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THRIFT CHARTER CONVERSION TAX ACT OF 1995

NOVEMBER 7, 1995.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ARCHER, from the Committee on Ways and Means, submitted the following

R E P O R T

[To accompany H.R. 2494]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 2494) to amend the Internal Revenue Code of 1986 to provide for the treatment of bad debt reserves of savings associations which are required to convert into banks, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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29–006

The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Thrift Charter Conversion Tax Act of 1995".

SEC. 2. TREATMENT OF RESERVES FOR BAD DEBTS OF SAVINGS ASSOCIATIONS WHICH ARE REQUIRED TO CONVERT INTO BANKS.

(a) IN GENERAL.—Section 593 of the Internal Revenue Code of 1986 (relating to reserves for losses on loans) is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Subsection (d) of section 50 of such Code is amended by adding at the end the following new sentence:

"Paragraphs (1)(A), (2)(A), and (4) of the section 46(e) referred to in paragraph (1) of this subsection shall not apply to any taxable year beginning after December 31, 1995."

(2) Subsection (e) of section 52 of such Code is amended by striking paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(3) Subsection (a) of section 57 of such Code is amended by striking paragraph (4).

(4) Section 246 of such Code is amended by striking subsection (f).

(5) Clause (i) of section 291(e)(1)(B) of such Code is amended by striking "or to which section 593 applies".

(6) Subparagraph (A) of section 585(a)(2) of such Code is amended by striking "other than an organization to which section 593 applies".

(7) Section 595 of such Code is hereby repealed.

(8) Section 596 of such Code is hereby repealed.

(9) Subsection (a) of section 860E of such Code is amended—

(A) by striking "Except as provided in paragraph (2), the" in paragraph (1) and inserting "The",

(B) by striking paragraphs (2) and (4) and redesignating paragraphs (3) and (5) as paragraphs (2) and (3), respectively, and

(C) by striking in paragraph (2) (as so redesignated) all that follows "subsection" and inserting a period.

(10) Paragraph (3) of section 992(d) of such Code is amended by striking "or 593".

(11) Section 1038 of such Code is amended by striking subsection (f).

(12) Clause (ii) of section 1042(c)(4)(B) of such Code is amended by striking "or 593".

(13) Subsection (c) of section 1277 of such Code is amended by striking "or to which section 593 applies".

(14) Subparagraph (B) of section 1361(b)(2) of such Code is amended by striking "or to which section 593 applies".

(15) The table of sections for part II of subchapter H of chapter 1 of such Code is amended by striking the items relating to sections 593, 595, and 596.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1995.

(2) REPEAL OF SECTION 595.—The amendment made by subsection (b)(7) shall apply to property acquired in taxable years beginning after December 31, 1995.

(d) 6-YEAR SPREAD OF ADJUSTMENTS.—

(1) IN GENERAL.—In the case of any taxpayer who is required by reason of the amendments made by this section to change its method of computing reserves for bad debts—

(A) such change shall be treated as a change in a method of accounting,

(B) such change shall be treated as initiated by the taxpayer and as having been made with the consent of the Secretary, and

(C) the net amount of the adjustments required to be taken into account by the taxpayer under section 481(a) of the Internal Revenue Code of 1986—

(i) shall be determined by taking into account only applicable excess reserves, and

(ii) as so determined, shall be taken into account ratably over the 6-taxable year period beginning with the first taxable year beginning after December 31, 1995.

(2) APPLICABLE EXCESS RESERVES.—

(A) IN GENERAL.—For purposes of paragraph (1), the term "applicable excess reserves" means the excess (if any) of—

(i) the balance of the reserves described in section 593(c)(1) of such Code (as in effect on the day before the date of the enactment of this Act) as of the close of the taxpayer's last taxable year beginning before January 1, 1996, over

(ii) the balance of such reserves as of the close of the taxpayer's last taxable year beginning before January 1, 1988.

(B) SPECIAL RULE FOR THRIFTS WHICH BECOME SMALL BANKS.—In the case of a bank (as defined in section 581 of such Code) which was not a large bank (as defined in section 585(c)(2) of such Code) for its first taxable year beginning after December 31, 1995—

(i) the balance taken into account under subparagraph (A)(ii) shall not be less than the amount which would be the balance of such reserve as of the close of its last taxable year beginning before January 1, 1996, if the additions to such reserve for all taxable years had been determined under section 585(b)(2)(A) of such Code, and

(ii) the opening balance of the reserve for bad debts as of the beginning of such first taxable year shall be the balance taken into account under subparagraph (A)(ii) (determined after the application of clause (i) of this subparagraph).

The preceding sentence shall not apply for purposes of paragraphs (4), (5), and (6).

(3) SUSPENSION OF RECAPTURE IF RESIDENTIAL LOAN REQUIREMENT MET.—

(A) IN GENERAL.—In the case of a taxpayer which meets the residential loan requirement of subparagraph (B) for any taxable year—

(i) no adjustment shall be taken into account under paragraph (1) for such taxable year, and

(ii) such taxable year shall be disregarded in determining—

(I) whether any other taxable year is a taxable year for which an adjustment is required to be taken into account under paragraph (1), and

(II) the amount of such adjustment.

(B) RESIDENTIAL LOAN REQUIREMENT.—A taxpayer meets the residential loan requirement of this subparagraph for any taxable year if—

(i) the principal amount of the residential loans made by the taxpayer during such year is not less than the base amount for such year, or

(ii) the principal amount of the residential loans made by the taxpayer during each of the 2 preceding taxable years is not less than the base amount for such preceding years.

Clause (ii) shall not apply for purposes of determining whether a taxpayer meets the residential loan requirement of this subparagraph for any taxable year beginning before January 1, 1998.

(C) RESIDENTIAL LOAN.—For purposes of this paragraph, the term "residential loan" means any loan described in clause (v) of section 7701(a)(19)(C) of such Code but only if such loan is incurred in acquiring, constructing, or improving the property described in such clause.

(D) BASE AMOUNT.—For purposes of subparagraph (B), the base amount is the average of the principal amounts of the residential loans made by the taxpayer during the 6 most recent taxable years beginning before January 1, 1996. At the election of the taxpayer who made such loans during each of such 6 taxable years, the preceding sentence shall be applied without regard to the taxable year in which such principal amount was the highest and the taxable year in such principal amount was the lowest. Such an election may be made only for the first taxable year beginning after December 31, 1995, and, if made for such taxable year, shall apply to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury or his delegate.

(E) INFLATION ADJUSTMENT OF BASE AMOUNT.—In the case of a taxable year beginning in a calendar year after 1996, the amount determined under subparagraph (D) shall be increased by an amount equal to—

(i) the amount so determined, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) of such Code for such calendar year, by substituting "calendar year 1995" for "calendar year 1992" in subparagraph (B) thereof.

