

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Mark Erichsen, Revenue Agent
(Large Business & International)

from: Associate Area Counsel (Detroit)
(Large Business & International)

subject: Application of Section 263A to OREO property

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

X Holding =
X =
City =
State =
a =
b =
c =
Year6 =
Year4 =
Year5 =
d =
e =
f =
g =
h =

ISSUE

Whether, and to what extent, a bank's costs associated with holding OREO property must be capitalized under I.R.C. § 263A.

CONCLUSION

Direct costs and an allocable share of indirect costs associated with OREO property produced or held primarily for resale must be capitalized to the basis of such property under I.R.C. § 263A. However, to the extent certain OREO properties are held for the production of rental or investment income, as opposed to being produced or held for resale, rental operating expenses for those properties would not be subject to capitalization under section 263A.

FACTS

X Holding is a publicly traded bank holding company headquartered in City. For all of the years in question, X Holding was the parent of an affiliated group which filed a consolidated tax return. X, a subsidiary of X Holding, is a state chartered commercial bank in State. X provides customary retail and commercial banking services to its customers, including real estate mortgage loans.

A significant portion of X's loan portfolio is secured by real property. X's Year6 Annual Report states,

" The downturn in the housing market in recent years has increased both the number and holding period of foreclosed properties owned by X. X generally takes title through foreclosure sales, or by "deed in lieu of foreclosure" in which the mortgagor voluntarily transfers title in exchange for cancellation of the remaining debt. These properties are referred to for financial accounting purposes as "Other Real Estate Owned" ("OREO"). X's OREO carrying costs increased in the years at issue as the amount of OREO properties increased.

X Holding is required by federal law to file reports with, and otherwise comply with, the rules and regulations of the Federal Reserve. X is regulated and supervised by the Commissioner of the _____ and by the Federal Deposit Insurance Corporation ("FDIC"). X is also a member of the Federal Home Loan Bank ("FHLB") and subject to its regulations.

"The general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date." See Federal Reserve Policy Statement on Rental of Residential Other Real Estate Owned Properties, April 5, 2012. The Federal Reserve generally allows bank holding companies to hold OREO property for up to five years. See 12 CFR § 225.140. An additional five-year extension may be granted if the bank has made a good faith effort to dispose of property, or if disposal within the initial five-year period would be detrimental. Id. Banks are generally permitted to rent OREO properties, within the applicable holding period.

State law prescribes the type and extent of a state-chartered bank's permissible investments in real estate, including OREO. For example, State law provides that a

bank may purchase, hold, and convey real property for specified purposes, including "

, " or "

" . State banks are permitted to invest not more than 10% of their total assets in the acquisition and development of real property for sale, or for the improvement of property for sale or rental purposes.

For financial accounting purposes, OREO is presumed to be held for sale.¹ As stated in X's Year6 Annual Report, "

" During the years at issue, X advertised all of its OREO property for sale. This was also true for foreclosed properties X rented to unrelated parties. Some of the properties acquired in prior and current tax years were sold during the years under examination. All gains or losses reported on sales of OREO property were treated as ordinary for federal tax purposes.

Banks incur legal fees and other direct costs in a foreclosure, and they subsequently incur various costs to maintain the OREO properties in a marketable condition.² For book purposes, these costs are generally expensed as incurred. Examples of costs X typically incurred with respect to OREO include real estate taxes, insurance, repairs, maintenance, capital improvements, professional fees, and utilities. Some of the property taxes X paid were assessed before X acquired the property, but paid after X acquired the property. If permanent improvements are made to an OREO asset that increase the property's value, these expenditures generally are capitalized to the cost of the OREO for book purposes.

As of December 31, Year6, X's balance sheet reflected OREO assets in the amount of \$c. OREO expenses were recorded in identifiable OREO accounts for book purposes. OREO expenses for books were \$d for Year6, \$e for Year5 and \$f for Year4. The taxpayer deducted identical amounts for tax purposes, reporting these amounts as "Other Deductions" on Line 26 of the consolidated Form 1120. X's Year6 Annual Report reflects bank premises and equipment construction in progress of \$g as of December 31, Year6 and \$h as of December 31, Year5."

