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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RICHARD A. WITKOWSKI
DISTRICT COUNSEL, ILLINOIS DISTRICT CC:MSR:ILD:CHI
Attention: John P. Jankowski, Special Litigation Assistant

FROM: Lon B. Smith
Acting Associate Chief Counsel, Financial Institutions and Products CC:FIP

SUBJECT:

This Field Service Advice responds to your memorandum dated May 12, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Taxpayer	=	
Holding 1	=	
Holding 2	=	
Thrift 1	=	
Thrift 2	=	
$a	=	
$b	=	
$c	=	
$d	=	
$e	=	
$f	=	
$g	=	
z	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Year 1	=	
Year 2	=	
Cycle 1	=	
Firm 1	=	

ISSUES

1. Whether "supervisory goodwill" qualifies as "money or other property" for purposes of § 597 of the Code?

2. Whether Taxpayer properly established a tax basis in the book asset identified as supervisory goodwill?

3. Whether Taxpayer properly claimed a loss under § 165 of the Code for amounts attributable to supervisory goodwill?

CONCLUSIONS

1. Supervisory goodwill is not financial assistance received from the Federal Savings and Loan Insurance Corporation (FSLIC) under section 406(f) of the National Housing Act (12 C.F.R. § 1729(f)). Accordingly, it does not qualify as money or other property for purposes of § 597 of the Code.

2. The Taxpayer properly did not establish a tax basis in a book asset identified as supervisory goodwill in Year 1. The Taxpayer cannot now establish a tax basis in that book asset.

3. The Taxpayer cannot deduct amounts attributable to supervisory goodwill as losses under § 165 of the Code.

FACTS

The facts are taken from the materials provided. To the extent that they refer to tax matters other than the proper tax treatment of supervisory goodwill, we have accepted the parties' characterization of these transactions and assertion that certain provisions of law were satisfied. For example, we have accepted that the merger of Thrift 2 into Thrift 1 on Date 1 satisfied the requirements for tax free reorganization set forth in § 368(a)(1)(A). Such acceptance, however, should not be construed as a legal conclusion based on independent analysis.

The Merger

On or about Date1, Thrift 1 acquired Thrift 2 by merger in a tax-free reorganization. At the time of the merger, Thrift 2 was solvent although operating in a weakened financial condition. The merger arrangement was a voluntary one.[1]

Prior to Date 1, Thrift 1 was approached by Thrift 2 which was seeking a merger partner. Based on its own evaluation, Thrift 1 was "in a much stronger financial condition than most other savings and loans." Merger Proposal ( ), at . The proposed merger with Thrift 2 was, according to Thrift 1, an opportunity to "increase resources and add needed [staffing]" to meet the perceived demands of an increasingly competitive

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[1] The draft Form 886-A states that the merger was "a supervisory merger induced and arranged by the [Federal Home Loan Bank Board (FHLBB)]." Contemporaneous documentation from Thrift 1, however, characterized the merger as a voluntary one. For purposes of our discussion, we have assumed that the merger was not arranged by the FHLBB or FSLIC operating as conservator or receiver for Thrift 2. Thus, to this extent , we assume that the merger was a voluntary one albeit heavily encouraged by the regulators.

environment. Id. at 1 and 2. In addition, as stated in an opinion letter from Firm 1 to the president of Thrift 1 dated less than 5 months prior to Date 1, it appears that Thrift 2 had:

> thoroughly investigated its potential for growth and its ability to continue to efficiently provide the high quality of service it has provided its members in the past. After carefully considering its opportunities for future growth without a merger into another savings and loan association, the opportunities for future growth with a merger, the Board of Directors concluded that it would be in the best interest of the association and its members to merge with [Thrift 1]. This conclusion was reached only after thoroughly examining all of the available information. Neither [Thrift 1] nor [Thrift 2] are in any difficulties with the various supervisory authorities that have jurisdiction over their operations. Both associations are solvent taxpayers and the proposed merger is on a purely voluntary basis.

Thrift 2's portfolio of mortgage loans was decreasing and it had an "extremely low yield." Merger Proposal ( ), at . In addition, its deposit base had decreased significantly and its cost of deposits exceeded its loan portfolio yield by approximately 250 basis points. Merger Proposal, at (compare to yield at). Moreover, its new loan activity was apparently "negligible." Merger Proposal, at . One of the factors focused on by Thrift 1 in connection with the economic impact of the merger was the availability of the "purchase method of accounting" for the business combination.[2] Merger Proposal, at . However, it appears that other factors also influenced Thrift 1's decision, including: (1) the fact that Thrift 2's loan portfolio was "clean with a negligible amount of non-performing assets" (Merger Proposal, at); (2) the fact that Thrift 2 had a profitable subsidiary (Merger Proposal, at); (3) the market served by Thrift 2 (Merger Proposal, at); (4) the value of Thrift 2's customer base (Merger Proposal, at); (5) the operational savings to be recognized by Thrift 1 through obtaining a substantial increase in deposits without the associated costs of developing that deposit base (see Merger Proposal, at); and (6) the

[2] This is further borne out by the terms and preconditions recited in the undated Letter of Understanding ( ) that was executed by the respective presidents of the two institutions less than 4 months prior to Date 1. In relevant part, it conditions the merger on receipt of a favorable opinion from counsel and the institutions' designated public accountants that the business combination 'can be effected: ... (e) in accordance with purchase accounting rules and regulations." Id., at .

fact that Thrift 2 had an experienced workforce (see Merger Proposal, at).

For book accounting purposes (GAAP), the merger of Thrift 2 into Thrift 1 was to be accounted for using the purchase method of accounting for business combinations. Under this method, Thrift 1 recorded the acquired assets and liabilities of Thrift 2 at their current fair market value on its own books of account for GAAP. The difference between that fair market value and Thrift 2's historic recorded book basis was recorded by Thrift 1 as goodwill.[3] This calculation eliminated Thrift 2's remaining net worth, which also was absorbed into goodwill. Although Thrift 1's GAAP treatment followed the above approach, certain purchase accounting adjustments resulted in yield adjustments (primarily to Thrift 2's mortgage loan portfolio), thereby lowering the amount of income recognized for GAAP in future years. For GAAP, the amount booked as goodwill was amortized by Thrift 1 over 40 years. Merger Proposal, at and . This same amount is now identified by the parties as supervisory goodwill.[4] For regulatory accounting purposes (RAP), supervisory goodwill was available to meet Thrift 1's regulatory capital requirements.[5]

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[3] Goodwill has been described for federal income tax purposes as the "total of all of the imponderable qualities that attract customers to a business." See Winstar, 518 U.S. 839, 849 at n. 5 (1996) quoting Newark Morning Ledger Co. v. United States, 507 U.S. 546, 556 (1993).

[4] Supervisory goodwill, as used in this memorandum, refers only to the amount of purchased goodwill stemming from Thrift 1's acquisition of Thrift 2 which was booked as a separate asset for GAAP by Thrift 1 on Date 1. The amount of this asset, however, appears to be uncertain and references to it have varied in value from $a (trial balance as of Date 2), to $b (claim filed on Date 5), to $c (claim filed on Date 7), and to $d (incoming request for advice dated May 12, 2000). It is not clear why the amounts referenced in these sources vary as they do. Moreover, it is not clear whether any or all of these values include those amounts attributable to the purchase price adjustments that resulted in a lower yield to Thrift 1 on certain items. As we understand the incoming materials, these yield adjustments resulted in lower income being reported by Thrift 1 over the remaining life of those affected items.