(F) CONTROLLED GROUPS.—In the case of a taxpayer which is a member of any controlled group of corporations described in section 1563(a)(1) of such Code, subparagraph (B) shall be applied with respect to such group.

(4) CONTINUED APPLICATION OF FRESH START UNDER SECTION 585 TRANSITIONAL RULES.—In the case of a taxpayer to which paragraph (1) applied and which was not a large bank (as defined in section 585(c)(2) of such Code) for its first taxable year beginning after December 31, 1995—

(A) IN GENERAL.—For purposes of determining the net amount of adjustments referred to in section 585(c)(3)(A)(iii) of such Code, there shall be taken into account only the excess of the reserve for bad debts as of the close of the last taxable year before the disqualification year over the balance taken into account by such taxpayer under paragraph (2)(A)(ii) of this subsection.

(B) TREATMENT UNDER ELECTIVE CUT-OFF METHOD.—For purposes of applying section 585(c)(4) of such Code—

(i) the balance of the reserve taken into account under subparagraph (B) thereof shall be reduced by the balance taken into account by such taxpayer under paragraph (2)(A)(ii) of this subsection, and

(ii) no amount shall be includible in gross income by reason of such reduction.

(5) CONTINUED APPLICATION OF SECTION 593(e).—Notwithstanding the amendments made by this section, in the case of a taxpayer to which paragraph (1) of this subsection applies, section 593(e) of such Code (as in effect on the day before the date of the enactment of this Act) shall continue to apply to such taxpayer as if such taxpayer were a domestic building and loan association but the amount of the reserve taken into account under such section 593(e) shall be only the balance taken into account by such taxpayer under paragraph (2)(A)(ii) of this subsection.

(6) CERTAIN ITEMS INCLUDED AS SECTION 381(c) ITEMS.—The balance of the applicable excess reserves, and the balance taken into account by a taxpayer under paragraph (2)(A)(ii) of this subsection, shall be treated as items described in section 381(c) of such Code.

(7) REGULATIONS.—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out this subsection, including regulations providing for the application of paragraph (3) in the case of mergers, spin-offs, and other reorganizations.

SEC. 3. DEDUCTION FOR SPECIAL ASSESSMENTS.

For purposes of subtitle A of the Internal Revenue Code of 1986, the amount allowed as a deduction under section 162 of such Code for a taxable year shall include the amount paid during such year as a special assessment under section 7(b)(6)(B) of the Federal Deposit Insurance Act, as amended by the Thrift Charter Conversion Act of 1995, as contained in subtitle B of title II of H.R. 2491 of the 104th Congress, as passed by the House of Representatives.

I. INTRODUCTION

A. PURPOSE AND SUMMARY

The bill (H.R. 2494, as amended) amends the Internal Revenue Code of 1986 to repeal the reserve method of determining deductions for bad debts by thrift institutions under section 593 and to provide rules to implement the change of the method of accounting required by the repeal of such section. The bill also clarifies that certain special assessments to be paid to the Savings Association Insurance Fund by thrift institutions are deductible.

B. BACKGROUND AND NEED FOR LEGISLATION

Title II (Chapter 2, subtitle B) of H.R. 2491 ("Seven-Year Balanced Budget Reconciliation Act of 1995"), which passed the House of Representatives on October 26, 1995, would require savings and loan institutions ("thrift institutions") to forego their Federal thrift charters and become either State-chartered depository institutions or Federally-chartered banks. Under proposed Treasury regulations, if a thrift institution becomes a bank, the thrift institution would be required to change its method of accounting for bad debts and would be subject to recapture of all or a portion of its bad debt reserve. It is understood that such recapture would require the institution immediately to record, for financial accounting purposes, a current or deferred tax liability for the amount of bad debt recapture for which liabilities previously had not been recorded (generally, with respect to the pre-1988 reserves), regardless of when such recapture is taken into account for Federal income tax purposes. It is further understood that the recording of this tax liability generally would decrease the regulatory capital of the new bank.

In addition, Title II of H.R. 2491 would require thrift institutions to pay a special assessment to the Savings Association Insurance Fund ("SAIF"). The SAIF generally is the insurance fund for deposits in thrift institutions. There is some question as to whether the special assessments paid to the SAIF would be deductible currently or required to be capitalized.

The Committee bill addresses the tax questions that arise concerning the H.R. 2491 banking legislation, and the provisions of the Committee bill are described in Part II of this report.

C. LEGISLATIVE HISTORY

H.R. 2494 was introduced by Chairman Archer, Mr. Leach, and Ms. Roukema on October 11, 1995, and the Committee on Ways and Means held a public hearing on H.R. 2494 on October 26, 1995. The Committee on Ways and Means marked up H.R. 2494 on November 1, 1995, and approved Chairman Archer's amendment in the nature of a substitute to the bill as introduced.

II. EXPLANATION OF THE BILL

A. TREATMENT OF BAD DEBT DEDUCTIONS AND RESERVES FOR BAD DEBT OF THRIFT INSTITUTIONS (SEC. 2 OF THE BILL AND SEC. 593 OF THE CODE)

Present Law and Background

Tax treatment of bad debt deductions of savings institutions

RESERVE METHOD OF ACCOUNTING FOR BAD DEBTS OF THRIFT INSTITUTIONS

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions may compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593 of the Internal Revenue Code. To qualify for this reserve method, a thrift institution must meet an asset test, requiring that 60 percent of its assets consist of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage must be computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution uses the reserve method of accounting, it must establish and maintain a reserve for bad debts and charge actual losses against the reserve, and is allowed a deduction for annual additions to restore the reserve to its permitted balance. Under section 593, a thrift institution annually may elect to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that also is available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). For taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. Prior to 1988, computing bad debts under a "base year" rule allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the thrift institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with adjusted bases of assets of $500 million or less) only may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. A large commercial bank must use the specific charge-off-method of section 166. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve balance in excess of the balance of related loans is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[1] is required to recapture its bad debt reserve. The percentage-of-taxable-income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institutions qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income either ratably over a 6-taxable year period, or under the 4-year recapture method or the cut-off method described above.

In addition, a thrift institution may be subject to a form of reserve recapture even if the institution continues to qualify for the percentage of taxable income method. Specifically, if a thrift institution distributes to its shareholders an amount in excess of its post-1951 earnings and profits, such excess is deemed to be distributed from the institution's bad debt reserve and is restored to income. In the case of any distribution in redemption of stock or in partial or complete liquidation of an institution, the distribution is treated as first coming out of the bad debt reserves of the institution (sec. 593(e)).

Proposed banking legislation (H.R. 2491)

Treatment of thrift institutions under H.R. 2491

Title II (Chapter 2, subtitle B) of H.R. 2491, which passed the House of Representatives on October 26, 1995, would require savings and loan institutions to forgo their Federal thrift charters and become either State-chartered depository institutions or Federally-chartered banks. Under proposed Treasury regulations, if a thrift institution becomes a bank, the institution would be required to recapture all or a portion of its bad debt reserve. As described in detail below, the Committee understands that such recapture would require the institution immediately to record, for financial accounting purposes, a current or deferred tax liability for the amount of bad debt recapture for which liabilities previously had not been recorded (generally, with respect to the pre-1988 reserves), regardless of when such recapture is taken into account for Federal income tax purposes. The Committee further understands that the recording of this liability generally would decrease the regulatory capital of the new bank.