LAW AND ANALYSIS

We have reviewed your proposed adjustment and we agree that the OREO expenses in question must be capitalized under § 263A.³ Additional expenses not yet identified in the draft report may also need to be capitalized. A discussion of the § 263A method of

¹ See Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144; American Institute of Certified Public Accountants (AICPA) Statement of Position 92-3, *Accounting for Foreclosed Assets* (SOP 92-3).

² FDIC rules require that OREO property be maintained and protected from deterioration.

³ Section references are to the Internal Revenue Code, unless otherwise stated.

accounting used and § 481(a) adjustment is also recommended. The following analysis may be helpful as you prepare your report.

As a threshold matter, X is subject to § 263A, because it is a reseller of real estate, and real estate is a type of non-inventory property which is subject to § 263A capitalization. Section 263A(a)(1); Treas. Reg. § 1.263A-1(a)(3)(i); Carpenter v. Commissioner, T.C. Memo. 1994-289. Taxpayers subject to § 263A must capitalize all direct costs, and certain indirect costs, properly allocable to certain property produced by the taxpayer, and certain property described in § 1221(a)(1) which is acquired by the taxpayer for resale. Treas. Reg. § 1.263A-1(a)(3)(i). With respect to non-inventory property (including real property), the term "capitalize" means to charge to a capital account or basis. Treas. Reg. § 1.263A-1(c)(3). Capitalized costs are recovered through depreciation, or by an adjustment to basis at the time the property is sold. See Treas. Reg. § 1.263A-1(c)(4) (2007).

Acquired for Resale: Section 1221(a)(1)

Section 263A applies to property that is acquired for resale. If § 263A applies, the taxpayer must capitalize both the direct costs of acquiring the property and the property's allocable share of indirect costs. Treas. Reg. §§ 1.263A-1(a)(3)(iii), 1.263A-3(a)(1). Property is considered acquired for resale if it is described in § 1221(a)(1). Section 1221(a)(1) describes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Section 1221(a)(1).

The question of whether a taxpayer is holding property primarily for sale to customers in the ordinary course of its trade or business is inherently factual. Courts must evaluate the particular facts of each case, including: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) the improvements to the property and the extent made by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and substantiality of the transactions; (6) the nature and extent of the taxpayer's business; (7) the extent of advertising to promote sales, or the lack of such advertising; and (8) listing of the property for sale directly or through brokers. See Mathews v. Commissioner, 315 F.2d 101, 107 (6th Cir. 1963), affg T.C. Memo. 1961-213; Gardner v. Commissioner, T.C. Memo. 2011-137. Federal and state regulations delineating permissible real estate activities and investments may inform this determination.

In this case, X clearly acquires OREO in foreclosure (or in lieu of foreclosure) with an intent to resell the property. Bank regulators restrict the holding period for OREO and expect banks to exercise good faith efforts to sell the property. As required by applicable state and federal policies and regulations, it is our understanding that X advertises its OREO properties for sale, including those properties which it rents out. X's Year6 Annual Report confirms that assets acquired through (or in lieu of) foreclosure are held for sale. In addition, OREO is acquired and held in the ordinary course of X's trade or business. X's Year6 Annual Report acknowledges as much when it states that

X may foreclose on and take title to properties securing loans "during the ordinary course of business." X engages in OREO transactions with frequency, regularity, and according to an "OREO disposition strategy." (Year6 Annual Report, p.17). Thus, the OREO held by X constitutes property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

This conclusion is supported by case law and published guidance. In Girard Trust Corn Exchange Bank v. Commissioner, a bank taxpayer frequently acquired property through foreclosure or deed in lieu of foreclosure, and made efforts to sell the properties, including making improvements to some properties. 22 T.C. 1343 (1954). The Court found that the taxpayer acquired the property in the ordinary course of its business, and according to its duty under state law, held the property for sale as soon as possible at a fair price. Id at 1359. Similarly, Revenue Ruling 74-159 held that real estate acquired through foreclosure was held "primarily for sale in the ordinary course of a bank's trade or business" within the meaning of § 1221(a)(1), where such property was not held for the production of rental income, but rather was advertised and sold as soon as possible. 1974-1 C.B. 232. Although Rev. Rul. 74-159 predates the enactment of § 263A, it applies the same § 1221 definition which was later incorporated into the § 263A regulations.