[5] We are unclear, however, how the grant of regulatory capital forbearance to Thrift 1 (that is, the right to use the asset identified as supervisory goodwill to meet Thrift 1's regulatory capital requirements) was accomplished here. It is possible that Thrift 1's entitlement was solely due to the FHLBB's allowance of the use of GAAP assets (including goodwill) to satisfy the FHLBB's regulatory capital requirements. Alternatively, it is possible that the FHLBB relied upon its inherent rule-making authority

For federal income tax purposes, the merger of Thrift 2 into Thrift 1 was characterized as a tax-free reorganization governed by §§ 368(a)(1)(A) and 362(b) of the Code. Neither Thrift 1 nor Thrift 2 recognized gain or loss on the transfer of Thrift 2's assets to, and assumption of liabilities by, Thrift 1. Sections 361(a), 357(a) and 1032(a) of the Code. As the larger institution, Thrift 1 survived and succeeded to the tax attributes of Thrift 2. Section 381 of the Code and section 1.381(c)(4)-1 of the Federal Income Tax Regulations.[6]

Thrift 1 was initially organized and chartered as a federal savings and loan association. Up to and including Date 1, Thrift 1 was regulated by the FHLBB and its deposits were insured by the FSLIC. With respect to the merger of Thrift 2 into Thrift 1, it appears that both Thrift 1 and Thrift 2 were subject only to local supervision by the FHLBB at all times up to and including Date 1.[7]

In connection with the FHLBB's approval of the merger, the local Principal Supervisory Agent stated that "[i]n this approval, I have considered that the assets of [Thrift 2] are acquired by [Thrift 1] in a merger instituted for supervisory reasons." See attachment identified as "Ex. 3" to item 9 in the supplemental materials. There is no reference to assistance from the FSLIC under section 406(f) of the National Housing Act in this approval letter and there is no indication of the supervisory reasons.

Based on the information provided for our consideration, especially, the materials provided by Thrift 1 and Thrift 2 to the local Principal Supervisory Agent between Date 1 and Date 2, it appears that both Thrift 1 and Thrift 2 were, in fact, solvent as of Date 1 (with assets in excess of liabilities) and that both Thrift 1 and Thrift 2 reflected a positive surplus.[8]

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to grant this form of capital forbearance formally to Thrift 1 based on the acquisition's characterization as "supervisory." For purposes of our discussion, however, we have assumed that Thrift 1 was granted this right in accordance with whatever FHLBB's practices and procedures were on Date 1.

[6] These tax consequences reflect the opinion of Firm 1.

[7] Local supervision is relevant as we understand that at the time of the merger the approval of financially assisted acquisitions was centralized in Washington, D.C., by the FHLBB.

[8] Apparently, Thrift 1 had a surplus in excess of $14 million and Thrift 2 had a surplus in excess of $3 million immediately prior to Date 1.

In addition, materials provided by Firm 1 to the local Principal Supervisory Agent pertaining to the completed merger and dated prior to Date 2 state the following:

> Accounting Principles Board Opinion No.16, “Accounting for Business Combinations” requires that an allocation of the purchase price in a business combination be ascribed to specifically identifiable intangible assets at fair values. In allocating the purchase price of [Thrift 2], [Thrift 1] has determined with our concurrence, that no specifically quantifiable intangible assets of [Thrift 2] are identified. Therefore, the excess of the cost of acquiring [Thrift 2] over the sum of its liabilities assumed has been recorded as goodwill. [The purchase accounting entries were apparently attached to the original letter.]
>
> Accounting Principles Board Opinion No.17, “Accounting for Intangible Assets” recognizes the problem with assigning an amortization period to goodwill. Any life assigned to goodwill is arbitrary because the life of goodwill is indefinite and an estimated period of existence is not reasonable. The accounting profession has, however, determined that even in instances in which the estimated life of goodwill is indefinite, the amortization period should not exceed 40 years.
>
> The goodwill arising from the merger in question is attached to the business of [Thrift 2] as a whole. This is described in some detail in the material accompanying the “merger” application. The period of existence of the combined institution is not measurable. In conjunction with the merger study, [Thrift 1] projected combined financial results into the future. These projections have also been incorporated into the merger application. While we are unable to assess the reasonableness of the assumptions used in these projections, we have reviewed the projections as a basis for determining whether the assertion of indefinite existence of the combined institutions is justified. We believe that the present financial condition of [Thrift 1] and the financial projections support the assertion of indefinite life. Therefore, we believe that the 40 year amortization is appropriate under generally accepted accounting principles.

Justification Letter from Firm 1 to the Principal Supervisory Agent.

<u>Thrift 1's Subsequent Use and Abandonment of Supervisory Goodwill</u>

Following the acquisition of Thrift 2, Thrift 1 commenced amortizing goodwill for GAAP purposes. We understand that for a period of approximately z years, Thrift 1 amortized goodwill at the rate of approximately $e per month and that there were occasional other adjustments to the amortization of goodwill. See IDR Response, at page 5. It appears, however, that Thrift 1 may not have taken a book expense with respect to all of the adjustments. IDR Response, n.1.

In 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), Pub. L. 101-73 (1989). As part of the changes enacted by FIRREA, institutions were restricted in their RAP use of supervisory goodwill. Thrift 1 wrote off approximately $f in Year 1 for book purposes and amortized amounts less than $e per month thereafter until it wrote off the remaining $g in Year 2 . See IDR Response, at page 5.

Thrift 1's Subsequent Organizational History

On Date 3, Holding 1 was formed to hold the stock of Thrift 1. Contemporaneously, Thrift 1 underwent a charter change to become a federal savings bank. On Date 4, Holding 1 made an initial public offering (IPO) and used the proceeds to acquire Thrift 1. On Date 6, Holding 1 merged with Holding 2 with Holding 1 surviving. Holding 1 underwent a name change as of that same time and is now known as Taxpayer. A subsidiary bank of Holding 2 was also merged into Thrift 1, with Thrift 1 surviving and undergoing a name change at that time.

Taxpayer's Claim for Refund

Taxpayer's representative states that "[t]here were no liquidations, reorganizations, or bankruptcies " in the Taxpayer's financial history. IDR Response, at 3. The Taxpayer's representative also states that Thrift 2 was merged into Thrift 1 "in a supervisory merger induced and arranged by the [FHLBB]." An affirmative reference to assistance from the FHLBB under section 406(f) of the National Housing Act is found later in that same document. IDR Response, at 4 and 5. As stated by the Taxpayer's representative:

> On [Date 1, Thrift 2] was effectively merged into [Thrift 1] in a supervisory merger induced and arranged by the FHLBB. As part of that merger the FHLBB determined that, pursuant to § 406(f) of the National Housing Act, assistance was necessary to facilitate the merger. In [Thrift 2's earlier Statement of Condition, Thrift 2] was nearing insolvency under both GAAP and regulatory accounting principles, with its assets exceeding its liabilities by [approximately $5 million]. With a continuous negative trend in earnings and a loss

> [of less than ½ million dollars as of the quarter prior to Date 1], the FHLBB calculated that [Thrift 2] had approximately six months of remaining operation before it became insolvent. Based upon this anticipated insolvency, the FHLBB recommended that the merger be classified as supervisory and processed accordingly.

Id.

The Taxpayer now claims entitlement to a tax basis in the intangible asset identified as supervisory goodwill and to an ordinary loss for that amount in the last taxable year of Cycle 1 because it ceased to use the asset. Taxpayer's claims appear to be founded on the asserted exclusion of the value of that supervisory goodwill from its gross income pursuant to section 597 of the Code. Taxpayer maintains that supervisory goodwill was property received by Thrift 1 from the FHLBB. Moreover, Taxpayer maintains that section 597 of the Code did not require it to reduce the basis of its assets to reflect its receipt of this assistance.

