the floor of the House. Accordingly, the terms "Ways and Means Committee bill," "House bill," and "House-passed bill" are synonymous.

93. H.R. REP. No. 91-413, pt. 1, *supra* note 34, at 123-25.



would compute their additions to the reserve for bad debts under the percentage-of-taxable-income formula (as modified by the Committee) or on the basis of their actual experience.

*Percentage-of-Taxable-Income Method (Sixty-Percent Method).* The deduction allowable under this method, formerly sixty percent of taxable income, was modified by the House Committee to reduce the advantage savings institutions enjoyed vis-à-vis other corporations. This was accomplished by revising downward the sixty percent figure, with other adjustments instituted in the method for computing the deduction.<sup>94</sup>

Under the House bill, the sixty percent deduction was gradually to be reduced to thirty percent, by annual reductions of three percent per year over a ten-year period. Accordingly, for taxable years beginning in 1970, the deduction would be 57 percent, in 1971, 54 percent, etc., continuing until 1979 and thereafter when the deduction would be fixed at thirty percent. The ceiling, whereby the deduction computed under this method (minus the amount added to the reserve for losses on non-qualifying loans) may not exceed the amount necessary to increase the balance of the reserve for losses on qualified real property loans to six percent of such loans, was not altered. Likewise retained was the twelve percent ceiling in section 593(b)(1)(B)(ii) of the 1954 Code (originally enacted in 1951), which limits the total bad debt reserve to twelve percent of the total deposits or withdrawable accounts of the institution.

Following and expanding upon a Treasury proposal, the House bill provided for the exclusion of certain income from the base upon which the percentage of taxable income is computed. This change was designed to assure that the percentage would apply only against the income earned from the investments upon which the basis of the special deduction rests, those investments which might conceivably give rise to bad debts.<sup>95</sup> Under prior law, the percentage was applied against the taxable income of the institution, before the bad debt deduction, and excluding certain distributions to shareholders. Under the House bill, additional categories of income were excluded from the computations:

1. The net capital gain arising from the sale or exchange of

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94. *Id.* at 126.

95. *Id.*; H.R. REP. NO. 91-413, pt. 2, 91st Cong., 1st Sess. 97 (1969).



- corporate stock, or of state and local obligations described in section 103(a)(1) of the 1954 Code.<sup>96</sup>
2. An amount equal to the lesser of (a)  $\frac{3}{8}$  of the net long term capital gain for the year, or (b)  $\frac{3}{8}$  of the net long term capital gains for the year from the sale or exchange of property other than that described in paragraph 1, above;<sup>97</sup> and
  3. Dividend income upon which a deduction is allowable under sections 243-45 of the 1954 Code.<sup>98</sup>

*Investment Standards.* The investment standards contained in the definition of a domestic building and loan association, section 7701(a)(19) of the Code, prior to its 1969 amendment, and applicable only to such institutions, were revised by the House bill, and made applicable to mutual savings banks as well as the other types of savings institutions.<sup>99</sup> The percentage of taxable income method of computing additions to the reserve for bad debts was made fully available only to institutions which invest at least eighty-two percent of their total assets (seventy-two percent in the case of mutual savings banks) in qualifying assets.<sup>100</sup> In general, the following constitute qualifying assets for purposes of the investment standard (as eventually enacted):

1. Liquidity items, including cash, governmental obligations (other than those giving rise to tax exempt interest), certain time and demand deposits in banks, and loans secured by the deposits or share of a member (*i.e.* passbook loans);<sup>101</sup>
2. Loans made for residential real property, which includes single and multi-family residences, and real property used primarily for church purposes, and improvement loans for such resi-

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96. INT. REV. CODE of 1954, § 593(b)(2)(E)(iii).

97. *Id.* § 593(b)(2)(E)(iv).

98. *Id.* § 593(b)(2)(E)(v).

