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Banks Not Required to Capitalize OREO Costs

The Office of the Chief Counsel of the Internal Revenue Service has issued a Legal Memorandum (Number AM2013-001, dated March 1, 2013) (the "Memorandum"), which has important implications and represents a victory for lenders who have acquired Other Real Estate Owned ("OREO") through foreclosure or deeds in lieu of foreclosure. The Memorandum appears to reverse an August 12, 2012 Field Attorney Advice issued by Associate Area Counsel in Detroit, Michigan (FAA 20123201F) that held costs associated with OREO property must be capitalized under I.R.C. §263A.

Generally, after a borrower defaults on a mortgage loan[1], the lender will commence foreclosure proceedings[2] against the property for the purpose of acquiring title to the property. Often, a borrower may voluntarily transfer title to the property through a "deed in lieu of foreclosure" in exchange for a release of the remaining debt obligation in excess of the value of the property at the time of the deed in lieu of foreclosure. The Memorandum addresses the issue of whether property acquired through foreclosure or by deed in lieu of foreclosure is considered to be acquired for resale to customers in the ordinary course of the bank's business. Historically, many banks have deducted expenses associated with OREO property currently rather than capitalizing them. Over the last few years, Internal Revenue Service Field Agents have been disallowing these deductions on the theory that they must in fact be capitalized under Section 263A.[3] However, the Memorandum instead adopts the rationale that banks have advanced in support of treating such expenses as deductible instead of being required to capitalize them under Section 263A.

I.R.C. § 263A(b)(2)(A) defines "property acquired for resale" as real or personal property described in I.R.C. §1221(a)(1) that is acquired by a taxpayer for resale. For the purpose of IRS Regulation §1.263A-1(a)(3)(iii), a reseller is a retailer, wholesaler or other taxpayer that acquires real or personal property described in I.R.C. §1221(a)(1), which includes property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business. As set forth in the Memorandum, in order to constitute "property acquired for resale" under § 263A(b)(2)(A), the property must be (i) held by the taxpayer primarily for sale to customers and (ii) "acquired" for resale. The Memorandum, in its analysis, assumes the first prong (i.e., that a bank holds its OREO primarily for sale to customers), and. thus, focuses on the second prong to determine whether a bank is in fact required to capitalize acquisition and associated costs. That is, does a bank acquire OREO through foreclosure or deed in lieu of foreclosure for the purpose of resale?

[1]As used in this Alert, "mortgage loan" would include loans secured by mortgages, deeds of trust or security deeds (deeds to secure debt) depending on the applicable jurisdiction. For purposes of this Alert, such instruments are referred to as "security instruments".
[2]The type of foreclosure proceeding will depend on the jurisdiction in which the property being foreclosed is located. For instance some states, allow sale of property through a power of sale contained in the security instrument, while other jurisdictions require a judicially supervised foreclosure process.
[3]On February 26, 2013, IRS Regional Counsel in Detroit, Michigan, issued a Field Service Advice concluding that the acquisition and other costs and expenses related to a bank's acquisition of property by foreclosure or deed in lieu of foreclosure should be capitalized

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The Memorandum notes that there is a special rule for banks and others that originate loans: the origination of loans is not considered the acquisition of property for resale, notwithstanding the frequency with which the taxpayer sells loans it originates or the percentage of loans that it sells[4]. As a result of this special rule, the Memorandum reasons, "a [b]ank's activity of originating loans is not considered the acquisition of property for resale within the meaning of § 263A(b)(2)(A)." The Memorandum concludes that acquisition of OREO through foreclosure or deed-in-lieu of foreclosure and its subsequent sale are simply an extension of a bank's loan origination activity and thus is not acquired for the purpose of resale[5], therefore, failing the second prong of the § 263A(b)(2)(A) test. It should be noted, however, that IRS's Office of Chief Counsel in reaching the conclusions expressed in the Memorandum contemplates that the bank will not improve the OREO property. Further, the Memorandum is not entitled to precedential treatment. However, it does provide guidance and support for the proposition that banks are not required to capitalize costs associated with OREO property.

If you would like more information on this topic, or if you have any questions, please contact a member of the **Shumaker Tax Practice Group**, the **Shumaker Financial Services Practice Group** or the **Shumaker Financial Institutions Practice Group**.

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[4]See, IRS Regulation §1.263A-1(b)(13).
[5]The Memorandum recognizes that normally a bank acquires OREO as a last resort and is economically compelled to do so in an attempt to recover its loan. Such a bank does not generally make a loan, hope that the borrower defaults, acquire the property and then hope that it makes a profit on the resale of the property.