In a document identified as Statement 2, which was also provided to the examining revenue agent, the Taxpayer states that:

> The acquisition of [Thrift 2] was a supervisory acquisition, induced and arranged by the [FHLBB]. The assistance provided by the FHLBB included a regulatory intangible asset [that is, supervisory goodwill], which represented the right to include such asset when calculating the regulatory capital ratios of [Thrift 1].
>
> For financial accounting purposes [the acquisition of Thrift 2] was accounted for under the purchase method of accounting. The fair market value of the [supervisory goodwill] was determined to be [$c]. The Asset was referred to as "goodwill" on the financial statements of [Thrift 1].

IDR Response, at 5. In addition, the Taxpayer states that:

> In preparing its [consolidated federal income tax returns for the last taxable year in Cycle 1], [Holding 1] did not take into account the loss from the abandonment of the Asset. Therefore, pursuant to [§ 165 of the Code], [Holding 1] is claiming, on Form 1120X, line 2, an additional tax deduction of [$c] for the loss from the abandonment of the Asset in [last taxable year in Cycle 1].

Id.

LAW AND ANALYSIS

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

Supervisory goodwill is a creature of RAP accounting although it bears a nexus to the GAAP asset of "purchased goodwill" that results under the purchase method of accounting upon the acquisition of one corporation by another. Based on the following analysis, we agree with your tentative conclusions that supervisory goodwill: (1) is not financial assistance from FSLIC under section 406(f) of the National Housing Act; and (2) does not qualify as money or other property for purposes of § 597 of the Code.

A. General Background

1) GAAP Requirements

As a general accounting concept, goodwill is an intangible asset that is entered on the books of account of a business at cost.[9] For GAAP, an intangible asset is amortized over its respective term (or useful life) and reflected as an annual expense, with a corresponding offsetting adjustment to the carrying charge (or starting balance) of the asset on the books of account. During the time frame at issue, intangible assets were required to be amortized under GAAP using a life or term not to exceed 40 years.[10] Siegel and Siegel, at 71-72.

Under GAAP, circa Date 1, business combinations could be accounted for in one of two ways, either under the "purchase method" or the "pooling of interests method". Id. at 157. For transactions accounted for under the purchase method, the acquirer would include the target's assets at their cost. Id. at 159. Under the purchase method, any excess of the purchase price paid by the acquirer over the fair market value of the target's assets was required to be shown as purchased goodwill on the acquirer's books of account. Id. at 160. The advantage of the purchase method of accounting, from Thrift 1's perspective, was that Thrift 2's existing goodwill (or going concern value) could be stated as a separate asset on

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[9] The following discussion draws mainly from Siegel and Siegel, Accounting and Financial Disclosure: A Guide to Basic Concepts, (West Publishing Co.) (1983) (hereafter referred to as "Siegel and Siegel").

[10] Shorter amortization periods could apply if, for example, the acquisition involved a holding company that was subject to Securities and Exchange Commission filings.

Thrift 1's books of account and on its balance sheet following its acquisition of Thrift 2.

2) RAP Requirements

Historically, the thrift industry was subject to a net worth requirement that operated as a “rough equivalent of a capital requirement [and] was applicable to member-owned mutual institutions as well as privately owned stock institutions.” See Carl Felsenfeld, The Savings and Loan Crisis, 59 Fordham L. Rev. S7, at S26 and n.125. In the banking industry, capital requirements are used as a measure of the safety and soundness of a financial institution. See Richard C. Breeden, Thumbs on the Scale: The Role That Accounting Practices Played in the Savings and Loan Crisis, 59 Fordham L. Rev. S71, at S75 (1991) (hereafter referred to as “Breeden”). The FHLBB was required to review and approve all applications for mergers by regulated thrifts, not just those entered into for supervisory considerations.

As described by one commentator, RAP requirements are the “accounting standards established by regulatory agencies to monitor compliance with statutory and administrative requirements. In the case of federally insured depository institutions, RAP [requirements] govern the financials that are submitted to the relevant federal oversight agency.” See Breeden, supra, at S77. For thrifts, the applicable RAP requirements were generally promulgated by the FHLBB and announced in the Federal Register.[11] Examples of situations where RAP departed from GAAP included the deferral for RAP of losses on the sale of mortgage-backed assets (46 Fed. Reg. 50,048 (1981)) and the acceleration for RAP of certain fee income on construction loans (44 Fed. Reg. 76,567 (1979)). Id. at S78-S79.

Prior to August 1981, the FHLBB required the amortization of purchased a period not to exceed 10 years. See Breeden, supra, at S82; 46 Fed. Reg. 42274 (1981). On August 20, 1981, however, the FHLBB eliminated this requirement and reverted to using the applicable GAAP period for amortization. See 46 Fed. Reg. 42274 (1981). As stated therein, “the [FHLBB determined] to allow application of [GAAP] in this area without regulatory restriction.” For purposes of RAP, the use of purchased goodwill resulting from mergers was generally provided for in 12 CFR § 563.23-3 to the extent that the applicant substantiated, in accordance with 12 CFR § 571.5(f), “the reasonableness of amounts attributed to goodwill, the method and period of amortization and the adequacy of reserves.” See 46 Fed. Reg. 42275, discussion of “Accounting Rules.” Such information was required to permit

[11] These pronouncements took various formats, including final regulations, proposed regulations, and policy memoranda.

the FHLBB to review merger applications “on a flexible basis.” Id. This change effectively resulted in the FHLBB’s return to “its case by case basis review of merger applications.” Id.

Based on the information provided, it appears that Thrift 1 established to the FHLBB’s satisfaction that its GAAP asset (that is, its “purchased goodwill”) should be amortized as well for RAP purposes over the GAAP amortization period of 40 years. The ability to use the longer GAAP amortization period for purchased goodwill in the instant case meant that Thrift 1 was able to use this GAAP asset for purposes of meeting applicable FHLBB regulatory capital (or net worth) requirements. See also Breeden, supra, at S83. For purposes of RAP, this GAAP asset is generally referred to as “supervisory goodwill.” Enactment of FIRREA altered Thrift 1's ability to use supervisory goodwill to meet its regulatory capital requirements.[12] Although FIRREA altered RAP, it did not alter Thrift 1's treatment of purchased goodwill for GAAP.

3) Book-Tax Differences

Just as RAP may coincide with or depart from GAAP to meet the regulatory requirements of a banking supervisory agency such as the FHLBB, the treatment of an item of income or loss or the significance of an asset or liability for tax may be different than the taxpayer’s treatment of it for GAAP book purposes. See Thor Power Tool Co., v. Commissioner, 439 U.S. 522, 542-544 (1979). For federal income tax purposes, we assume that Thrift 1's acquisition of Thrift 2 qualified as a tax-free reorganization under section 368(a)(1)(A) of the Code as stated by Firm 1. Consequently, Thrift 1 took a carryover basis in Thrift 2's assets and reported no gain or loss on the acquisition (other than any tax resulting solely from the conforming accounting method changes required under section 381 of the Code). Thrift 1 correctly did not book for federal income tax purposes, a corresponding asset for purchased goodwill because:

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[12] FIRREA altered the capital requirements for thrifts by extending the general concept of risk-based capital tests to them. Following FIRREA, thrifts had to satisfy three separate standards: (1) tangible capital; (2) core capital; and (3) risk-based capital. See, generally, 12 C.F.R. § 567. Thrifts were no longer permitted to use supervisory goodwill to meet tangible capital although, if an institution qualified as an eligible institution and the supervisory goodwill met the definition of qualifying supervisory goodwill, supervisory goodwill was still available to meet core capital (and, by extension, risk-based capital) requirements for the remaining five year phase-out period. Id.; see also Julie L. Williams, Savings Institutions: Mergers, Acquisitions and Conversions (L. Journal Seminars-Press) (1990), ¶ 6.06[1].

