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December 21, 2006

Internal Revenue Service
CC:PA:LPD:PR: (Reg-109367-06)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: IRS Proposed Regulation Regarding Section 1221(a)(4) *Capital Asset Exclusion for Accounts and Notes Receivable* (REG-109367-06)

Ladies and Gentlemen:

The American Bankers Association (ABA) is pleased to submit comments on the IRS Proposed Regulation regarding the Section 1221(a)(4) *Capital Asset Exclusion for Accounts and Notes Receivable* (the "Proposed Regulation"). The ABA brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies as well as savings associations, trust companies and savings banks – makes ABA the largest banking association in the country.

The Proposed Regulation seeks to clarify the circumstances in which accounts or notes receivable are "acquired . . . for services rendered" within the meaning of section 1221(a)(4) of the Internal Revenue Code (the "Code"). The Proposed Regulation concludes that if in exchange for a note or account receivable a taxpayer provides more than de minimis consideration (such as money) other than services or property described in section 1221(a)(1), the character of such note or account receivable is capital. In other words, if a lender receives a note for providing a loan to a customer, such note would constitute a capital asset under the Proposed Regulations because other consideration (money) was provided to the customer in addition to the service of providing the loan.[1] It is our view that the Proposed Regulation is unwise and would seriously interfere with the normal operation of lending, which would harm the industry and its customers. In the context of the lending business, the lender's business is the service of providing loans to its customers. For the reasons set forth in greater detail in the remainder of this letter the Proposed Regulation should be withdrawn.

Financial services organizations provide a variety of loan products that include money and services, such as first- and second-lien residential mortgages and home equity lines of credit; auto loans, credit and charge card lines of credit; student

[1] Because banks get ordinary treatment under section 582, the Proposed Regulation would impact only non-bank lenders.

loans and other unsecured personal loans; and commercial loans and credit facilities. This letter is focused on lending activities conducted by a financial services organization ("Lender") operating through related entities (including an affiliated group of corporations that either files a consolidated federal income tax return or is a member of a controlled group).[2]

I. LENDERS SHOULD CONTINUE TO RECEIVE ORDINARY TREATMENT ON SALES AND DISPOSTIONS OF LOAN RECEIVABLES ORIGINATED OR ACQUIRED IN THE ORDINARY COURSE OF BUSINESS

Congress intended that "profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gains or loss."[3] Consistent with this intent, the Supreme Court has applied a rule of construction that "the definition of 'capital asset' must be narrowly applied and its exclusions interpreted broadly."[4]

A. Lending is a Service in the Context of Sec. 1221(a)(4)

Currently, Lenders treat their loan receivables as ordinary (i.e., non-capital) assets. Section 1221(a)(4) excludes from the definition of capital assets, "accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of [inventory]." Following the Service's acquiescence in *Burbank Liquidating*[5] and several Revenue Rulings relying on that decision,[6] the Tax Court held that mortgage loan receivables acquired by Fannie Mae fit within the scope of section 1221(a)(4) and should be treated as ordinary in nature.[7] The Tax Court based its decision in part on its finding that Fannie Mae was providing a service in acquiring mortgages from loan originators:

> We note initially that [Fannie Mae's] operation is restricted by statute and regulations designed to further its purpose – to provide stability to the secondary market for home mortgages and liquidity for originating lenders, allowing them to extend further loans. The actual operation of FNMA further supports that it was providing a service in exchange for the mortgages. We believe that mortgage issuers benefited from FNMA's activity which serves to increase the level of bank lending; it

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[2] See Appendix for discussion of operations of lending organizations operating through an affiliated and/or controlled group.

[3] *Corn Products Refining Co, v. Comm'r*, 350 U.S. 46, 52 (1955).

[4] *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212, 220 (1988). In contrast, the Proposed Regulation can be viewed as a broad application of the definition of a capital asset by narrowly interpreting its exclusions to loans acquired or originated in only certain limited types of lending situations without any legal or policy reason to do so.