99. H.R. REP. No. 91-413, pt. 1, *supra* note 34, at 126.

100. Under a tentative decision of the Ways and Means Committee, mutual savings banks would have been generally subject to the full eighty-two percent investment standard, but would be accorded a five year transition rule to ease the adaptation of their business methods to the imposition of such standards. See House Ways and Means Committee Press Release No. 13 (July 25, 1969). Under this tentative decision, a mutual savings bank would qualify for the full percentage deduction under INT. REV. CODE of 1954, § 593(b)(2)(A), for taxable years beginning in 1970 if its investment in qualified assets totaled seventy-four percent of total assets. This requirement would be raised by two percentage points per year until the full eighty-two percent figure was reached. This decision was altered by the Ways and Means Committee in its final bill in favor of the approach described above.

101. INT. REV. CODE of 1954, § 7701(a)(19)(C)(i) through (iv).



dential and church property. Also included are public facilities (such as schools and libraries) located in residential developments, or property used on a nonprofit basis for residents (*e.g.*, swimming pools and other recreational facilities), and mobile homes not used on a transient basis;<sup>102</sup>

3. Loans made for the improvement of commercial or residential property located within urban renewal areas as defined in the Housing Act of 1949,<sup>103</sup> or an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act of 1966;<sup>104</sup>
4. Loans for educational, health, or welfare institutions or facilities, including buildings designed or used primarily for residential purposes by students, residents, patients, employees, or members of the staff of such institutions (such as dormitories or other school or college facilities), nursing homes, hospitals, medical centers and clinics, etc.;<sup>105</sup>
5. Property acquired through the liquidation of any of the loans mentioned in paragraphs 2 through 4 above;<sup>106</sup>
6. Student loans;<sup>107</sup> and
7. Property used by the institution in the conduct of its business.<sup>108</sup>

The House bill also adopted the approach suggested earlier by the Treasury whereby the failure of an institution to meet the foregoing eighty-two percent test would not necessarily preclude utilization of the percentage-of-taxable-income method. Rather, a flexible standard was applied and phased in over a transition period ending in 1977. Under this flexible standard the full percentage provided in section 593(b) (2)(A) of the 1954 Code, would be reduced on a designated scale as the institution's percentage of qualifying assets failed to conform to the required eighty-two percent standard (seventy-two percent in the case of mutual savings banks).<sup>109</sup> Thus, when the new standard would be-

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102. *Id.* § 7701(a) (19) (C) (v).

103. 63 Stat. 413.

104. INT. REV. CODE OF 1954, § 7701(a) (19) (C) (vi).

105. *Id.* § 7701(a) (19) (C) (vii).

106. *Id.* § 7701(a) (19) (C) (viii).

107. *Id.* § 7701(a) (19) (C) (ix).

108. *Id.* § 7701(a) (19) (C) (x).

109. For savings institutions subject to the eighty-two percent test (*i.e.* all except mutual savings banks) the reduction would be as follows: for taxable years beginning before 1972, the deduction percentage is reduced by one percentage point for each one percentage point of difference between actual and required percentages; for years beginning after 1971, but before 1977, reduction is one percentage point for each 1½ percentage points of difference; and for taxable years beginning after 1976,



come fully effective (*i.e.* taxable years beginning after 1976), the percentage deduction would be reduced by one percentage point for each two percentage points (one, in the case of mutual savings banks) by which an institution's qualifying assets fall below the required standard.

In no event would the House bill permit the percentage-of-taxable-income method to be utilized where the qualifying assets amount to less than sixty percent of the total assets of the institution.

*Experience Method.* Under the House bill, savings institutions could utilize the experience method as an alternative to the percentage-of-taxable-income method, in the same manner as additions to reserves for bad debts would be computed by commercial banks under section 585 (b) (1) of the 1954 Code, as newly enacted by the House bill.<sup>110</sup> As is the case with commercial banks, new institutions, for the first ten years of their existence, would be allowed to establish bad debt reserves on the basis of the industry-wide average for the six years preceding the taxable year in question, if this would produce a larger bad debt reserve deduction than that obtained on the basis of the institution's own experience. Where the percentage deduction allowable under the percentage-of-taxable-income method is reduced by virtue of a substandard percentage of investment in qualified assets, the deduction on the basis of the six-year moving average, as provided in section 585(b)(1)(A) of the 1954 Code, is to be utilized with respect to the proportion of the institution's investments represented by the difference between eighty-two percent (seventy-two percent for mutual savings banks) and the percentage actually held in qualifying assets.<sup>111</sup>

