Client Alert

March 2013

IRS Reverses its Position on Capitalization of Certain OREO Costs

In August, 2012, the Internal Revenue Service took the position in a field attorney advice memorandum (the "FAA") that a bank's direct costs and an allocable share of its indirect costs associated with holding foreclosed real estate (commonly referred to as other real estate owned or "OREO") must be capitalized to the basis of such property under the uniform capitalization rules of Internal Revenue Code section 263A. The FAA caused concern among banks because banks generally were not capitalizing costs associated with their OREO property. In March, 2013, the Internal Revenue Service reversed its position in a chief counsel memorandum (the "CCM") holding since OREO property was not acquired for resale within the meaning of the capitalization rules of Internal Revenue Code section 263A(b)(2), the costs allocable to that property did not have to be capitalized.

Reversal of Position Taken in Prior FSA

In general, Internal Revenue Code section 263A requires taxpayers to capitalize their direct costs and an allocable portion of their indirect costs incurred with respect to real property which is acquired by the taxpayer for resale. The FAA noted that a bank's OREO property is treated as being held for sale for financial statement purposes. In the FAA, the Internal Revenue Service concluded that because the OREO property was being held for resale, the property was subject to the capitalization rules of Internal Revenue Code section 263A. Under these rules, the costs a bank incurs in holding its OREO property would be required to be capitalized as part of the tax basis in the property rather than being expensed. Examples of these costs include insurance, real estate taxes, repairs, maintenance, capital improvements, utilities and professional fees. This caused concern among banks because, prior to the issuance of the FAA in August, 2012, most banks expensed these costs.

On March 1, 2013, however, the Internal Revenue Service released the CCM reaching a different conclusion. In the CCM, the Internal Revenue Service concluded that OREO property acquired by the loan-originating bank through foreclosure proceedings or by deed-in-lieu of foreclosure is not property acquired for resale within the meaning of Internal Revenue Code section 263A(b)(2). In the CCM, the Internal Revenue Service noted that when a borrower defaults on a mortgage loan and the bank takes possession of the property through foreclosure, the bank does so as a means of mitigating its loss on the loan and not as reseller of property. The Internal Revenue Service held that the bank was acting in its role as lender and, as such, should not be treated as acquiring the OREO property for resale for purposes of Internal Revenue Code section 263A. Accordingly, the CCM held the capitalization rules of Internal Revenue Code section 263A should not apply to OREO property acquired by the loan-originating bank through foreclosure preceedings or by deed-in-lieu of foreclosure because the property is not property acquired for resale within the meaning of Internal Revenue Code section 263A(b)(2). This is great news for the banking industry that generally favors expensing these carrying costs on its OREO property.

Open Issues

The CCM was issued by the Internal Revenue Service's Office of Chief Counsel which litigates matters for the Internal Revenue Service. It is welcome news to banks that the Internal Revenue Service's counsel agrees with the banking industry's position that the carrying costs on OREO property should not

be required to be capitalized. It would help further if the Internal Revenue Service's Large Business and International Division that issued the FAA would issue a statement agreeing with the Chief Counsel's office and withdrawing the position taken in the FAA. Until such a statement is issued, any bank that faces an audit on the issue of capitalization of OREO costs, should cite the CCM in support of deducting those costs.

Although the CCM is extremely helpful, it is limited to its specific facts and the CCM cannot be relied upon generally by other taxpayers. Therefore, the Internal Revenue Service should issue general guidance in the form of a Revenue Ruling that could be relied on by banks in general.

Finally, some banks may have changed their method of accounting for OREO costs by capitalizing these costs in response to the FAA. If a bank now wants to revert to expensing such OREO costs, the change would be treated as a change in an accounting method. Since this change is not a permitted automatic method change request, absent any relief from the Internal Revenue Service, the bank would have to file an advance consent method change on Form 3115 and pay a $7,000 user fee to the Internal Revenue Service.

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