Financial accounting treatment of tax reserves of bad debts of thrift institutions

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deductible for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will become liable for tax

[1] Prop. Treas. reg. sec. 1.593–13.

in a future period when the timing item "reserves" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required for pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was indefinite (i.e., generally, a reversal only would occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and the Committee understands that thrift institutions generally have recorded deferred tax liabilities for these additions.[2]

Reasons for Change

The Committee believes that the reserve method of bad debts accorded to qualified thrift institutions under present law results in a mismeasurement of economic income and provides those institutions with a tax benefit not provided to similarly-situated depository institutions.

The Committee also believes that whenever a taxpayer changes its method of accounting, it is appropriate to implement such change in a manner such that items of income or expense are not taken into account twice—once under the old method and again under the new method. Thus, under present law, most accounting method changes are implemented under section 481 which requires the calculation of an adjustment that reflects the cumulative effect of the method change and that is restored to income over a specified period of time. Specifically, under present law, whenever a thrift institution no longer qualifies for the reserve method of accounting for bad debts, the bad debt reserve of the thrift institution must be restored to income.

A provision of H.R. 2491, as passed by the House of Representatives on October 26, 1995, will require Federally-chartered savings

[2] For taxable years beginning before 1988, the base year balance of a thrift institution was the reserve balance whenever the institution changed from one bad debt method to another (e.g., from the percentage of taxable income method to the experience method). How the establishment of 1987 as a permanent base year changed the nature of the bad debt reserves of thrift institutions between pre-1988 years and post-1987 years (which, in turn, changed the financial accounting treatment of such reserves) can be illustrated by the following example:

Assume that a thrift institution ("T") always had used the percentage of taxable income ("PTI") method to deduct bad debts through 1986 when its reserve balance was $10,000. Further assume that in 1987, T: (1) has insufficient taxable income to use the PTI method, (2) has actual bad debt losses of $1,000, and (3) under the six-year average formula of the experience method, would be allowed a deduction of $900. Under these facts, T would be allowed a bad debt deduction of $1,000 (rather than $900) in 1987 because $1,000 is the amount necessary to restore the reserve to its base year (PTI) level. Specifically, in 1987, T would charge the year-end 1986 reserve of $10,000 for the $1,000 actual loss and then add (and deduct) $1,000 to the reserve so that the balance of the reserve at year end 1987 is once against $10,000. Thus, T's former PTI deductions, which gave rise to the $10,000 reserve balance, generally would not be restored to income (unless subject to sec. 593(e)).

Further assume that in 1988, T has sufficient taxable income to be allowed a PTI deduction of $1,500, increasing the balance of the reserve to $11,500 at year-end 1988. Further assume that in 1989, T: (1) again has insufficient taxable income to use the PTI method, (2) has actual bad debts of $2,500, and (3) under the six-year average formula of the experience method would be allowed a deduction of $900. Under these facts, T would be allowed a deduction of $1,000 (i.e., the amount necessary to restore the reserve to its base year (year-end 1987) level). Specifically, T would charge the year-end 1988 reserve balance of $11,500 for the $2,500 actual loss and then add (and deduct) $1,000 to the reserve to restore the balance to the $10,000 base year amount. Thus, T's post-1987 PTI deduction of $1,500 is restored to income (i.e., T actually had losses of $2,500 in 1989, but only was allowed to deduct $1,000).

and loan institutions to become Federally-chartered banks or State-chartered depository institutions. Under proposed Treasury regulations, the choice of charter will have different Federal income tax effects—those institutions choosing bank charters will have a recapture of their bad debt reserves while those institutions choosing State thrift charters may escape recapture. Further, the Committee understands that, because thrift institutions had not provided deferred taxes with respect to a portion of their bad debt reserves for financial and regulatory accounting purposes, requiring recapture at this time would reduce the regulatory capital of thrift institutions converting to banks.

The Committee believes that in order to further national banking policy, certain changes to the Internal Revenue Code are warranted. First, the Committee believes that, in order to provide similar treatment to similarly-situated depository institutions, the special bad debt reserve methods available to qualified thrift institutions should be repealed. In implementing this change in accounting method, the Committee believes it is appropriate to provide relief from the recapture of that portion of the bad debt reserves for which thrift institutions have not recorded deferred tax liabilities for financial and regulatory accounting purposes. The Committee believes that this relief should not directly benefit the shareholders of the institution in a manner similar to the way in which present-law section 593(e) provides a limitation on the direct enjoyment of the benefits of section 593 by shareholders of a thrift institution.

Finally, the Committee is concerned that the proposed banking legislation may cause a change in thrift institutions' traditional roles as home mortgage lenders and may result in a shortage in the availability of mortgage loans in some regions. The Committee bill addresses this issue by providing an incentive for former thrift institutions to continue to provide a level of residential mortgage financing. The Committee recognizes that it may be appropriate to reexamine, in the future, this and other issues raised by the bill.

Explanation of Provisions

Repeal of section 593

The bill repeals the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under the bill, thrift institutions that qualify as small banks are allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks are required to use only the specific charge-off method. Thus, the percentage of taxable income method of accounting for bad debts is no longer available for any institution. The bill also repeals the following present-law provisions that only apply to thrift institutions to which section 593 applies: (1) the denial of a portion of certain tax credits to a thrift institution (sec. 50(d)(1)); (2) the special rules with respect to the foreclosure of property securing loans of a thrift institution (sec. 595); (3) the reduction in the dividends received reduction of a thrift institution (sec. 596); and (4) the ability of a thrift institution to use a net operating loss to offset its income from a residual interest in a REMIC.

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts will treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury.[3] Any section 481(a) adjustment required to be taken into account with respect to such change generally will be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves shall be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves will be the excess of (1) the balance of its reserves described in section 593(c)(1) (i.e., its supplemental reserve for losses on loans, its reserve for losses on qualifying real property loans, and its reserve for losses on nonqualifying loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Thus, unless the taxpayer meets the residential loan requirement described below, a thrift institution that is treated as a large bank generally is required to recapture its post-1987 additions to its bad debt reserves, whether such additions are made pursuant to the percentage of taxable income method or the experience method.