*Ten Year Net Operating Loss Carryback.* Realizing the potential effect of reducing the amount which savings institutions may add tax-free to their bad debt reserves, the Ways and Means Committee allowed these institutions, as well as commercial banks, a more generous net operating loss carryback. This gesture was intended "to minimize any

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reduction is one percentage point for each two percentage points of difference. In the case of mutual savings banks, the reductions for the same periods of time were, respectively, two percentage points for each one percentage point of difference, 1½ percentage points for each one percentage point of difference, and one percentage point for each percentage point of difference. See H.R. REP. NO. 91-413, pt. 1, *supra* note 34, at 127-28.

110. Note that § 442(a)(1) of the House bill (eventually enacted as § 432(a)(1) of the 1969 Act) amended Code § 593(b)(1)(A) to provide that the deduction for a reasonable allowance to the reserve for losses on nonqualifying loans would likewise be computed in the manner provided for commercial banks under § 585(b)(3).

111. H.R. REP. NO. 91-413, pt. 1, *supra* note 34, at 128.



possibility of hardship from an unexpected surge of bad debt losses.”<sup>112</sup> Accordingly, financial institutions were permitted to carry net operating losses back ten taxable years, rather than the three year carryback allowed other corporations. The apparent benefit conferred by this provision seems to be largely offset by the fact that a taxpayer who treats bad debts on the reserve method is not allowed a current deduction for an unexpected surge of bad debt losses. Rather, the benefit of such a liberal loss carryback rule is enjoyed by such taxpayers only after a period of time in which inordinate losses are reflected in its experience, thus producing a larger deduction with respect to subsequent taxable years.

### *Senate*

In the hearings before the Senate Finance Committee, representatives of the Treasury Department endorsed the experience method of computing bad debt deductions for all financial institutions. This approach would require the experience method in lieu of the approach adopted in existing law and in the House bill. To correlate the principle of tax equity, which apparently served as the basis for the foregoing proposal, with that of fostering residential construction, a long-standing factor in the taxation of financial institutions, however, the Treasury urged that a new means of accomplishing the latter policy be substituted for the investment standards formerly relied upon. The Treasury view was summarized as follows:

The Administration endorses the concept that the bad debt deduction should be based on actual loss experience, but we also support the allowance of a special deduction to encourage investment by financial institutions in residential real estate mortgages. Investment by these institutions in residential mortgages is a vital policy goal of the Administration and traditionally has been encouraged through the use of tax incentives. We believe that this goal will be more effectively accomplished by extending the same incentive to all banking institutions, not just the mutual thrift institutions.

The investment standards applied by existing law and the bill to savings and loan institutions and mutual savings banks serve this goal imperfectly and limit free and open competition between these institutions and commercial banks. Conversely, those com-

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112. *Id.* at 128-29.



mercial banks which have traditionally invested in home mortgage financing will be prejudiced by the provisions of the bill which deny their present special deduction but retain a special deduction for the other two types of institutions with which they compete.<sup>113</sup>

The Treasury proposed that a new deduction be provided as a further incentive to savings institutions and commercial banks to provide credit in "socially preferred" areas, such as residential construction, student loans, and loans guaranteed by the Small Business Administration. The amount of this proposed deduction would be five percent of gross interest income from such loans, subject to a ceiling whereby such deduction could not reduce interest income below sixty percent of taxable income (adjusted to include tax exempt interest and the full amount of corporate dividends).

This proposal was not adopted by the Senate Finance Committee. Indeed, in broad outline, the bill reported by the Senate Finance Committee differed little from the House-passed version. The amendments made by the Senate Committee were aimed primarily at simplification and refinement of technical points.

*Percentage-of-Real-Property-Loans Method.* The Senate amendment, like the House bill, provided for the elimination of the three percent method.