Production Activities

A reseller that also produces property must generally capitalize the additional § 263A costs associated with any property it produces. Treas. Reg. § 1.263A-3(a)(2). Some activity X undertakes with respect to OREO constitutes production within the meaning of § 263A. X performs capital improvements on some foreclosed properties. Taxpayers must capitalize all direct costs, and a proper share of indirect costs, allocable to property they produce. Treas. Reg. § 1.263A-1(a)(3)(i) and (ii); Treas. Reg. § 1.263A-2(a)(1)(i). The term "produce" includes construct, build, install, develop, or improve. Section 263A(g)(1); Treas. Reg. § 1.263A-2(a)(1)(i). Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production. Treas. Reg. § 1.263A-1(e)(3)(i). X must therefore capitalize its direct costs and an allocable share of its indirect costs of production. In addition, producers must capitalize interest during the production period, pursuant to § 263A(f) and the regulations thereunder.

Section 263A applies whether the property is sold or used in the taxpayer's trade or business. See § 1.263A-1(a)(3)(ii). Thus, for example, § 263A would apply to production costs associated with improving an OREO property for rental use, or the construction of a new bank branch. To the extent X engaged in production of real estate for use in its trade or business, § 263A requires capitalization of interest and other production costs allocable to this activity.

Identification and Allocation of Costs

The next step in the analysis is to identify the amount of costs allocable to OREO. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs which are properly allocable to property acquired for resale. Treas. Reg. § 1.263A-3(c)(1). Indirect costs are properly allocable to property produced or acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Treas. Reg. § 1.263A-1(e)(3)(i). The regulations provide a non-exclusive list of types of indirect costs which are required to be capitalized, including: property taxes⁴, repairs and maintenance⁵, indirect materials costs⁶, insurance⁷, utilities⁸, and costs of employees and independent contractors.⁹ Treas. Reg. § 1.263A-1(e)(3)(ii). X must capitalize an allocable portion of these otherwise deductible costs to the basis of OREO property.

X must also capitalize service costs to the extent allocable to OREO. Treas. Reg. § 1.263A-1(e)(3)(ii)(W). Service costs are a type of indirect cost, such as general and administrative costs, that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. Treas. Reg. § 1.263A-1(e)(4)(i)(A). Service costs are capitalizable if they directly benefit or are incurred by reason of the performance of production or resale activities. Mixed service costs are service costs that are partially allocable to production or resale activities and partially allocable to non-production or resale activities. Treas. Reg. § 1.263A-1(e)(4)(ii)(C). Examples of service costs which are generally capitalizable include administration and coordination of production or resale activities, legal services, and accounting services. Treas. Reg. § 1.263A-1(e)(4)(iii). Thus, X must capitalize an allocable portion of their general and administrative costs, including professional fees, to the basis of OREO. The simplified service cost method under Treas. Reg. § 1.263A-1(h) provides a method for allocating mixed service costs to X's production or resale activities. Non-inventory property held for resale is eligible for the simplified service cost method. Treas. Reg. § 1.263A-1(h)(2)(i)(B).

Finally, after § 263A costs have been identified and allocated to X's resale and/or production activities, the amount of costs allocable to property remaining on hand at the end of the year must be determined. Treas. Reg. § 1.263A-1(f) provides various facts-and-circumstances methods for allocating direct and indirect costs to property produced and property acquired for resale. For example, the specific identification method traces costs to cost objectives on the basis of a cause and effect or other reasonable relationship. Treas. Reg. § 1.263A-1(f)(2). In lieu of a facts-and-circumstances allocation method, eligible taxpayers may use one of the simplified methods provided in the regulations.

⁴ Treas. Reg. § 1.263A-1(e)(3)(ii)(L)

⁵ Treas. Reg. § 1.263A-1(e)(3)(ii)(O)

⁶ Treas. Reg. § 1.263A-1(e)(3)(ii)(E)

⁷ Treas. Reg. § 1.263A-1(e)(3)(ii)(M)

⁸ Treas. Reg. § 1.263A-1(e)(3)(ii)(N)

⁹ Treas. Reg. § 1.263A-1(e)(3)(ii)(A)