In the case of a thrift institution that becomes a "small bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves will be the excess of (1) the balance of its reserves described in section 593(c)(1) as of the close of its last taxable year beginning before January 1, 1996, over (2) the greater of the balance of: (a) its pre-1988 reserves or (b) what the institution's reserves would have been at the close of its last taxable year beginning before January 1, 1996, had the institution always used the experience method described in section 585(b)(2)(A) (i.e., the six-year average method). For purposes of the future application of section 585, the beginning balance of the small bank's reserve for its first taxable year beginning after December 31, 1995, will be the greater of the two amounts described in (2) in the preceding sentence, and the balance of the reserve at the close of the base year (for purposes of sec. 585(b)(2)(B)) will be the amount of its pre-1988 reserves. If such small bank later becomes a large bank, any section 481(a) adjustment amount required to be taken into account under section 585(c)(3) will not include any portion of the bank's pre-1988 reserve. Similarly, if the bank elects the cut-off method to implement its conversion to large bank status, the amount of the reserve against the bank charges its actual losses will not include any portion of the bank's pre-1988 reserve and the amount by

[3] A thrift institution that uses a reserve method described in section 593 will be deemed to have changed its method of computing reserves for bad debts even though such institution will be allowed to use the reserve method of section 585.

which the pre-1988 reserve exceeds actual losses will not be included in gross income.

The balance of the pre-1988 reserves will continue to be subject to the provisions of present-law section 593(e) (requiring recapture in the case of certain excess distributions to, and redemptions of, shareholders). Thus, section 593(e) will continue to apply to an institution regardless of whether the institution becomes a bank or remains a thrift institution. In addition, the balance of the pre-1988 reserve will be treated as a tax attribute to which section 381 applies. Treasury regulations are expected to provide rules for the continued application of section 593(e) in the case of mergers, acquisitions, spin-offs, and other reorganizations of thrift and other institutions. The Committee strongly believes that any such regulations should provide that if the stock of an institution with a pre-1988 reserve is acquired by another taxpayer, the pre-1988 reserve will not be restored to income by reason of the acquisition. Similarly, if an institution with a pre-1988 reserve is merged or liquidated tax-free into a bank, the pre-1988 reserve should not be restored to income by reason of the merger or liquidation.[4] Rather, the bank will inherit the pre-1988 reserve and the post-1951 earnings and profits of the former thrift institution and section 593(e) will apply to the bank as if it were a thrift institution. That is, the pre-1988 reserve will be restored into income in the case of any distribution in redemption of the stock of the bank or in partial or complete liquidation of the bank following the merger or liquidation. In the case of any other distribution, the pre-1988 reserve will not be restored to income unless the distribution is in excess of the sum of the post-1951 earnings and profits inherited from the thrift institution and the post-1913 earnings and profits of the acquiring bank. Treasury regulations should address the case where the shareholders of an institution with a pre-1988 reserve are "cashed out" in a taxable merger of the institution and a bank. Such regulations may provide that the pre-1988 reserve may be restored to income if such redemption represents a concealed distribution from the former thrift institution. For example, cash received by former thrift shareholders pursuant to a taxable reverse merger may represent a concealed distribution if, immediately preceding the merger, the acquiring bank had no available resources to distribute and its existing debt structure, indenture restrictions, financial condition, or regulatory capital requirements precluded it from borrowing money for purposes of making the cash payment to the former thrift shareholders. Treasury regulations also should address the treatment of boot received in a tax-free reorganization.

Further, it is anticipated that any balance of a taxpayer's pre-1988 reserve will be restored to income if the taxpayer no longer qualifies as a bank, as defined by section 581.

Residential loan requirement

Under a special rule, if the taxpayer meets the "residential loan requirement" for any taxable year, the recapture of the applicable excess reserves otherwise to be taken into account as a section

[4] The issue of whether section 593(e) applies in cases where a thrift institution is merged into a bank does not arise under present law because such merger results in a charter change under present law, requiring full bad debt reserve recapture.

481(a) adjustment for such year will be suspended. The residential loan requirement will continue to apply to subsequent taxable years until the taxpayer recaptures its entire section 481(a) adjustment (i.e., the residential loan requirement would no longer apply once the taxpayer has failed to meet the requirement in six separate taxable years and has thus recaptured its entire adjustment). A taxpayer meets the residential loan requirement if, for any taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. A taxpayer will be deemed to meet the residential loan requirement for any taxable year beginning after December 31, 1997, if the taxpayer met the requirement for the two preceding years (determined without the application of this special, two-out-of-three rule).

For the first taxable year beginning after December 31, 1995, the "base amount" for a taxpayer means the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount may be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest. This election must be made for the first taxable year beginning after December 31, 1995, and applies to all succeeding years unless revoked with the consent of the Secretary of the Treasury or his delegate. For taxable years beginning after December 31, 1996, the base amount is indexed for inflation.

For purposes of the residential loan requirement, a loan will be deemed to be "made" by a financial institution to the extent the institution is, in fact, the principal source of the loan financing. Thus, any loan only can be "made" once. The Committee expects that Treasury regulations may provide that loans "made" by a financial institution may include, but are not limited to, loans (1) originated directly by the institution through its place of business or its employees, (2) closed in the name of the institution, (3) originated by a broker that acts as an agent for the institution, and (4) originated by another person (other than a financial institution) and that are acquired by the institution pursuant to a preexisting, enforceable agreement to acquire such loans. In addition, Treasury regulations also may provide that loans "made" by a financial institution may include loans originated by another person (other than a financial institution) acquired by the institution soon after origination if such acquisition is pursuant to a customary practice of acquiring such loans from such person. A loan acquired by a financial institution from another financial institution generally will be considered to be made by the transferor rather than the transferee of the loan; however, such loan may be completely disregarded if a principal purpose of the transfer was to allow the transferor to meet the residential loan requirement. A loan may be considered to be made by a financial institution even if such institution has an arrangement to transfer such loan to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

For purposes of the residential loan requirement, a "residential loan" is a loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real and church property and certain mobile homes),[5] but only to the extent the loan is made to the owner of the property to acquire, construct, or improve the property. Thus, mortgage refinancings and home equity loans are not considered to be residential loans, except to the extent the proceeds of the loan are used to acquire, construct, or improve qualified residential real property. The Committee understands that pursuant to the Home Mortgage Disclosure Act, financial institutions are required to disclose the purpose for which loans are made. The Committee further understands that for purposes of this disclosure, institutions are required to classify loans as home purchase loans, home improvement loans, refinancings, and multifamily dwelling loans (whether for purchase, improvement or refinancing of such property). The Committee expects that taxpayers (and the Secretary of the Treasury in promulgating guidance) may take such reporting into account, and make such adjustments as are appropriate,[6] in determining: (1) whether or not a loan qualifies as a "residential loan" and (2) whether the institution "made" the loan. A taxpayer must use consistent standards for determining whether loans qualify as residential loans made by the institution both for purposes of determining its base amount and for purposes of determining whether it met the residential loan requirement for a taxable year.