*Percentage-of-Taxable-Income Method.* The Senate amendment would reduce the sixty percent method for computing the addition to the reserve for bad debts on qualifying real property loans to fifty percent, over a four-year period. Under this version, the deduction would be 57 percent for a taxable year beginning in 1970, 54 percent in 1971, 51 percent in 1972, and 50 percent for taxable years beginning in 1973 and thereafter. The Finance Committee, apparently considering the House reduction of this deduction to thirty percent an unwarranted measure, expressed the belief that "the reduction to 50 percent represents a sufficient increase in taxes for these mutual institutions at this time."<sup>114</sup> Because of this liberalization, the Committee also found it unnecessary to adopt the ten-year loss carryback rule contained in the House bill.<sup>115</sup>

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113. Statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, in *Hearings on H.R. 13270, supra* note 35, at 547, 599-600.

114. S. REP. NO. 91-552, 91st Cong., 1st Sess. 162 (1969).

115. *Id.* at 166.



The Senate Finance Committee accepted the provisions of the House bill relating to the exclusion of certain portions of net capital gain for purposes of the percentage-of-taxable-income method. However, the Senate Committee added a new section, 596, to the 1954 Code, which provided for the allocation of the inter-corporate dividends received deduction<sup>116</sup> between the portion of the income actually subject to tax and the portion which is allowed as a bad debt reserve deduction. Thus, a portion of the dividends received deduction, equal to the applicable percentage allowable for the particular year under the special percentage method provided in section 593 of the 1954 Code, will be disallowed. It should be noted that this change affects the allowance of this deduction for all purposes, not only for purposes of the percentage of taxable income method. For example, an institution entitled to a bad debt deduction under section 593(b)(2) for a given taxable year equal to forty-eight percent of its taxable income (as defined in that section), would encounter disallowance of forty-eight percent of the dividends received deduction otherwise allowable. Such disallowance would produce a corresponding increase in both taxable income and bad debt deduction.

*Investment Standards.* The Senate Committee amended the complex manner in which the House bill provided for reduction of the percentage deduction where the institution's proportion of qualifying loans failed to qualify it for the full deduction. The full percentage would continue to be available only if the institution had a prescribed percentage of its investments in qualifying assets; this percentage would be seventy-two percent for mutual savings banks, and eighty-two percent for other savings institutions. In the case of such "eighty-two percent" institutions, the percentage would be reduced by one percent for every one percent by which the institution's qualifying assets fall short of the prescribed percentage of total assets. In the case of mutual savings banks, the reduction would be 1.5 percent for every one percent of such difference.<sup>117</sup>

The Senate Committee also modified the types of loans considered in determining whether a savings institution qualifies under the eighty-two or seventy-two percent asset requirement. The urban renewal category was expanded to include loans secured by an interest in real property located in an urban renewal area to be developed for predominantly

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116. INT. REV. CODE OF 1954, §§ 243-45.

117. S. REP. NO. 91-552, *supra* note 114, at 164.



residential use under an urban renewal plan, or real property located in an area covered by a program under the Demonstration Cities and Metropolitan Development Act of 1966.<sup>118</sup> The House bill included only loans for the *improvement* of such property. Loans for residential purposes were defined as including loans secured by redeemable ground rents. Included also were loans to finance the acquisition or development of land which will become residential property, provided there is assurance that the building will actually occur within a period of three years; the loan would be retroactively disqualified if such building did not occur. Finally, it was provided that an apartment building containing some commercial establishments would qualify as residential property for this purpose provided that eighty percent of the usable space in the building is residential space.<sup>119</sup>

*Experience Method.* Like the House bill, the Senate bill provided that savings institutions could compute their bad debt reserves on the basis of a six-year moving average of their own experience, rather than utilizing the percentage deduction method. As under the House bill, reference was made to the commercial bank provision (Code section 585) for such method. Minor amendments to the House bill were made to reflect the changes in section 585 made by the Senate Committee, as described above.