> Qualification as a reorganization for tax purposes bears no relationship to application of purchase or pooling accounting. Therefore, a particular acquisition might result in carryover basis for tax purposes, but an increase in value for accounting purposes, or vice-versa. ...

Siegel and Siegel, supra, at 164.

Moreover, the Supreme Court noted in Winstar that goodwill (even when recognized as a tax asset) was not subject to recovery by depreciation or amortization. See Winstar, supra, at 851, n. 7. This abiding tax principle is unchanged after Newark Morning Ledger. Winstar, supra.

B. Section 597

When Thrift 1 acquired Thrift 2, the version of section 597 of the Code in effect was the version originally enacted in 1981. As so enacted, section 597 required that a domestic building and loan association receive money or other property from the FSLIC pursuant to section 406(f) of the National Housing Act before section 597 could apply. Therefore, application of section 597 here turns on whether either Thrift 1 or Thrift 2, in fact, received money or other property from the FSLIC pursuant to section 406(f) of the National Housing Act.[13]

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[13] Section 406(f) of the National Housing Act (12 U.S.C. §1729) dealt with the liquidation of insured institutions. As amended by the Garn-St. Germaine Depository Institutions Act of 1982, Pub. L. 97-320 (October 15, 1982), the FSLIC was expressly authorized "to make loans to, to make deposits in, or to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured institution." 12 U.S.C. § 1729(f)(1). Prior to amendment, the FSLIC was authorized under section 406(f): (1) "to make loans to, to purchase the assets of, or to make a contribution to an insured institution or an insured institution in default" under 12 U.S.C. § 1729(f)(1); and (2) "to purchase any such assets, or assume any such liabilities, or make loans to such other insured institution, or guarantee such other insured institution against loss" under 12 U.S.C. § 1729(f)(2) with respect to an acquisition (whether by merger or consolidation) by that other insured institution of an insured institution in default or in danger of default. As amended, 12 U.S.C. § 1729(f)(2) also authorized, with respect to an acquiring insured institution, the FSLIC to take any or all of the actions authorized under 12 U.S.C. § 1729(f)(1), as well as to guarantee the acquirer against loss. Additionally, the 1982 amendment explicitly authorized the FSLIC "to increase or maintain the capital of a qualified institution by making periodic purchases of capital instruments to be known as net worth certificates ... ." 12 U.S.C. § 1729(f)(5)(A)(i).

If either Thrift 1 or Thrift 2 received such assistance, the money or other property would be excluded, pursuant to section 597(a) of the Code, from gross income whether or not a note or other instrument was issued in exchange for that money or other property. However, the only form of assistance identified by the Taxpayer here is supervisory goodwill. Therefore, before we can determine whether section 597 applies, we must first ascertain whether supervisory goodwill is a form of assistance provided by the FSLIC pursuant to section 406(f) of the National Housing Act.

1) Legislative History of Section 597

Section 597 of the Code, as added by section 244 of the Economic Recovery Act of 1981, Pub. L. 97-34 (Aug. 13, 1981) (the "Act"), provided:

> (a) Exclusion From Gross Income. - Gross income of a domestic building and loan association does not include any amount of money or other property received from the Federal Savings and Loan Insurance Corporation pursuant to section 406(f) of the National Housing Act (12 U.S.C. sec. 1729(f)), regardless of whether any note or other instrument is issued in exchange therefor.
>
> (b) No Reduction in Basis of Assets. - No reduction in the basis of assets of a domestic building and loan association shall be made on account of money or other property received under the circumstances referred to in subsection (a).

Section 246(c) of the Act made section 597 of the Code applicable to **payments** made on or after January 1, 1981. The statutory language of section 597 clearly contemplates forms of financial assistance provided by the FSLIC.

Although the legislative history to section 244 of the Act is somewhat sparse, it also supports the conclusion that section 597 covers only financial assistance that is provided by the FSLIC. The above tax provision appears to have been first added in the version of H.R. 4242 that was considered and passed by the House on July 29, 1981. The legislative history also indicates that this tax provision was initially agreed to in the Senate as a floor amendment (captioned "Section 604 FSLIC Financial Assistance) on July 23, 1981.

In support of the Senate amendment, the congressional record reflects that the "amendment would facilitate the infusion of capital to a failing savings and loan, or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events." Id. In further support of the amendment, a letter from the then-chairman of the FHLBB, Richard T. Pratt, was introduced into the record; relevant excerpts from which follow:

> ... A new Section 597 would be enacted to ensure that no tax liability would result from FSLIC capital infusions to weakened associations and subsequent repayments of the infusions by rehabilitated associations.
>
> In order to prevent a default or restore an insured institution in default to normal operations, the FSLIC may make loans to purchase the assets of, make contributions to, or arrange the merger of a failing institution. ... The [FHLBB] recognizes the extraordinary nature of mergers arranged in a supervisory context and exempts them from certain procedural requirements and general rules usually applicable in non-supervisory cases. ...
>
> A literal reading of the Internal Revenue Code might result in FSLIC assistance to an institution in the form of cash or an interest bearing note being treated as a contribution to capital by a non-shareholder, with reductions in the basis of assets required under Section 362(c). Also, if a recipient institution issues a mutual capital certificate or similar equity instrument in consideration for the FSLIC assistance, repayment of the assistance might be determined to be subject to the rules of Section 593(e) regarding redemption of capital stock and produce adverse tax consequences to the association. Finally, there are varying degrees of uncertainty concerning the tax-free reorganization status of various types of supervisory mergers ... .

127 Cong. Rec. at S8286 (daily ed. July 23, 1981).

The use of terms such as “payment,” ”capital infusion,” and “repayment” during the legislative process are further indications of a congressional intent to limit section 597 solely to forms of financial assistance. The conference report, moreover, indicates that this amendment was intended to resolve the question of whether financial assistance from the FSLIC was to be included in income or treated as a non-shareholder contribution to capital (with a consequential reduction in the tax basis of assets) by the taxpayer. H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981).

Section 597 was one of four thrift-related amendments to be added in this manner. Section 241 of the Act amended section 368(a)(3)(D) of the Code (dealing with agency proceedings involving financial institutions) to clarify that section 368(a)(1)(G) would apply to certain transfers even in the absence of the receipt of stock or securities by the transferring corporation provided certain preconditions were met. One of the preconditions was that either the FHLBB or the FSLIC certify that the grounds set forth in 12 U.S.C. §1464(d)(6)(A)(i), (ii), or (iii) exist (or will shortly exist) with respect to the transfer unless action is taken by the FHLBB or the

FSLIC.[14] See 95 Stat. 254. Section 241 was effective for transfers made on or after January 1, 1981. Section 246(a) of the Act, 95 Stat. 256. Section 241 of the Act initially appeared as section 601 in the Senate floor amendment. 127 Cong. Rec., supra, at S8287.

Section 242 of the Act amended section 382(b)(7) of the Code (dealing with limitations on net operating carryover losses of financial institutions in situations similar to bankruptcy cases) to treat depositors of the transferring institution as if they were stockholders immediately before the transfer. See 95 Stat. 255. Section 242 was also effective for transfers made on or after January 1, 1981. Section 246(a) of the Act, 95 Stat. 256. Section 242 of the Act initially appeared as section 602 in the Senate floor amendment. 127 Cong. Rec., supra, at S8287.