The residential loan requirement is determined on a controlled group basis. Thus, for example, if a controlled group consists of two thrift institutions with applicable excess reserves that are wholly owned by a bank, the residential loan requirement will be met (or not met) with respect to both thrift institutions by comparing the principal amount of the residential loans made by all three members of the group during the taxable year to the group's base amount. The group's base amount will be the average principal amount of residential loans made by all three members of the group during the base period. The election to disregard the high and low taxable years during the 6-year base period also would be applied on a controlled group basis (i.e., generally by treating the members of the group as one taxpayer so that all members of the group must join in the election, and the same corresponding years of each member would be so disregarded).

The balance of a taxpayer's applicable excess reserve is treated as a tax attribute to which section 381 applies. Thus, if an institution with an applicable excess reserve is acquired in a tax-free reorganization, the balance of such reserve will not be immediately restored to income but will continue to be subject to the residential loan requirement in the hands of the acquirer. Treasury regulations will provide rules for the application of the residential loan requirement in the case of mergers, acquisitions, and other reorganizations of thrift and other institutions. The Committee expects

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[5] For this purpose, as under present law, if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan will be deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). In addition, loans made to finance the acquisition or development of land will be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary of the Treasury, there is a reasonable assurance that the property will become residential real property within a period of three years from the date of acquisition of the land.

[6] For example, adjustments will be required with respect to the reporting of multifamily dwellings in order to distinguish home purchase, home improvement, and refinancing loans.

that if a financial institution joins or merges into (or leaves) a group of financial institutions, the base amount of the acquiring (or remaining) group will be appropriately adjusted to reflect the base amount of the acquired (or departing) institution for purposes of determining whether the group meets the residential loan requirement for the year of the acquisition (or departure) and subsequent years. Similarly, for purposes of determining whether the group meets the special two-out-of-three rule for the year of, and the year following, the acquisition (or departure), the group must determine whether or not it would have satisfied the test had the new member also been a member of the group (or had the departing member never been a member of the group). Finally, if a controlled group of institutions had made an election to disregard its high and low years in computing its base amount, it is anticipated that such election shall be binding on any institution that subsequently joins the group and the election shall be applied to the new member by disregarding the high and low years of the new member even if such years do not correspond to the years applicable to the other members of the group.

Finally, the Committee expects that any balance of a taxpayer's applicable excess reserve will be restored to income if the taxpayer no longer qualifies as a bank, as defined by section 581.

Effective Date

The repeal of section 593 is effective for taxable years beginning after December 31, 1995. The repeal of section 595 is effective for property acquired in taxable years beginning after December 31, 1995.

B. TAX TREATMENT OF SPECIAL ASSESSMENTS (SEC. 3 OF THE BILL AND SEC. 162 OF THE CODE)

Present Law and Background

Title II (Chapter 1, subtitle B) of H.R. 2491, as passed by the House, would require thrift institutions to pay a special assessment to the Savings Association Insurance Fund ("SAIF"). The SAIF generally is the insurance fund for deposits in thrift institutions. The amount of the assessment would be the amount necessary to ensure that the SAIF has reserves of $1.25 for each $100 of insured deposits, and the due date of the payment would be the first business day of January 1996. Effective January 1, 1998, the SAIF would be merged with the Bank Insurance Fund ("BIF") (the insurance fund for deposits in banks). Thrift institutions and banks also are required to pay annual premiums to the SAIF and BIF, respectively, based on the amount of their insured deposits. Currently, the premium rate for the SAIF deposits is substantially higher than the premium rate for BIF deposits. After the merger of the SAIF and BIF in 1998, under H.R. 2491, thrift institutions and banks would be subject to the same lower deposit insurance rates generally applicable to banks.

In general, a taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business during the taxable year (sec. 162). However, amounts that give rise to a permanent improvement or betterment must be capitalized rather than deducted currently (sec. 263). Whether an expenditure is deductible under section 162 or must be capitalized under section 263 is often a matter of dispute between the IRS and taxpayers, and has been the subject of significant litigation. Most recently, in *INDOPCO* v. *Commissioner*, 503 U.S. 79 (1992), the U.S. Supreme Court noted that the capitalization of expenditures is the norm and that a current "income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."[7] In *INDOPCO*, the Supreme Court found that the record supported the lower courts' findings that the investment banking fees in question produced significant benefits extending beyond the tax year in which they were incurred so as to warrant capitalization. The scope of the *INDOPCO* decision and its application to the payments of the special assessments provided in H.R. 2491 may be open to interpretation.

Reasons for Change

The Committee believes that the treatment of the special assessments paid to the SAIF pursuant to H.R. 2491 should be statutorily clarified in a manner consistent with the analysis of the Treasury Department for the proper treatment of such payments under present law.[8]

Explanation of Provision

The bill provides that the special assessments paid to the SAIF are deductible when paid. Because such payments relate to the current needs of the SAIF fund, the Committee understands that section 172(f) does not apply to any net operating loss occurring as a result of the deduction provided by the bill. No inference is intended with respect to the treatment of any payment or assessment not described in the bill.

Effective Date

The provision is effective upon enactment.

III. VOTES OF THE COMMITTEE

In compliance with clause 2(l)(2)(B) of rule XI of the Rules of the House of Representatives, the following statement is made concerning the votes of the Committee in its consideration of the bill, H.R. 2494.

Motion to report the bill

The bill, H.R. 2494, as amended, was ordered favorably reported by voice vote on November 1, 1995, with a quorum present.

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[7] *INDOPCO*, citing *Interstate Transit Lines* v. *Comm.*, 319 U.S. 590, 593 (1943); *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940); and *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (19934).

[8] See, e.g., the testimony of Cynthia G. Beerbower, Deputy Assistant Secretary (Tax Policy) Department of the Treasury, on H.R. 2494 before the House Committee on Ways and Means, October 26, 1995, which provides that it is the view of the Treasury Department that the special assessments would be deductible under current law.

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATE OF BUDGETARY EFFECTS

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effects on the budget of this bill, H.R. 2424, as reported.

The bill, as amended, is estimated to have the following effects on budget receipts for fiscal years 1996–2000:

ESTIMATED BUDGET EFFECTS OF H.R. 2494, THE THRIFT CHARTER CONVERSION TAX ACT OF 1995 AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS

[In millions of dollars]

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996–2000	1996–2002	1996–2005
The "Thrift Charter Conversion Tax Act of 1995".	tyba 12/31/95	69	106	103	105	106	107	100	489	696	952

Note.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

B. STATEMENT REGARDING NEW BUDGET AUTHORITY AND TAX EXPENDITURES

In compliance with subdivision (B) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the bill as amended involves no new budget authority.

The Committee further states that the bill as amended involves a reduction of tax expenditures of $489 million for the fiscal year period 1996–2000. (For year-by-year amounts, see revenue table in Part IV.A., above.)

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with subdivision (C) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, requiring a cost estimate prepared by the Congressional Budget Office ("CBO"), the following statement prepared by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, November 7, 1995.