*Mergers of Savings and Loan Associations.* The Senate Committee added a provision dealing with the treatment of bad debt reserves of an institution which undergoes a tax-free reorganization or liquidation. Under general principles, a taxpayer which previously has deducted additions to its bad debt reserve must restore the reserve to income when the need for the reserve ceases. Where the taxpayer is acquired in a tax-free reorganization, however, the reserve is carried over to the acquiring company under section 381(c)(4) of the 1954 Code and accordingly need not be restored to income. In the case of a merger or reorganization of a domestic building and loan association, section 593(f) provides generally for the treatment described above. The Senate bill amended section 593(f) of the 1954 Code to provide that in a transaction to which section 381 applies, the bad debt reserves would not have to be restored to income, that is, the provisions of section 593(f) are not applicable. This change was intended as a mere clari-

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118. 80 Stat. 1255.

119. S. REP. NO. 91-552, *supra* note 114, at 165.



fication of existing law, obviating the need for an Internal Revenue Service ruling in such cases.<sup>120</sup>

### *Conference Committee Action and Final Passage*

The Senate passed its version of the Tax Reform Act on December 11, 1969, adopting without significant change the Finance Committee provisions governing financial institutions. The House and Senate bills were duly committed to a conference committee, which eliminated differences in the two bills. Final passage occurred in both houses on December 22, 1969, and President Nixon signed the measure into law eight days later.

The Conference Committee adopted the Senate version of the financial institutions provisions almost intact,<sup>121</sup> the principal exception being the rate change and resultant transition period with respect to the percentage-of-taxable-income method of computing the bad debt reserve. Whereas the House had selected thirty percent of taxable income as the ultimate percentage rate, and the Senate had raised this to fifty, the Conference Committee provided a rate of forty percent, the former sixty percent rate to be reduced over a ten year period. Savings institutions now apply the percentage of taxable income method on the following basis for the period 1969 through 1979:

For a taxable year beginning in—	The applicable percentage is—
1969 .....	60 percent
1970 .....	57 percent
1971 .....	54 percent
1972 .....	51 percent
1973 .....	49 percent
1974 .....	47 percent
1975 .....	45 percent
1976 .....	43 percent
1977 .....	42 percent
1978 .....	41 percent
1979 or thereafter .....	40 percent <sup>122</sup>

120. *Id.* at 168-69.

121. H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 310-12 (1969) (Conference Report on the Tax Reform Act of 1969).

122. INT. REV. CODE OF 1954, § 593(b)(2)(A).



Having made this change, the Conference Committee deemed it appropriate to reinstate the ten year loss carryback provision from the House bill.

To summarize, the 1969 Act makes the following changes in the bad debt reserve deduction of savings institutions:

1. The three percent of qualifying real property loans alternative in computing the bad debt reserve allowance is eliminated.
2. The addition to the reserve for losses on nonqualifying loans is computed on the "experience method," utilizing a six year moving average, the same manner as is now authorized with respect to commercial banks in new Code section 585.
3. The percentage of taxable income method is amended as follows:
  - a. The former sixty percent amount is reduced to forty percent over a ten year period, with the reduction becoming fully effective for taxable years beginning in 1979 and thereafter.
  - b. If the percentage of the institution's total assets which is invested in "qualifying" assets is less than eighty-two percent (seventy-two percent for mutual savings banks), the applicable percentage for the taxable year in question must be reduced by three-fourths of one percentage point (one percentage point for mutual savings banks) for each percentage below the required figure. Where the percentage of qualifying assets does not equal or exceed sixty percent, the bad debt reserve must be computed solely on the basis of experience, as governed by the commercial bank provision, section 585.
  - c. The taxable income base against which the appropriate percentage is applied is reduced by excluding the following additional categories of income: (i) net gain arising from the sale or exchange of corporate stocks or tax exempt obligations; (ii) three-eighths of the net long-term capital gain; and (iii) a portion of the income received from dividends.
4. The experience method continues to be available with respect to qualifying loans, but is modified to correlate this with the experience method provided for commercial banks generally.