Section 243 of the Act amended section 593(e)(1) of the Code (dealing with distributions to shareholders under the thrift bad debt reserve provision) to include distributions to FSLIC made in redemption of an interest originally received by the FSLIC in exchange for financial assistance under section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)). See 95 Stat. 255. Section 243 was effective for distributions made on or after January 1, 1981. Section 246(b) of the Act, 95 Stat. 246. Section 243 of the Act initially appeared as section 603 in the Senate floor amendment. 127 Cong. Rec., supra, at S8287.

2) Section 597 Is Inapplicable Here

Nothing in the legislative history indicates that section 597 was intended to apply to assistance other than financial assistance from the FSLIC. Both the statutory language and the legislative history limited application of section 597 to financial assistance provided by the FSLIC. Congress clearly differentiated between the FHLBB and the FSLIC for purposes of applying various, contemporaneously enacted, provisions of the Internal Revenue Code. Compare sections 243 and 244 of the Act (in which Congress spoke only to actions by the FSLIC) with section 241 of the Act (in which Congress spoke to actions by either the FHLBB or the FSLIC).

[14] Section 1464(d)(6)(A) listed several possible grounds for the FHLBB appointing the FSLIC as conservator or receiver for a covered thrift. Among these grounds were the following: subparagraph (i) concerning insolvency based on an institution's obligations to creditors exceeding its assets; subparagraph (ii) concerning the substantial dissipation of an institution's assets or earnings due to a violation of law (including a violation of applicable rules and regulations, or any unsafe or unsound practice); and subparagraph (iii) concerning the existence of any unsafe or unsound condition to transact business.

Before section 597 can apply, therefore, a taxpayer must establish that some form of financial assistance was provided by the FSLIC pursuant to section 406(f) of the National Housing Act. Nothing in the materials provided for our consideration indicates that the FSLIC provided any assistance, financial or otherwise, in connection with the acquisition of Thrift 2 by Thrift 1. In fact, the Taxpayer has stated that there was no cash or other form of **financial** assistance provided by the FSLIC. Even if supervisory goodwill were financial assistance contemplated by section 597, it was not provided by the FSLIC which was a separate corporation for tax purposes. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Further, the FSLIC had no authority to allow supervisory goodwill to be counted towards regulatory capital requirements under the rules of the FHLBB.

We note the Supreme Court in United States v. Winstar, 518 U.S. 839 (1996), held that certain thrifts had an enforceable contract with the FHLBB and the FSLIC with respect to the use of supervisory goodwill to meet regulatory capital requirements for periods that could extend up to 40 years. Although the Court found that the concept of supervisory goodwill was part of an accounting regime designed to induce healthy thrifts to acquire failing ones, and that the FHLBB essentially devised this regime as a cash substitute because the FSLIC had insufficient funds to liquidate these failing thrifts, the Court did not find that supervisory goodwill was provided by the FSLIC under section 406(f) of the National Housing Act within the meaning of section 597 of the Code. [15]

The Taxpayer has filed a complaint, alleging a cause of action under Winstar and seeking pecuniary damages and other forms of relief for breach of contract with respect to Thrift 1's acquisition of Thrift 2. Regardless of the outcome of the Taxpayer’s pending Winstar litigation, neither Thrift 1's RAP asset of supervisory goodwill nor Thrift 1's right to use it to meet its regulatory capital requirements is, for the reasons set forth above, section 597(a) assistance.

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

A. Tax Basis Considerations

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[15] The Court recognized that an accounting complication also arose as a result of the FHLBB allowing the full amount of supervisory goodwill to be amortized for RAP over the GAAP amortization period for purchased goodwill while permitting the accretion of income over a shorter period without reducing supervisory goodwill to reflect the purchase adjustments required under GAAP. Id. at 851-52.

Absent the application of certain provisions that provide for the tax-free receipt of property (for example, the application of section 597 of the Code), a taxpayer generally must include the fair market value of property received in income in order to obtain a tax basis in such property. See Treas. Reg. § 1.61-2(d); Strong v. Commissioner, 91 T.C. 627 (1988). The amount of a taxpayer's basis is thus, generally, equal to the amount included in income (that is, the property's fair market value). [16]

1) No Tax Basis for Supervisory Goodwill

Generally, a taxpayer's basis in acquired property is its cost basis as computed under section 1012 of the Code. However, special basis rules apply in connection with assets and liabilities acquired by means of tax-free reorganizations. Under these rules, for federal income tax purposes, a taxpayer (such as Thrift 1) generally steps into the shoes of the transferor corporation (such as Thrift 2) with respect to basis. See section 362(b) of the Code. However, neither purchased goodwill (Thrift 1's GAAP asset) nor supervisory goodwill (Thrift 1's RAP asset) was ever an asset on Thrift 2's financial, regulatory, or tax books. Consequently, Thrift 1 could not obtain a carry over basis in such an asset. See also sections 357(a) and 1032(a) of the Code.

As Thrift 1 could not apportion basis to supervisory goodwill under section 362(b), the Taxpayer must identify a fresh source from which basis can be obtained. The Taxpayer, therefore, would have section 597 apply to provide a tax-free source of income from which this fresh basis can be said to derive. For the reasons set forth above, under Issue 1, section 597 is not applicable to the acquisition of supervisory goodwill by Thrift 1. Thus, Thrift 1 properly did not allocate basis on Date 1 to supervisory goodwill under section 597.[17] Because supervisory goodwill was not received by the Taxpayer as assistance from the FSLIC under section 406(f) of the National Housing Act, the Taxpayer would not have been entitled to exclude the value of supervisory goodwill from gross income under section 597(a) of the Code. As the Taxpayer did not include the fair market value of the RAP asset in gross income, the Taxpayer cannot now claim that it had

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[16] A transfer of property that is treated as non-shareholder contribution to capital does not create gross income to the transferee but the transferee will not have any tax basis in the property so acquired. See sections 118 and 362(c) of the Code.

[17] Supervisory goodwill arose for RAP because of the existence of purchased goodwill under GAAP. As previously discussed under Issue 1, however, GAAP does not control the federal income tax consequences of a tax-free reorganization under section 368(a)(1)(A) of the Code. See Siegel and Siegel, supra, at 164.

a tax basis in that RAP asset. See Treas. Reg. § 1.61-2(d); Strong v. Commissioner, supra.

The Taxpayer, moreover, cannot be said to have received the RAP asset of supervisory goodwill in addition to the GAAP asset of purchased goodwill as the RAP asset was measured solely by reference to the value of the GAAP asset. Thus, even assuming that the Taxpayer received an asset from the regulators, this additional asset can only be the **right to use** purchased goodwill to meet regulatory capital requirements. Even assuming, arguendo, that Thrift 1's right to use goodwill to meet its regulatory capital requirements was a form of tax-free assistance pursuant to section 597, it did not result from the receipt of a financial payment. Therefore, this right would have to be considered “other property” and its tax basis determined under rules applicable to the receipt of property. As the value of the purchased goodwill (that is, the underlying GAAP asset) was already reflected for federal income tax purposes in the higher book values Thrift 1 inherited from Thrift 2, any tax basis attributable to the receipt of this right would not be determined by reference to the amount of that purchased goodwill. Rather, Thrift 1's basis would be determined solely by reference the fair market value of the right to use that asset for RAP. See section 1012 of the Code.