Hon. BILL ARCHER,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office and the Joint Committee on Taxation (JCT) have reviewed H.R. 2494, as ordered reported by the House Committee on Ways and Means on November 1, 1995. The JCT estimates that this bill would increase receipts by $69 million in fiscal year 1996 and by $696 million over fiscal years 1996 through 2002. CBO concurs with the estimate.

H.R. 2494 addresses the tax treatment of thrift institutions in two ways. First, the bill would repeal the reserve method of accounting allowed under section 593 of the Internal Revenue Code for the bad debts of thrifts. A thrift institution would be required to include in taxable income over a six-year period some portion of its post-1987 additions to its bad debt reserve. The inclusion in income would be suspended during years in which the institution made qualifying residential loans in excess of a specified base amount. Second, the bill would provide that a special assessment paid by thrifts, established in H.R. 2491 (the "Seven-Year Balanced Budget Reconciliation Act of 1995"), passed by the House of Representatives on October 26, 1995, would be allowed as a deduction in computing taxable income. No direct revenue effect is estimated for this second provision.

CBO understands that the JCT estimate represents the effects of H.R. 2494 on governmental receipts (revenue) under the assumption that it is a stand-alone bill, as well as the combined effect on governmental receipts of H.R. 2494 and the thrift provisions of H.R. 2491. As discussed in my letter to Chairman Leach dated October 6, 1995, the reconciliation provisions of the House Committee on Banking and Financial Services, included in H.R. 2491, could cause many federal thrifts to reorganize as banks, which could affect future corporate income tax revenues. The JCT estimates, however, that any such effect from H.R. 2491 would be dominated by the effect of H.R. 2494 if it were included in H.R. 2491. The revenue effects of H.R. 2494 are summarized below:

REVENUE EFFECTS OF H.R. 2494

[By fiscal year, in millions of dollars]

	1996	1997	1998	1999	2000	2001	2002
Change in Revenues	69	106	103	105	106	107	100

If you wish further details, please feel free to contact me or your staff may wish to contact Mark Booth.

Sincerely,

JAMES L. BLUM
(For June E. O'Neill, *Director*).

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. COMMITTEE OVERSIGHT FINDINGS AND RECOMMENDATIONS

With respect to subdivision (A) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, relating to oversight findings, the Committee advises that it was as a result of the Committee's oversight activities concerning the treatment of thrift institution conversion legislation included in H.R. 2491 as passed by the House and the tax-related issues involved in that legislation that the Committee concluded that it is appropriate to enact the provisions contained in the bill as amended. (See also Parts I.B. and I.C. of this report for a discussion of the background of this bill and the legislative history of, and hearings on, the bill.)

B. SUMMARY OF FINDINGS AND RECOMMENDATIONS OF THE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

With respect to subdivision (D) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee advises that no oversight findings or recommendations have been submitted to this Committee by the Committee on Government Reform and Oversight with respect to the provisions contained in this bill.

C. INFLATIONARY IMPACT STATEMENT

In compliance with clause 2(l)(4) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions of the bill are not expected to have an overall inflationary impact on prices and costs in the operation of the national economy.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1986

* * * * * * *

Subtitle A—Income Taxes

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter A—Determination of Tax Liability

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PART IV—CREDITS AGAINST TAX

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Subpart E—Rules for Computing Investment Credit

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SEC. 50. OTHER SPECIAL RULES.

(a) * * *

* * * * * * *

(d) CERTAIN RULES MADE APPLICABLE.—For purposes of this subpart, rules similar to the rules of the following provisions (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply:

(1) * * *

* * * * * * *

(7) Section 48(r) (relating to certain 501(d) organizations.

Paragraphs (1)(A), (2)(A), and (4) of the section 46(e) referred to in paragraph (1) of this subsection shall not apply to any taxable year beginning after December 31, 1995.

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Subpart F—Rules for Computing Targeted Jobs Credit

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SEC. 52. SPECIAL RULES.

(a) * * *

* * * * * * *

(e) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—Under regulations prescribed by the Secretary, in the case of—

【(1) an organization to which section 593 (relating to reserves for losses on loans) applies,】

【(2)】 *(1)* a regulated investment company or a real estate investment trust subject to taxation under subchapter M (section 851 and following), and

【(3)】 *(2)* a cooperative organization described in section 1381(a), rules similar to the rules provided in subsections (e) and (h) of section 46 (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply in determining the amount of the credit under this subpart.

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PART VI—ALTERNATIVE MINIMUM TAX

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SEC. 57. ITEMS OF TAX PREFERENCE.

(a) GENERAL RULE.—For purposes of this part, the items of tax preference determined under this section are—

(1) * * *

* * * * * * *

【(4) RESERVES FOR LOSSES ON BAD DEBTS OF FINANCIAL INSTITUTIONS.—In the case of a financial institution to which section 593 applies, the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience.】

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PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

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SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

(a) * * *

* * * * * * *

[(f) CROSS REFERENCE.—

[For special rule relating to mutual savings banks, etc., to which section 593 applies, see section 596.]

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PART XI—SPECIAL RULES RELATING TO CORPORATE PREFERENCE ITEMS

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SEC. 291. SPECIAL RULES RELATING TO CORPORATE PREFERENCE ITEMS.

(a) * * *

* * * * * * *

(e) DEFINITIONS.—For purposes of this section—

(1) FINANCIAL INSTITUTION PREFERENCE ITEM.—The term "financial institution preference item" includes the following:

(A) * * *

(B) INTEREST ON DEBT TO CARRY TAX-EXEMPT OBLIGATIONS ACQUIRED AFTER DECEMBER 31, 1982, AND BEFORE AUGUST 8, 1986.—

(i) IN GENERAL.—In the case of a financial institution which is a bank (as defined in section 585(a)(2)) [or to which section 593 applies], the amount of interest on indebtedness incurred or continued to purchase or carry obligations acquired after December 31, 1982, and before August 8, 1986, the interest on which is exempt from taxes for the taxable year, to the extent that a deduction would (but for this paragraph or section 265(b)) be allowable with respect to such interest for such taxable year.

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Subchapter H—Banking Institutions

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PART I—RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

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SEC. 585. RESERVES FOR LOSSES ON LOANS OF BANKS.

(a) RESERVE FOR BAD DEBTS.—

(1) * * *

(2) BANK.—For purposes of this section—

(A) IN GENERAL.—The term "bank" means any bank (as defined in section 581) [other than an organization to which section 593 applies].

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PART II—MUTUAL SAVINGS BANKS, ETC.

* * * * * * *

⟦Sec. 593. Reserves on losses on loans.⟧

* * * * * * *

⟦Sec. 595. Foreclosure on property securing loans.

⟦Sec. 596. Limitation on dividends receiving deduction.⟧

* * * * * * *

⟦SEC. 593. RESERVES FOR LOSSES ON LOANS.