Thrift institutions may likewise elect to utilize the "percentage method" provided for commercial banks, although it does not appear likely that this would normally produce a greater allowance than the percentage method specifically created for savings institutions under section 593(b)(2) of the 1954 Code.

5. Investment standards are imposed upon all savings institutions as a precondition to utilization of the special bad debt reserve rules. The categories of qualifying loans for this purpose are liberalized to eliminate limitations upon multi-family residential property, and to provide a twenty percent leeway for commercial usage in multi-family structures. Furthermore, loans to finance land acquisitions will qualify initially where there is "reasonable assurance" that residential building will commence within three years.
6. Section 593(f) of the 1954 Code is amended to clarify the intent of Congress that a domestic savings and loan association is not required to restore its bad debt reserves to income upon undergoing a tax-free reorganization or liquidation to which section 381 applies.

#### OTHER 1969 CHANGES AFFECTING FINANCIAL INSTITUTIONS

In addition to the detailed treatment of the deduction allowable to financial institutions for reasonable additions to the reserve for bad debts, the 1969 Act contains a number of other provisions specifically directed at financial institutions. These other changes are outlined briefly here.

##### *Treatment of Bonds and Other Securities Held by Financial Institutions*

Under prior law, all financial institutions received special tax treatment with respect to their transactions in bonds and other corporate and governmental evidences of indebtedness. Gains from such transactions were treated as long-term capital gains for tax purposes, as in the case of other taxpayers. Such institutions, however, were permitted to treat capital losses from such transactions as ordinary losses, deductible without limit against ordinary income. Section 433 of the 1969 Act<sup>123</sup> amends section 582(c) of the 1954 Code to eliminate such capital gain treatment, thus providing parallel treatment for gains and losses on such transactions. A transitional rule is provided for bonds held by financial

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123. Tit. IV, 83 Stat. 623.



institutions on July 11, 1969, the date of the House Ways and Means Committee press release initially dealing with this topic. Gains arising on or before that date are afforded full capital gains treatment. Gains arising subsequently will continue to receive capital gain treatment, based upon the proportion of the holding period prior to that date. The balance will be taxed as ordinary income.

### *Limitation on Dividends Received Deduction*

Section 434 of the 1969 Act<sup>124</sup> adds new section 596 to the 1954 Code, providing that institutions which utilize the percentage of taxable income method under section 593(b)(2) must reduce the dividends received deductions allowed under sections 243, 244, and 245 of the Code by an amount equal to the applicable percentage for the taxable year in question, as determined under sections 593(b)(2)(A) and (B). For example, in 1979 when the reduction becomes fully applicable, a savings institution which is entitled to the maximum percentage under this method must reduce the dividends received deduction by forty percent. Where the percentage of total assets invested in qualified assets is sufficiently low as to cause a reduction in the applicable percentage, the dividends received deduction undergoes a similar reduction. The manner in which this amendment affects the allowable bad debt deduction, under the percentage-of-taxable-income method, is discussed above.

### *Minimum Tax on Tax Preference Income*

Under new 1954 Code sections 56 through 58, added by section 301 of the 1969 Act,<sup>125</sup> all taxpayers (including financial institutions) are subject to an additional tax, beyond the regular income tax, on designated "items of tax preference." In the case of a financial institution to which section 585 or section 593 of the 1954 Code applies, the base against which the minimum tax is applied must include the amount by which the allowable bad debt deduction exceeds "the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience."<sup>126</sup> The complexity of the discussion which comprises the bulk of this article provides an ample demonstration of the ambiguity inherent in the above

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124. Tit. IV, 83 Stat. 624.

125. Tit. III, 83 Stat. 580.

126. INT. REV. CODE OF 1954, § 57(a)(7).



quoted phrase. While the amount deducted under section 585 or section 593 of the 1954 Code will be readily ascertainable upon completing the tax return for an institution, there is little guidance as to what constitutes a bad debt allowance "on the basis of actual experience." Indeed, it appears from this language that even an institution which maintains its reserves on the basis of the "experience method" provided in section 585(b)(3) (and made available to savings institutions under section 593(b)(4)) may be possessed of this tax preference. The failure of the draftsmen to refer to a well-defined standard is inexplicable, particularly in view of the relative ease with which this might have been accomplished.<sup>127</sup> The only insight into the new term is the reference in the Senate Finance Committee Report that a new institution may utilize "industry experience," in lieu of "its own actual bad debt loss experience."<sup>128</sup> It appears that this provision must have been inserted in haste by tax reformers as a means of providing additional fairness in this area. It remains to be seen how the affected industries will cope with this facet of the new law.