2) No Tax Basis for the Right to Use Goodwill

As a general matter, the creation of rights under governmental regulatory and licensing arrangements (“property rights”) will usually not result in the recognition of gross income to the recipient of those property rights.[18] See, e.g., Rev. Rul. 92-16, 1992-1 C.B. 15 (holding that the issuance of emission allowance by the Environmental Protection Agency does not result in gross income to the taxpayer (a utility) that receives it). Moreover, not even the excess of the fair market value of the property right over the cost of acquisition of that right will be income. See, e.g., Rev. Rul. 67-135, 1967-1 C.B. 20 (holding that the excess of the fair market value over the cost of a lease obtained by a taxpayer in a lottery conducted by the United States Bureau of Land Management is not includable in gross income).

Even where a tax basis in such a property right is properly determined under section 1012, that basis is generally limited to the taxpayer’s cost of acquiring the property right (not the fair market value of the right itself). The Service’s position with respect to the proper determination of tax basis to be accorded to the acquisition of these types of property rights has been implicitly adopted by a number of courts in cases holding that taxpayers’ bases in similar property rights were the respective taxpayers’ costs of obtaining those rights. See, e.g., Nachman

[18] See GCM 39606 (Feb. 27, 1987) for additional discussion of supporting authority.

v. Commissioner, 191 F.2d 934 (5th Cir. 1951); Nicolazzi v. Commissioner, 79 T.C. 109 (1982), aff'd per curiam, 722 F.2d 324 (6th Cir. 1983); Radio Station WBIR v. Commissioner, 31 T.C. 803 (1959). Under the holdings in these cases, because the respective taxpayers' bases did not include the fair market value of the underlying property, the courts must have assumed that no income was imputed to the recipients on receipt of the underlying property rights.

B. No Tax Basis Means No Tax Loss

As we have discussed above, the Taxpayer here properly cannot establish (on Date 1) a tax basis in the regulatory asset identified as supervisory goodwill, regardless of whether section 597 of the Code applies. Moreover, the Taxpayer cannot establish (on Date 1) a tax basis in the right to use that regulatory asset to meet regulatory capital requirements, again regardless of whether section 597 applies. Because Thrift 1 (as of Date 1) properly recognized no separate tax asset corresponding to either supervisory goodwill or the right to use it, Holding 1 cannot claim (as of Date 4) to have acquired that asset for tax purposes upon its acquisition of Thrift 1. Therefore, Holding 1 also could not properly assign tax basis to either Thrift 1's supervisory goodwill or its right to use it to meet regulatory capital requirements. Finally, because the Taxpayer properly could not establish a tax basis for either supervisory goodwill or the right to use it to meet regulatory capital requirements, the Taxpayer properly may not now establish a tax basis in that regulatory asset for purposes of claiming a loss under section 165 of the Code.

Issue 3: Whether the Taxpayer properly claimed a loss under section 165 of the Code for amounts attributable to supervisory goodwill?

A. Losses Under Section 165

Section 165 allows as a deduction any loss which was sustained by taxpayer during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(d) provides that a loss shall be allowed as a deduction only for the taxable year in which the loss is sustained. Moreover, Treas. Reg. §1.165-1(b) requires that, to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, and fixed by identifiable events. See United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927).

Based on these requirements, even if the Taxpayer could establish a tax basis as discussed above under Issue 2 (as of Date 1) in the right to use goodwill to meet its regulatory capital requirements, the Taxpayer would be entitled to claim a loss with respect to that asset only in the taxable year in which the loss was sustained and only to the extent that it was not compensated for that loss. For GAAP purposes, however, it appears that the Taxpayer has written off amounts attributable to its purchased goodwill in earlier tax years. Taxpayer took the write-offs for GAAP, for the most part, in Year 1 and Year 2.

1) Computing the Amount of Loss

As the discussion of basis would indicate, even assuming that the Taxpayer were allowed a tax basis for the fair market value of the right received, that fair market value would not approach the full amount of the supervisory goodwill booked on Date 1 for RAP. Accordingly, the Taxpayer would not be entitled to a tax loss in an amount equal to the supervisory goodwill, but only in an amount equal to the right to use that supervisory goodwill to meet Thrift 1's regulatory capital requirements. This was made clear in a case determining the damages to another plaintiff in a case identical to the Winstar litigation, which stated as follows:

> Plaintiff argues that its loss of goodwill as capital was a cost for which it should be reimbursed. However, goodwill is not a cost that should be reimbursed dollar for dollar. [Plaintiff] quantified goodwill on its books and used that number to meet its capital requirements. While goodwill was used as capital for those purposes, it is not equivalent to capital and does not have a dollar for dollar value.

California Federal Bank v. United States, 43 Fed. Cl. 445, 449 (1999), appeal docketed, 99-5108 and 99-5119 (Fed. Cir. June 14 & 28, 1999).

Further, in determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any insurance or other compensation received. Treas. Reg. § 1.165-1(c)(4). The regulations under section 165 also provide that if an event occurs which may result in a loss and, in the year of the event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not the reimbursement will be received. Treas. Reg. § 1.165-1(d)(2)(i).

Whether a reasonable prospect for recovery exists with respect to a claim for reimbursement of the loss is a question of fact to be determined upon examination of all of the facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. The determination of whether reasonable certainty exists as to reimbursement is an objective inquiry into the facts and circumstances surrounding the loss as of the close of the taxable year in which the deduction is claimed. See Boehm v. Commissioner, 326 U.S. 287, 292-93 (1945); Ramsey Scarlett & Co. v.

Commissioner, 61 T.C. 795, 811 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975); Brown v. Commissioner, T.C. Memo. 1996-284.

In the present case, the Taxpayer has filed a claim against the United States government to receive damages based on a breach of contract (the "Contract Claims") or, alternatively, a taking of property without compensation (the "Constitutional Claims"). Plaintiffs in the Winstar litigation prevailed on the breach of contract claim. The Taxpayer's filing of a lawsuit to recover the same loss as deducted on its refund claims is evidence that the taxpayer had a reasonable prospect of recovery. See Ramsey Scarlett, 61 T.C. at 812-13. In fact, filing suit has been held to give rise to an inference of such a reasonable prospect. Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir. 1982); Estate of Scofield v. Commissioner, 266 F.2d 154, 159 (6th Cir. 1959); Brown, supra. In such circumstances, the claimant's subjective belief in the reasonable prospect of recovery becomes objective evidence of that prospect. See Boehm, 326 U.S. at 292-93; Jeppson v. Commissioner, T.C. Memo. 1995-342, aff'd, 128 F.3d 1410 (10th Cir. 1997).

Where the claim involved in a suit is neither speculative nor meritless (which would seem to be the case in these Winstar Contract Claims), and where the claimant believes that there is a reasonable chance of recovery (which is indicated by prosecuting the law suit with reasonable diligence), claiming a tax loss should wait until the conclusion of the lawsuit.[19] Estate of Scofield, 266 F.2d at 159; Jeppson, supra; see also Ramsay Scarlett, 61 T.C. at 811.

2) Abandonment of Intangible Assets

The Taxpayer here, even if it could establish a tax basis in an appropriate amount, has also not established that it is entitled to claim a tax loss for abandoning that property right. This purported tax asset is an intangible asset. The requirements for an abandonment loss are found in the regulations under section 165. Specifically, Treas. Reg. § 1.165-2(a) allows a loss incurred in a business and arising from the sudden termination of the usefulness of any nondepreciable property, in a case where the business is discontinued or where the property is permanently discarded from use therein, as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

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[19] The amount of time and money spent by a taxpayer investigating and prosecuting a claim, as well as whether a taxpayer ultimately recovered the loss, are also relevant factors. National Home Products, Inc. v. Commissioner, 71 T.C. 501, 526 (1979); Huey v. Commissioner, T.C. Memo. 1985-348.