⟦(a) RESERVE FOR BAD DEBTS.—

⟦(1) IN GENERAL.—Except as provided in paragraph (2), in the case of—

⟦(A) any domestic building and loan association,

⟦(B) any mutual savings bank, or

⟦(C) any cooperative bank without capital stock organized and operated for mutual purposes and without profit,

there shall be allowed a deduction for a reasonable addition to a reserve for bad debts. Such deduction shall be in lieu of any deduction under section 166(a).

⟦(2) ORGANIZATION MUST MEET 60-PERCENT ASSET TEST OF SECTION 7701(a)(19).—This section shall apply to an association or bank referred to in paragraph (1) only if it meets the requirements of section 7701(a)(19)(C).

⟦(b) ADDITION TO RESERVES FOR BAD DEBTS.—

⟦(1) IN GENERAL.—For purposes of subsection (a), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of—

⟦(A) the amount determined to be a reasonable addition to the reserve for losses on nonqualifying loans, computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under section 585(b)(2), plus

⟦(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2) or (3), whichever is the larger, but the amount determined under this subparagraph shall in no case be greater than the larger of—

⟦(i) the amount determined under paragraph (3), or

⟦(ii) the amount which, when added to the amount determined under subparagraph (A), equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951).

⟦(2) PERCENTAGE OF TAXABLE INCOME METHOD.—

⟦(A) IN GENERAL.—Subject to subparagraphs (B) and (C), the amount determined under this paragraph for the taxable year shall be an amount equal to 8 percent of the taxable income for such year.

⟦(B) REDUCTION FOR AMOUNTS REFERRED TO IN PARAGRAPH (1)(A).—The amount determined under subparagraph (A) shall be reduced (but not below 0) by the amount determined under paragraph (1)(A).

⟦(C) OVERALL LIMITATION ON PARAGRAPH.—The amount determined under this paragraph shall not exceed the amount necessary to increase the balance at the close of the taxable year of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

⟦(D) COMPUTATION OF TAXABLE INCOME.—For purposes of this paragraph, taxable income shall be computed—

⟦(i) by excluding from gross income any amount included therein by reason of subsection (e),

⟦(ii) without regard to any deduction allowable for any addition to the reserve for bad debts,

⟦(iii) by excluding from gross income an amount equal to the net gain for the taxable year arising from the sale or exchange of stock of a corporation or of obligations the interest on which is excludable from gross income under section 103,

⟦(iv) by excluding from gross income dividends with respect to which a deduction is allowable by part VIII of subchapter B, reduced by an amount equal to 8 percent of the dividends received deduction (determined without regard to section 596) for the taxable year, and

⟦(v) if there is a capital gain rate differential (as defined in section 904(b)(3)(D)) for the taxable year, by excluding from gross income the rate differential portion (within the meaning of section 904(b)(3)(E)) of the lesser of—

⟦(I) the net long-term capital gain for the taxable year, or

⟦(II) the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in clause (iii).

⟦(3) EXPERIENCE METHOD.—The amount determined under this paragraph for the taxable year shall be computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under section 585(b)(2).

⟦(c) TREATMENT OF RESERVE FOR BAD DEBTS.—

⟦(1) ESTABLISHMENT OF RESERVES.—Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts, but no deduction shall be allowed for any addition to the supplemental reserve for losses on loans.

⟦(2) CERTAIN PRE-1963 RESERVES.—Notwithstanding the second sentence of paragraph (1), any amount allocated pursuant to paragraph (5) (as in effect immediately before the enactment of the Tax Reform Act of 1976) during a taxable year beginning before January 1, 1977, to the reserve for losses on qualifying real property loans out of the surplus, undivided profits, and bad debt reserves (determined as of December 31, 1962) attributable to the period before the first taxable year beginning after December 31, 1951, shall not be treated as a reserve for bad debts for any purpose other than determining the amount referred to in subsection (b)(1)(B), and for such purpose such amount shall be treated as remaining in such reserve.

⟦(3) CHARGING OF BAD DEBTS TO RESERVES.—Any debt becoming worthless or partially worthless in respect of a qualifying real property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be charged in whole or in part to the supplemental reserve for losses on loans.

⟦(d) LOANS DEFINED.—For purposes of this section—

⟦(1) QUALIFYING REAL PROPERTY LOANS.—The term "qualifying real property loan" means any loan secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan, but such term does not include—

⟦(A) any loan evidenced by a security (as defined in section 165(g)(2)(C));

⟦(B) any loan, whether or not evidenced by a security (as defined in section 165(g)(2)(C)), the primary obligor on which is—

⟦(i) a government or political subdivision or instrumentality thereof;

⟦(ii) a bank (as defined in section 581); or

⟦(iii) another member of the same affiliated group;

⟦(C) any loan, to the extent secured by a deposit in or share of the taxpayer; or

⟦(D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of are established to be for bona fide business purposes.

For purposes of subparagraph (B)(iii), the term "affiliated group" has the meaning assigned to such term by section 1504(a); except that (i) the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1504(a), and (ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

⟦(2) NONQUALIFYING LOANS.—The term "nonqualifying loan" means any loan which is not a qualifying real property loan.

⟦(3) LOAN.—The term "loan" means debt, as the term "debt" is used in section 166.

⟦(4) TREATMENT OF INTERESTS IN REMIC'S.—A regular or residual interest in a REMIC shall be treated as a qualifying real property loan; except that, if less than 95 percent of the assets of such REMIC are qualifying real property loans (determined as if the taxpayer held the assets of the REMIC), such interest shall be so treated only in the proportion which the assets of such REMIC consist of such loans. For purposes of determining whether any interest in a REMIC qualifies under the preceding sentence, any interest in another REMIC held by such REMIC shall be treated as a qualifying real property loan under principles similar to the principles of the preceding sentence, except that if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of this paragraph.

⟦(e) DISTRIBUTIONS TO SHAREHOLDERS.—

⟦(1) IN GENERAL.—For purposes of this chapter, any distribution of property (as defined in section 317(a)) by a domestic building and loan association or an institution that is treated as a mutual savings bank under section 591(b) to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made—

⟦(A) first out of its earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof,

⟦(B) then out of the reserve for losses on qualifying real property loans, to the extent additions to such reserve exceed the additions which would have been allowed under subsection (b)(3),

⟦(C) then out of the supplemental reserve for losses on loans, to the extent thereof,

⟦(D) then out of such other accounts as may be proper.

This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association, or an institution that is treated as a mutual savings bank under section 591(b), except that any such distribution shall be treated as made first out of the amount referred to in subparagraph (B), second out of the amount referred to in subparagraph (C), third out of the amount referred to in subparagraph (A), and then out of such other accounts as may be proper. This paragraph shall not apply to any transaction to which section 381 applies, or to any distribution to the Federal Savings and Loan Insurance Corporation (or any successor thereof) or the Federal Deposit Insurance Corporation in redemption of an interest in an association, if such interest was originally received by any such entity in exchange for assistance provided under a provision of law referred to in section 597(c).