The simplified resale method can be used to determine the additional § 263A costs properly allocable to property on hand at the end of the taxable year. Treas. Reg. § 1.263A-3(d)(1). The simplified resale method may be used for non-inventory property, such as real estate, which is held primarily for sale to customers in the ordinary course of business. Treas. Reg. § 1.263A-3(d)(2). However, the simplified resale method is generally only available to "a trade or business exclusively engaged in resale activities." Treas. Reg. § 1.263A-3(d)(2). With limited exceptions, a taxpayer may not elect the simplified resale method if the taxpayer is engaged in both production and resale activities. Treas. Reg. § 1.263A-3(a)(4)(i). A reseller may still elect the simplified resale method if its production activities are de minimis and incident to its resale of personal property described in § 1221(a)(1). Treas. Reg. § 1.263A-3(a)(4)(ii).¹⁰

X engages in both resale and production activities with respect to OREO. X does not meet the definition of de minimis production activities because its production activities are associated with real property, and are not "incident to its resale of personal property." See Treas. Reg. § 1.263A-3(a)(4)(ii). X is therefore not eligible to use the simplified resale method. Instead, the simplified production method may be used to account for both the production and resale activities associated with X's OREO property. See Treas. Reg. § 1.263A-2(b)(2).

Change of Accounting Method

A change from not applying § 263A to applying § 263A is a change of accounting method for which a § 481(a) adjustment is required. Treas. Reg. § 1.263A-7(d)(1). Once the Commissioner determines that a taxpayer's method does not clearly reflect income, he can select a method of accounting which does clearly reflect income. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). A description of the § 263A accounting method used to compute the adjustments should be discussed in the final report, and the § 481(a) adjustment should be separately identified.

Rental expenses

In general, X holds OREO property for resale. In some instances, X rents OREO properties to third parties. Rental activity is not production or resale activity subject to 263A. To the extent certain of X's OREO properties are held primarily for the production of rental or investment income, as opposed to being produced or held for resale, X's rental operating expenses for those properties are not subject to capitalization under § 263A. If a particular OREO property is described in § 1231(b)(1) (certain real property used in a trade or business) rather than § 1221(a)(1), the operating expenses associated with that property would not be capitalizable under the provisions of § 263A. However, to the extent X makes improvements to such property, X may still have to

¹⁰ Production activities are presumed de minimis if gross receipts from the sale of property produced are less than 10% of total gross receipts of the trade or business, and labor costs allocable to the trade or business' production activities are less than 10% of the total labor costs allocable to its trade or business. Treas. Reg. § 1.263A-3(a)(2)(iii)(A).

capitalize direct and indirect costs of such improvements under §§ 263(a) and 263A.

Property taxes assessed prior to acquisition

X paid and deducted some property taxes that accrued with respect to the OREO property prior to foreclosure (the "pre-acquisition taxes"). Real property taxes are generally deductible in the taxable year in which they are paid or accrued. § 164(a). However, if real property is sold during the tax year, the property tax must be allocated between the seller and purchaser. § 164(d). The tax allocable to the period which ends on the day before the date of sale is treated as imposed on the seller, and the tax allocable to the period beginning on the date of sale is treated as imposed on the purchaser. § 164(d)(1). Rev. Rul. 72-237 held that the § 164(d) apportionment requirement applies to secured real property acquired by a building and loan association through a foreclosure sale. 1972-1 C.B. 51. As a result, the pre-acquisition taxes paid by X are not treated as incurred or deductible by X under § 164.

Although not currently deductible by the taxpayer, the delinquent taxes paid represent costs of acquiring the OREO property. Pre-acquisition taxes are treated as part of the purchase price. The payment of pre-acquisition taxes by a mortgagee who forecloses on a property is considered a capital expenditure, which must be added to the cost of the property. Casel v. Commissioner, 79 T.C. 424, 436-437 (1982). Therefore, X must capitalize the pre-acquisition real estate taxes to the basis of the OREO property acquired.

Property taxes are capitalizable under § 263A to the extent these costs directly benefit or are incurred by reason of the performance of production or resale activities. Treas. Reg. § 1.263A-1(e)(3)(ii)(L). However, a cost which is not otherwise deductible for a given taxable year is not treated as a cost properly allocable to property produced or acquired for resale for that year. Treas. Reg. § 1.263A-1(c)(2)(i). Thus, to the extent the delinquent property taxes paid by X are treated as non-deductible capital expenditures, they are not subject to further capitalization under § 263A.

CASE DEVELOPMENT AND HAZARDS

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Please call (313) 628-3113 if you have any further questions.

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