Office of Chief Counsel
Internal Revenue Service
Memorandum
Release Number: 20175101F
Release Date: 12/22/2017

CC: LB&I: NRC: MIA: AMTktin
POSTF-129450-17

UILC: 597.00-00

date: October 25, 2017

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from: Associate Area Counsel (South Florida)
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subject: Acquiring Bank – Sec. 597 Issue

Disclosure Statement

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Acquiring Bank  =
Failed Bank  =
X  =
Amount 1  =
Amount 2  =
Amount 3  =
Amount 4  =
Amount 5  =
Amount 6  =
Amount 7  =
Amount 8  =
Amount 9  =
Amount 10  =
Amount 11  =
Amount 12  =
Amount 13  =
Amount 14  =
Amount 15  =
Issue

Whether Acquiring Bank properly reported Amount 1 in Section 597 income (as defined below) on its Year 2 income tax return.

Conclusion

No. Acquiring Bank should not have reported this income based on the facts provided in its protective claim for refund for the tax year Year 2.

Facts

The following facts have been provided by Acquiring Bank (the “Taxpayer”):

In Date 1, the Taxpayer acquired the assets of Failed Bank pursuant to a standard FDIC purchase and assumption agreement. The acquired assets included 100 percent of the common stock of X REIT (“X REIT”). X REIT was not a consolidated subsidiary of the Taxpayer.\(^1\) As such, after the acquisition, X REIT retained a carryover basis in its loans equal to Amount 2 of unpaid principal balance (“UPB”).\(^2\) The Taxpayer also applied the limitations of section 382(h) to X REIT’s loans—i.e., since the Taxpayer acquired X REIT’s stock in an ownership change (within the meaning of section 382(g)), built-in losses in those loans were subject to limitation. The Taxpayer continued to treat X REIT as the owner of the loans for purposes of the REIT qualification requirements under section 856 as well.

Concurrently, the Taxpayer created a special account to which it allocated “phantom” basis of Amount 3 for those X REIT loans that were covered by FDIC loss guarantees. (The Taxpayer characterizes this basis as “phantom” basis because the Taxpayer did not actually acquire the X REIT loans.) The Taxpayer allocated Amount 3 in phantom basis to this special account based on its erroneous interpretation of Treas. Reg. § 1.597-3(a). The Taxpayer incorrectly believed that, under § 1.597-3(a), it was treated as having directly acquired X REIT’s loans. The Taxpayer further believed that, under § 1.597-

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\(^1\) REITs may not file consolidated income tax returns as part of an affiliated group. I.R.C. § 1504(b)(6).

\(^2\) Treas. Reg. § 1.597-5(b) treats a bank and its consolidated subsidiaries as selling their assets in a deemed asset sale under certain circumstances. Non-consolidated subsidiaries (such as REITs) are not subject to deemed asset sale treatment.
5(c)(3)(ii), it was required to classify the X REIT's loans covered by FDIC loss guarantees as Class II assets. At the same time, the Taxpayer treated X REIT as the owner of the loans for all other Federal income tax purposes, and X REIT continued reporting those loans at their historic cost basis amounts. The Taxpayer also classified the stock of X REIT as a separately purchased Class V asset.

By treating X REIT's loans as Class II assets that the Taxpayer directly acquired from Failed Bank, the Taxpayer determined that the fair market value of its acquired Class I and Class II assets exceeded the purchase price. The Taxpayer thus included Amount 4 in income under Treas. Reg. § 1.597-5(d)(2)(iii) ("Section 597 income") over a six-year period (taxable years Year 1-Year 3).³

The Taxpayer allocated purchase price among the assets as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Class</th>
<th>Amount (in billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>Amount 5</td>
</tr>
<tr>
<td>Loans &amp; Securities</td>
<td>II</td>
<td>Amount 6</td>
</tr>
<tr>
<td>X REIT Loans</td>
<td>II</td>
<td>Amount 7</td>
</tr>
<tr>
<td>Other</td>
<td>II</td>
<td>Amount 8</td>
</tr>
<tr>
<td>REIT Stock</td>
<td>V</td>
<td>---</td>
</tr>
<tr>
<td>Total Assets</td>
<td></td>
<td>Amount 9</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td>Amount 10</td>
</tr>
<tr>
<td>Section 597 Income Reported By Taxpayer</td>
<td></td>
<td>Amount 12</td>
</tr>
</tbody>
</table>

The Taxpayer reported Amount 1 in Section 597 income from the above transaction on its Year 2 income tax return, i.e., one-sixth of Amount 4.