⟦(2) AMOUNTS CHARGED TO RESERVE ACCOUNTS AND INCLUDED IN GROSS INCOME.—If any distribution is treated under paragraph (1) as having been made out of the reserves described in subparagraphs (B) and (C) of such paragraph, the amount charged against such reserve shall be the amount which, when reduced by the amount of tax imposed under this chapter and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution; and the amount so charged against such reserve shall be included in gross income of the taxpayer.

⟦(3) SPECIAL RULES.—

[(A) For purposes of paragraph (1)(B), additions to the reserve for losses on qualifying real property loans for the taxable year in which the distribution occurs shall be taken into account.

[(B) For purposes of computing under this section the amount of a reasonable addition to the reserve for losses on qualifying real property loans for any taxable year, any amount charged during any year to such reserve pursuant to the provisions of paragraph (2) shall not be taken into account.]

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[SEC. 595. FORECLOSURE ON PROPERTY SECURING LOANS.

[(a) NONRECOGNITION OF GAIN OR LOSS AS A RESULT OF FORECLOSURE.—In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

[(b) CHARACTER OF PROPERTY.—For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.

[(c) BASIS.—The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was security (determined as of the date of the acquisition of such property), properly increased for costs of acquisition.

[(d) REGULATORY AUTHORITY.—The Secretary shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

[SEC. 596. LIMITATION ON DIVIDENDS RECEIVED DEDUCTION

[In the case of an organization to which section 593 applies and which computes additions to the reserve for losses on loans for the taxable year under section 593(b)(2), the total amount allowed under sections 243, 244, and 245 (determined without regard to this section) for the taxable year as a deduction with respect to dividends received shall be reduced by an amount equal to 8 percent of such total amount.]

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Subchapter M—Regulated Investment Companies and Real Estate Investment Trusts

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PART IV—REAL ESTATE MORTGAGE INVESTMENT CONDUITS

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SEC. 860E. TREATMENT OF INCOME IN EXCESS OF DAILY ACCRUALS ON RESIDUAL INTERESTS.

(a) EXCESS INCLUSIONS MAY NOT BE OFFSET BY NET OPERATING LOSSES.—

(1) IN GENERAL.—【Except as provided in paragraph (2), the】 *The* taxable income of any holder of a residual interest in a REMIC for any taxable year shall in no event be less than the excess inclusion for such taxable year.

【(2) EXCEPTION FOR CERTAIN FINANCIAL INSTITUTIONS.—Paragraph (1) shall not apply to any organization to which section 593 applies. The Secretary may by regulations provide that the preceding sentence shall not apply where necessary or appropriate to prevent avoidance of tax imposed by this chapter.】

【(3)】 *(2)* SPECIAL RULE FOR AFFILIATED GROUPS.—All members of an affiliated group filing a consolidated return shall be treated as 1 taxpayer for purposes of this subsection【, except that paragraph (2) shall be applied separately with respect to each corporation which is a member of such group and to which section 593 applies.】.

【(4) TREATMENT OF CERTAIN SUBSIDIARIES.—

【(A) IN GENERAL.—For purposes of this subsection, a corporation to which section 593 applies and each qualified subsidiary of such corporation shall be treated as a single corporation to which section 593 applies.

【(B) QUALIFIED SUBSIDIARY.—For purposes of this subsection, the term ″qualified subsidiary″ means any corporation—

【(i) all the stock of which, and substantially all the indebtedness of which, is held directly by the corporation to which section 593 applies, and

【(ii) which is organized and operated exclusively in connection with the organization and operation of 1 or more REMIC's.】

【(5)】 *(3)* COORDINATION WITH SECTION 172.—Any excess inclusion for any taxable year shall not be taken into account—

(A) in determining under section 172 the amount of any net operating loss for such taxable year, and

(B) in determining taxable income for such taxable year for purposes of the 2nd sentence of section 172(b)(2).

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Subchapter N—Tax Based on Income From Sources Within or Without the United States

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PART IV—DOMESTIC INTERNATIONAL SALES CORPORATIONS

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Subpart A—Treatment of Qualifying Corporations

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SEC. 992. REQUIREMENTS OF A DOMESTIC INTERNATIONAL SALES CORPORATION.

(a) * * *

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(d) INELIGIBLE CORPORATIONS.—The following corporations shall not be eligible to be treated as a DISC—

(1) * * *

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(3) a financial institution to which section 581 ❲or 593❳ applies,

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Subchapter O—Gain or Loss on Disposition of Property

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PART III—COMMON NONTAXABLE EXCHANGES

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SEC. 1038. CERTAIN REACQUISITIONS OF REAL PROPERTY.

(a) * * *

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❲(f) REACQUISITIONS BY DOMESTIC BUILDING AND LOAN ASSOCIATIONS.—This section shall not apply to a reacquisition of real property by an organization described in section 593(a) (relating to domestic building and loan associations, etc.).❳

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SEC. 1042. SALES OF STOCK TO EMPLOYEE STOCK OWNERSHIP PLANS OR CERTAIN COOPERATIVES.

(a) * * *

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(c) DEFINITIONS; SPECIAL RULES.—For purposes of this section—

(1) * * *

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(4) QUALIFIED REPLACEMENT PROPERTY.—

(A) * * *

(B) OPERATING CORPORATION.—For purposes of this paragraph—

(i) IN GENERAL.—The term "operating corporation" means a corporation more than 50 percent of the assets of which were, at the time the security was purchased or before the close of the replacement period, used in the active conduct of the trade or business.

(ii) Financial institutions and insurance companies.—The term "operating corporation" shall include—

(I) any financial institution described in section 581 [or 593], and

(II) an insurance company subject to tax under subchapter L.

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Subchapter P—Capital Gains and Losses

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PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

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Subpart B—Market Discount on Bonds

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SEC. 1277. DEFERRAL OF INTEREST DEDUCTION ALLOCABLE TO ACCRUED MARKET DISCOUNT.

(a) * * *

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(c) NET DIRECT INTEREST EXPENSE.—For purposes of this section, the term "net direct interest expense" means, with respect to any market discount bond, the excess (if any) of—

(1) the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, over

(2) the aggregate amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such bond.

In the case of any financial institution which is a bank (as defined in section 585(a)(2)) [or to which section 593 applies], the determination of whether interest is described in paragraph (1) shall be made under principles similar to the principles of section 291(e)(1)(B)(ii). Under rules similar to the rules of section 265(a)(5), short sale expenses shall be treated as interest for purposes of determining net direct interest expense.

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Subchapter S—Tax Treatment of S Corporations and Their Shareholders

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PART I—IN GENERAL

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SEC. 1361. S CORPORATION DEFINED.

(a) * * *

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(b) SMALL BUSINESS CORPORATION.—

(1) * * *

(2) INELIGIBLE CORPORATION DEFINED.——For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is—

(A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof),

(B) a financial institution to which section 585 applies (or would apply but for subsection (c) thereof) [or to which section 593 applies],

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