The minimum tax computation itself is accomplished by totalling all of the taxpayer's items of tax preference, and subtracting from this sum (a) a \$30,000 exemption, and (b) the taxpayer's regular income tax liability. Ten percent of the balance is due and payable in addition to the regular income tax.

### CONCLUSION

Representatives of both commercial banks and mutual savings institutions requested in 1969 that, at the least, more study be given to the matter of the bad debt reserves of both types of institutions before the enactment of restrictive legislation which might seriously disrupt the body of lending and investment practices then existing.<sup>129</sup> As was pointed out at the time, the original intention of the Treasury Department and the aim of the House version of the 1969 Act was to equalize

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127. INT. REV. CODE of 1954, § 593(b)(4). Prior to the 1969 Act, § 593(b)(4) of the Code based the allowance under the experience method upon "[t]he amount determined . . . under section 166(c) [the general bad debt reserve provision]. . . ." Creation of the new standard of "actual experience" may be construed as referring to yet another amount.

128. S. REP. No. 91-552, *supra* note 114, at 114.

129. See Statement of Willis W. Alexander on behalf of The American Banking Association, in *Hearings on H.R. 13270 Before the Comm. on Finance of the Senate*, 91st Cong., 1st Sess., pt. 3, at 1790, 1799-1800 (1969), and Statement on behalf of the United States Savings and Loan League, *id.* at 1897.



effective tax rates (at approximately thirty percent) for savings and loan associations,<sup>130</sup> and commercial banks. This intention resulted in the 1969 Act provisions despite the differences in the operations of the institutions involved and despite the fact that other factors, such as investments in tax exempt securities, were responsible for the rates on which the Treasury's proposals were based.<sup>131</sup>

The proposals forwarded by the Treasury in its testimony before the Senate Finance Committee, however, have a certain superficial appeal. That similar organizations should be treated similarly for tax purposes is not an offensive concept, as far as it goes. The use of a special deduction to direct private funds into socially and governmentally favored sectors of the economy is also a familiar and accepted concept in our federal taxing scheme. The appeal of these propositions quickly becomes tarnished, however, when applied to the taxation of financial institutions. Such propositions fail to take into account the factors which historically have served as the basis for extending favorable tax treatment to such institutions: the extreme importance of assuring their solvency, and the corresponding need for a stable financial community. Certainly, to abandon the bad debt reserve machinery in the 1954 Code for a mechanism which affords no corresponding solvency to the institutions and their savers has only surface appeal. This is particularly true when they are not treated equally under the applicable regulatory provisions.

A constructive alternative, it is submitted, would be to gear the allowable deductions for additions to bad debt reserves to the amounts which these institutions are required by their respective supervisory authorities to maintain as reserves. It would seem that the reserves of financial institutions constitute a subject which the regulatory agencies, such as the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, understand well; the concept of tandem regulatory and tax reserve rules would therefore appear most sensible.

Because such required reserves are presumably set at a minimum level, designed merely to prevent financial disaster, some upward adjustment of the reserve allowed would be necessary. Such an approach would be geared with some precision to the actual needs of these institutions, and would be subject to review by authorities who are best suited to the task. Rather than pursuing the elusive goal of relative fairness, it would enable the deductible reserves of a given institution to bear a direct re-

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130. See Testimony of Under Secretary Charls Walker, in *Hearings on H.R. 13270*, *supra* note 35, at 755.