As a general matter, an abandonment loss requires (1) an intention on the part of the owner to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Citron, 97 T.C. at 209; CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990). Moreover, the transaction must be considered to be a closed and completed transaction within the meaning of Treas. Reg. §1.165-1(b). See Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, aff'd, 789 F.2d 1234 (7th Cir.), cert. denied, 479 U.S. 995 (1986).

It is clear that intangible assets may be the subject of an abandonment loss. Parmelee Transportation Co. v. United States, 351 F.2d 619 (Ct. Cl. 1965); see also Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1959), acq. 1973-2 C.B. 2; Solar Nitrogen Chemicals, Inc. v. Commissioner, T.C. Memo. 1978-486. However, goodwill is generally not abandoned until the business to which it relates ceases to operate. Thrifticheck Service Corp. v. Commissioner, 33 T.C. 1038 (1960), aff'd, 287 F.2d 1 (2d Cir. 1961); Illinois Cereal Mills, supra; Danco Products, Inc. v. Commissioner, T.C. Memo. 1962- 52.

Exceptions to this general rule may occur when the taxpayer abandons a portion of its business that has a "distinct transferrable value" (as defined in Metropolitan Laundry Co. v. United States, 100 F. Supp. 803 (N.D. Cal. 1951)). The taxpayer in Metropolitan Laundry was permitted an abandonment loss for a portion of a customer list that was attributable to a specific geographic area.[20] The taxpayer originally purchased the customer lists of several laundry businesses in San Francisco and Oakland. During World War II, the government seized the taxpayer's San Francisco plant for military purposes. After the war, the taxpayer had trouble reestablishing its business and abandoned its San Francisco routes although it continued its operations in Oakland. The court found that the costs attributable to the abandoned San Francisco customer lists met this exception and, consequently, were deductible at the time even though the taxpayer continued in operation. The Tax Court has followed Metropolitan Laundry and, in Massey-Ferguson, held that "if there is a clearly identifiable and severable asset, its abandonment entitles the taxpayer to a loss deduction." Massey-Ferguson, 59 T.C. at 225 (allowing an abandonment loss for a line of business the taxpayer had purchased from another party and operated at a distinct location, even though the taxpayer continued to manufacture similar products under a different trade name at another location).

Further, a taxpayer's intent to abandon this property right, standing alone, is not sufficient to establish a recognition event for purposes of section 165 of the

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[20] Customer lists are closely associated with goodwill. See Metropolitan Laundry, 100 F. Supp. at 806.

Code. Abandonment does not result simply from cessation of use. Beus v. Commissioner, 261 F.2d at 180; Citron, 97 T.C. at 210. Rather, there must be an affirmative act of abandonment. See Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983); Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958); Citron, 97 T.C. at 210; Zurn v. Commissioner, T.C. Memo. 1996-386.

Arguably, as a result of this affirmative act requirement, there is also an inherent prerequisite that the taxpayer claiming the loss (rather than some other party) take that necessary affirmative act. Thus, mere participation in a government program which required the taxpayer to discontinue a dairy operation was not considered an affirmative act of abandonment where there was no showing of an irrevocable intent to abandon, or to never use, the property again. Strandley v. Commissioner, 99 T.C. 259 (1992), aff'd on another issue, 73 A.F.T.R. 2d (RIA) 2118 (9th Cir. 1994). Other cases have similarly held that these types of restrictive actions by the government affect only the value of the property where the taxpayer continues to hold onto that property. See CRST, 92 T.C. at 1259-61; Beatty v. Commissioner, 46 T.C. 835 (1966); Consolidated Freight Lines, Inc. v. Commissioner, 37 B.T.A. 576 (1938), aff'd, 101 F.2d 813 (9th Cir. 1939).

In addition, even in those cases where a taxpayer properly establishes a tax basis in a contract right, when the taxpayer determines not to pursue an opportunity under that contract, the taxpayer must still affirmatively act to abandon the opportunity before a tax deduction is allowed. International Educational Publishing Co. v. Commissioner, 79 F.2d 343 (3d Cir. 1935). However, where it is the other party that wishes to cancel a contract, it has been held that the affirmative act occurs when the taxpayer accepts the cancellation. George Freitas Dairy, Inc. v. United States, 582 F.2d 500, 502 (9th Cir. 1978).

It has also been held that the mere diminution in value of property over time is not enough to establish an affirmative act of abandonment so as to entitle a taxpayer to claim the loss. Kraft, Inc. v. United States, 30 Fed. Cl. 739, 785-86 (1994); Lakewood Associates v. Commissioner, 109 T.C. 450, 456 (1997), aff'd, 99-1 USTC ¶50,127 (4th Cir. 1998); see also S.S. White Dental, 274 U.S. at 401. Specifically, diminution in value fails to satisfy the requirement under the regulations that a loss be “evidenced by closed and completed transactions, fixed by identifiable events.” Sunset Fuel Co. v. United States, 519 F.2d 781, 783 (9th Cir. 1975); see also S.S. White Dental, 274 U.S. at 401.

B. No Entitlement to Loss As Claimed

Based on the above analysis, we conclude that the Taxpayer cannot deduct the amounts claimed for supervisory goodwill as losses under § 165 of the Code.

We base this conclusion on the application of the above principles to the facts of this case.

The basis for disallowance stems from the fact that the Taxpayer would not have recognized a loss under section 165 in Cycle 1 because of the timing of its Winstar litigation. The Taxpayer is actively pursuing its own litigation for Contract Claims (which are similar to the successfully pursued claims of the litigants in the Winstar case) and there is a strong likelihood that its litigation of these claims will consume a substantial amount of time and money. Consequently, we conclude that the Taxpayer had a reasonable expectation of recovery as of the last day of its last tax year in Cycle 1 (the "claim year"). Therefore, even assuming that the Taxpayer could establish a tax basis for this property right, the Taxpayer should not have deducted any tax loss attributable to this asset in the claim year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Issue 4. Whether additional factual development is required to support the revenue agent's proposed disallowance of Taxpayer's claimed loss?

A) Supervisory Goodwill

With respect to footnote 3, supra, the purchase price adjustments appear to effect an accelerated amortization for GAAP of that portion of the excess of book over fair market value for the affected items (primarily Thrift 2's mortgage loans). [redacted]

With respect to assistance under section 406(f) of the National Housing Act, we have seen nothing that indicates the FSLIC provided any assistance whatsoever to either Thrift 1 or Thrift 2, either prior to or in connection with the Date 1 merger. However, should further factual development indicate otherwise, additional analysis under 12 U.S.C. § 1729(f) may be needed. Supervisory goodwill (or the right to use it), even if provided directly by the FSLIC, must also qualify as "money or other property" to be eligible for consideration under section 597. We do not believe that either supervisory goodwill, or the right to use it to meet regulatory capital requirements, is inherently pecuniary in nature. Thus, we do not think that it would directly qualify as "other property" for purposes of section 597. However, because we concluded above that supervisory goodwill is not assistance provided by the FSLIC under section 406(f) of the National Housing Act, we do not reach the issue of whether supervisory goodwill (or the right to use it) is "other property" within the meaning of section 597. Should the facts ultimately indicate that the FSLIC provided some form of financial assistance (for example, a promissory note or capital certificates), some additional analysis under section 597 may be needed. (For example, to consider whether any of the value of the purchased goodwill can be said to be due to such FSLIC financial assistance as it is possible that such contributions by the FSLIC were reflected on Thrift 2's books as assets for GAAP and carried over to Thrift 1 at Thrift 2's book value.)