The Taxpayer filed a protective claim for the taxable year Year 2 with respect to the Section 597 income that it reported for that year. The Taxpayer acknowledges that it should have allocated purchase price only to those loans it actually acquired from Failed Bank and its consolidated subsidiaries. The Taxpayer argues that it should not have included the fair market value of X REIT's loans in the calculation; instead, it should have

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³ Section 1.597-5(c)(3)(ii) provides that the fair market value of an acquired asset covered by a Loss Guarantee is deemed to be not less than the greater of the asset's highest guaranteed value or the highest price at which the asset can be put. This raises the possibility that the Acquirer's acquisition basis in the asset will equal highest guaranteed value, which, in turn, will exceed Acquirer's actual acquisition cost. Section 1.597-5(d)(2)(iii) accounts for the possibility that the deemed acquisition basis may exceed Acquirer's actual cost by requiring Acquirer to take the difference into income over six years, which is the Section 597 income in issue. The rules requiring inclusion of Section 597 income, however, assume that the Acquirer purchased the asset directly, and not indirectly through a non-consolidated entity.
allocated purchase price to the X REIT stock. The Taxpayer argues that, had it done things correctly, its allocation of the purchase price to Class I and Class II assets would have been Amount 11 (Amount 13 cash, Amount 14 of loans, and Amount 15 of other assets). Because the purchase price (the amount of deposit liabilities assumed) under the Taxpayer's proposed approach would have exceeded the fair market value of the Class I and Class II assets acquired, no inclusion of Section 597 income (under § 1.597-5(d)(2)(iii)) would have been required.

Legal Analysis

During the tax years at issue, Treas. Reg. § 1.597-3(a) provided that, for all federal income tax purposes, an Institution is treated as the owner of all assets covered by a Loss Guarantee, regardless of whether Agency (e.g., the FDIC) otherwise would be treated as the owner under general principles of income taxation.

In calculating its reported Section 597 income, the Taxpayer recorded a basis of Amount 3 for X REIT's loans as Class II assets based on its interpretation of Treas. Reg. § 1.597-3(a), which the Taxpayer believed required it to be treated as having directly acquired X REIT's loans. As a result, the Taxpayer reported Section 597 income on its Year 1 – Year 3 income tax returns.

On May 20, 2015, proposed regulations were issued under Treas. Reg. § 1.597-1 et seq. Final regulations (which contained no significant changes to the proposed regulations) were published on October 19, 2017. The proposed and final regulations clarified § 1.597-3(a) by amending it to read as follows:

Ownership of assets. For all income tax purposes, Agency is not treated as the owner of assets subject to a Loss Guarantee, yield maintenance agreement, or cost to carry or cost of funds reimbursement agreement, regardless of whether it otherwise would be treated as the owner under general principles of income taxation.

The preamble to the proposed regulations (see 80 FR 28872) contains the following explanation:

Covered Assets Not Owned by an Institution

Section 1.597-3(a) of the current regulations provides that, for all Federal income tax purposes, an Institution is treated as the owner of all Covered Assets, regardless of whether Agency otherwise would be treated as the owner under general principles of income taxation. The Treasury Department and the IRS have become aware of certain instances in which Agency has provided Loss Guarantees to an Institution for assets held by a subsidiary of the Institution that is not a member of the Institution's consolidated group (for example, a real estate investment trust ("REIT")).
The intent behind § 1.597-3(a) of the current regulations was to prevent Agency from being considered the owner of Covered Assets even though Agency might have significant indicia of tax ownership with respect to such assets. The question of whether the Institution or its non-consolidated subsidiary should be treated as the owner of a Covered Asset was not considered because that scenario was not envisioned at the time the current regulations were promulgated. The proposed regulations modify this rule to clarify that the entity that actually holds the Covered Asset will be treated as the owner of such asset. (Emphasis added).

We agree that Treas. Reg. § 1.597-3(a) should not be interpreted to mean that an Institution is deemed the owner of the Covered Assets of a non-consolidated subsidiary for purposes of calculating Section 597 income. This interpretation is supported by Treas. Reg. § 1.597-5(b), which provides that only an Institution or a Consolidated Subsidiary is treated as selling all of its assets in a Taxable Transfer. It follows that the Taxpayer, which purchased the stock of a nonconsolidated subsidiary (X REIT), is treated as purchasing the REIT's stock and not its underlying assets. Accordingly, the Section 597 income in question should not have been reported by the Taxpayer.

If you wish to discuss this matter, please call Reviewing Attorney or Assigned Attorney.

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