131. S. REP. NO. 91-552, *supra* note 114, at 161.



Figure 1

S. REP. NO. 91-552, 91st Cong., 1st Sess. 161 (1969)

TABLE 13.—INCOME TAX REPORTED IN "STATISTICS OF INCOME" AS A PERCENT OF INCOME SUBJECT TO TAX AND AS A PERCENT OF ECONOMIC INCOME OF COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1955-67

	[Dollar amounts in millions]												
	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
I. Income subject to tax (SOI):													
A. Commercial banks.....	(1)	(1)	(1)	(1)	\$1,600	\$2,014	\$2,855	\$2,531	\$2,360	\$2,202	\$2,204	\$2,002	\$2,470
B. Mutual savings banks.....	(1)	(1)	(1)	(1)	33	33	55	57	10	15	24	22	14
C. Savings and loan associations.....	(1)	(1)	(1)	(1)	16	15	15	20	264	208	317	251	236
II. Federal income tax (SOI): <sup>2</sup>													
A. Commercial banks.....	\$721.0	\$763.3	\$988.4	\$1,215.5	\$807.8	\$1,302.0	\$1,291.7	\$1,108.7	\$1,078.8	\$909.8	\$870.9	\$845.2	\$977.8
B. Mutual savings banks.....	\$1.9	\$1.2	\$5.8	\$1.5	\$9.0	\$8.8	\$1.5	\$1.5	\$3.4	\$5.2	\$3.2	\$7.2	\$4.3
C. Savings and loan associations.....	\$5.6	\$6.7	\$5.9	\$7.3	\$6.2	\$5.6	\$5.8	\$7.2	\$115.6	\$122.2	\$126.0	\$98.1	\$90.1
III. Tax as a percent of income subject to tax:													
A. Commercial banks.....	(1)	(1)	(1)	(1)	47.6	46.8	45.2	46.2	45.6	43.6	39.9	40.4	39.4
B. Mutual savings banks.....	(1)	(1)	(1)	(1)	33.2	31.3	29.9	21.9	32.9	34.8	33.9	33.0	31.3
C. Savings and loan associations.....	(1)	(1)	(1)	(1)	38.5	37.7	38.6	35.5	43.8	41.1	39.8	39.1	38.1
IV. Economic income: <sup>3</sup>													
A. Commercial banks.....	\$2,109	\$2,257	\$2,578	\$3,379	\$2,360	\$3,001	\$3,020	\$3,513	\$3,523	\$3,546	\$3,783	\$3,643	(1)
B. Mutual savings banks.....	\$132	\$130	\$133	\$182	\$150	\$115	\$127	\$139	\$158	\$100	\$240	\$118	(1)
C. Savings and loan associations.....	\$346	\$301	\$398	\$444	\$539	\$539	\$704	\$811	\$723	\$824	\$830	\$579	(1)
V. Tax as a percent of economic income:													
A. Commercial banks.....	34.2	33.8	38.3	36.0	34.2	37.8	35.6	33.3	30.6	38.2	23.3	23.2	(1)
B. Mutual savings banks.....	1.4	0.9	0.6	0.8	0.6	0.6	0.7	1.1	2.2	2.7	3.3	6.1	(1)
C. Savings and loan associations.....	1.6	1.7	1.5	1.6	1.2	1.0	.8	.9	16.0	14.8	15.2	16.9	(1)

<sup>1</sup> Not available.<sup>2</sup> Figures for 1962-67 are after tax credits; for prior years, tax is gross before tax credits.<sup>3</sup> Economic income includes receipts from all sources less deductions as shown in SOI adjusted by adding the bad debt deduction in SOI and subtracting actual losses.

Sources: Internal Revenue Service Statistics of Income, Source Book; Federal Deposit Insurance Corporation, annual report; 1967 information is preliminary and subject to revision.



lationship to the individual needs of that institution. This would appear to be in the best interest of all concerned: the institutions themselves, their shareholders, the saving and lending public, and the Federal government.

The 1969 Act has succeeded in bringing the bad debt reserves of all financial institutions under statutory formulae for the first time. Beyond this, little of a positive nature has been achieved. Despite this preventative maintenance, the machinery whereby financial institutions are taxed still vitally needs a deliberate and complete overhaul.