In addition, the materials provided for our consideration raise an inference that both the formation of Holding 1 on Date 3, along with its related IPO, and Holding 1's subsequent merger on Date 6 with Holding 2 may have each had their own supervisory implications based on Thrift 1's changing capital position over time. However, there is insufficient documentary evidence to establish that inference as a factual matter. Accordingly, for purposes of our discussion, we have assumed that these later corporate reorganizations are not directly linked to Thrift 1's acquisition of Thrift 2 and that the Taxpayer's claims for refund relate solely to assistance provided in connection with the acquisition of Thrift 2 by Thrift 1. Thus, we have assumed that the alleged loss at issue in the Taxpayer's tax refund claims arose upon abandonment by Thrift 1 of its supervisory goodwill asset. It is possible, however, that the Taxpayer may be basing its tax refund claims, at least in part, on a perceived loss in value of the stock of Thrift 1, a separate asset held by Holding 1. Should that be the case, additional facts and arguments may be appropriate and the agent may wish to seek supplemental advice[redacted]

[redacted]

[redacted]

[redacted]

B) Section 165 Loss

On its return for its last taxable year in Cycle 1, the Taxpayer deducted $c with respect to supervisory goodwill as a loss under section 165. As a preliminary matter, the amount of this loss is excessive because even if it could establish that a tax loss was properly claimed in that year, the Taxpayer's basis would have been substantially less. As discussed above in Issue 2, we believe that the Taxpayer's tax basis in this regulatory asset is properly zero ($0). However, even if it were not zero, the amount of the Taxpayer's basis would not exceed its costs of acquiring that asset. Moreover, even assuming that section 597 of the Code applied and that the Taxpayer was entitled to treat this "property right" as "other property," the Taxpayer's tax basis would be limited to the fair market value of the **right to use** that supervisory goodwill. Thus, under even these operating assumptions, the Taxpayer would not be entitled to an initial tax basis equal to the amount of supervisory goodwill booked on Date 1.

Apparently, the Taxpayer took write-offs for GAAP with respect to its purchased goodwill in tax years prior to claiming a loss for the tax purposes with respect to the regulatory asset. These write-offs were in irregular amounts, and it is not clear why they were taken in this manner. [redacted]

With respect to the Taxpayer's ability to establish a tax basis for this asset, we note that we think this argument is very strong. However, there is little case law supporting the proposition that the grant of government rights is not income. We believe that this dearth of case law is due to the fact that this position (that is, there is no imputed income) is normally an advantageous one for taxpayers. We doubt, however, that the Taxpayer would be able to convince a court that merely entering in an advantageous contract should have resulted in its obtaining a tax basis for that contract benefit in the absence of an admission that the value of that benefit should have been recognized in income by it.

As we concluded above, under Issue 3, whether there is a reasonable prospect for reimbursement looks at the facts at the end of the taxable year for which the loss is claimed. See Ramsey Scarlet, 61 T.C. at 811-12. [redacted].[21] [redacted]

Nevertheless, the Taxpayer may have an argument that its supervisory goodwill was worthless when it could no longer be used to meet regulatory capital reserve requirements. Thus, the Taxpayer may be able to distinguish this case from those cases in which the government's action merely left the property right much less valuable but not completely worthless. See CRST, supra; Consolidated Freight, supra; Beatty, supra.

With respect to the Taxpayer's ability to claim a loss under section 165 based on the perceived worthlessness of supervisory goodwill in the claim year, we note that Echols v. Commissioner, 950 F.2d 209 (5th Cir. 1991), allowed a loss on a partnership interest in the year in which an affirmative act of abandonment occurred and also allowed the same loss in that year on the separate grounds of worthlessness. However, the Service does not follow Echols and Echols may not be followed in other circuits. See Corra Resources Ltd. v. Commissioner, 945 F.2d 224, 226-27 (7th Cir. 1991); Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 402 (3d Cir. 1990). Moreover, the Tax Court's position on this issue is not completely clear. See Norwest v. Commissioner, 111 T.C. 105, 139-40 (1998); but see Thrifticheck, 33 T.C. at 1046; Oak Harbor Freight Lines, Inc. v. Commissioner, T.C. Memo. 1999-291. Consequently, after Echols, it is unclear whether a taxpayer will be required to take an affirmative act of abandonment for an asset for which it can establish worthlessness in the same taxable year in which it claims an intent to abandon the property at issue.

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[21] The statute of limitations for filing a breach of contract suit in Winstar related litigation was six years from the breach of contract, as provided by 28 U.S.C.A. § 2501. The Court of Federal Claims held that the breach occurred on December 7, 1989, when final regulations mandated by FIRREA were published. Thus, all claims filed before December 8, 1996, were timely. Plaintiffs in Winstar-Related Cases v. United States, 37 Fed. Cl. 174, 181 (1997), aff'd sub nom., Ariadne Financial Services Pty. Ltd. v. United States, 133 F.3d 874 (Fed. Cir.), cert. denied, 119 S.Ct. 67 (1998).

In addition, with respect to the requirement of an affirmative act, losses have been found to result from the actions of the government if future use of the property is seen as impossible. See, e.g., Sheffield Denifrice Co. v. Commissioner, 13 BTA 877 (1928), nonacq. 1929-1 C.B. 60; Zakon v. Commissioner, 7 BTA 687 (1927), nonacq. 1928-2 C.B. 53, nonacq. withdrawn and acq., 1947-2 C.B. 5, (resulting losses allowed when alcohol was banned during Prohibition).

There is also some question as to whether supervisory goodwill cases aredistinguishable from that line of cases holding that goodwill may not be abandoned until the business is terminated. The Taxpayer here may argue that the intangible it is valuing is the contract right to use the supervisory goodwill and not the supervisory goodwill itself. The case law recognizes the difference between a severable intangible asset that is related to goodwill and the goodwill that is the favorable customer relations or, more broadly, the going concern value of a company itself. See Meredith Broadcasting Co. v. United States, 405 F.2d 1214, 1224-25 (Ct. Cl. 1969); Massey-Ferguson, 59 T.C. at 225. The first may be abandoned while the business continues, while the second cannot be abandoned. See Meredith Broadcasting, 405 F.2d at 1224-25.

In addition, even assuming that the Taxpayer's right to use supervisory goodwill is considered an asset separate and distinct from the RAP asset of supervisory goodwill, the Taxpayer would still not be entitled to a refund. As set out more fully above in connection with our discussion of supervisory goodwill, the Taxpayer would also not be entitled to a refund based on the "loss" of the right to use supervisory goodwill because: (1) the right to use supervisory goodwill is not financial assistance provided by the FSLIC under section 406(f) of the National Housing Act (12 U.S.C. § 1729(f)); (2) the right to use supervisory goodwill is not money or other property within the meaning of section 597 of the Code; (3) the right to use supervisory goodwill was not an asset on the books of Thrift 2 at the time it was acquired by Thrift 1 (thus, no tax basis could be assigned to it under section 362(b)); (4) the Taxpayer properly did not establish a tax basis in the right to use supervisory goodwill when the right was acquired on or about Date 1; and (5) the Taxpayer has not established its entitlement to a loss under section 165 of the Code. Cf. Winstar, supra, at n. 7 (discussing the different treatment accorded purchased goodwill for GAAP and tax).

Please call if you have any further questions.

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