[5] *Burbank Liquidating Corp. v. Comm'r*, 39 T.C.999 (1963), acq. sub nom *United Associates, Inc.*, 1965-1 C.B. 3, aff'd in part and reversed in part on other grounds, 335 F.2d 125 (9th Cir. 1964).

[6] Rev. Rul. 72-238, 1972-1 C.B. 65; Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul. 80-57, 1980-1 C.B. 157.

[7] *Federal National Mortgage Ass'n v. Comm'r,* 100 T.C. 541 (1993). Apparently, Fannie Mae had a closing agreement with the IRS under which the parties agree to treat loan receivables as ordinary. The extent of similar closing agreements in the financial services industry is not known but it suggests the settled expectations of the industry which should not be disrupted lightly.

> was a service to the mortgage lending business and the members thereof . . . .[8]

Relying on this established case law, Lenders have treated account and loan receivables as ordinary assets under section 1221(a)(4) for more than 40 years. Not surprisingly, ordinary gain or loss treatment on the sale or disposition of consumer loans generally matches the character of income and expense arising out of those receivables as discussed in the following section. This is entirely consistent with the premise that core business assets that consistently give rise to ordinary income and expense and ordinary bad debt deductions during their lives should similarly give rise to ordinary gain or loss on a sale or disposition – regardless of whether the seller is classified as a section 582(c) Bank, a section 475 dealer or neither.[9]

B. The Proposed Regulation Would Create Character Mismatches Between the Income Derived From Loan Receivables and Gain or Loss on Sale or Disposition

In the notice of proposed rule making, the IRS and Treasury commented that:

> [t]he expansion of section 1221(a)(4) [to include notes receivable acquired by a lender in the ordinary course of its business] cannot be reconciled with Congress' stated purpose for enacting the statute. Acquisition of notes or mortgages using consideration other than services or section 1221(a)(1) property generally does not trigger current ordinary income and so does not create a potential for the character mismatch that concerned Congress when it enacted section 1221(a)(4).

We respectfully disagree with the premise that excluding loans or accounts receivable originated in the ordinary course of a lending business from section 1221(a)(4) would not cause a character mismatch. Instead, as discussed below, the revised rule would create character mismatches, thereby frustrating Congressional policy, and likely would have a detrimental effect on the financial markets by forcing lenders to adjust

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[8] 100 T.C. at 578-579. IRS pronouncements regarding credit card fees are not directly relevant to the question of whether a loan receivable is acquired in the ordinary course of business for services rendered within the meaning of section 1221(a)(4). For example, the IRS has indicated in a variety of Revenue Rulings and Private Letter Rulings that some fees received by credit card issuing banks constitute compensation for the use or forebearance of money – i.e., interest – rather than for services. *See, e.g.,* Rev. Rul. 77-417, 1977-2 C.B. 690 (cash advance, check advance, overdraft fees); Rev. Rul. 74-187, 1974-1 C.B. 48 (utility late fees). With respect to merchant discount and interchange fees, the IRS has been less consistent. *Compare* Rev. Rul. 71-365, 1971-2 C.B. 218 (merchant discount fees are for services) *with* Treas. Reg. Section 1.954-1(h)(4) Example 6 (merchant discount constitutes factoring income and is, therefore, income equivalent to interest). See also PLR 200533022, PLR LEXIS 542 (May 10, 2005) (late fees are interest; merchant fees are not); PLR 200533023 PLR LEXIS 543 (May 10, 2005) (late payment, OTL, cash advance and NSF fees are interest; annual fees and merchant discount are not). Consequently, the treatment of such fees as for services, interest or original issue discount should not control the characterization of the loan as having been issued for services for purposes of section 1221(a)(4). In any event, there is no dispute that these fees produce ordinary income. See the discussion in the next section.

[9] An analysis of the legislative history of section 582(c) and section 1221(a)(4) supports the view that Congress did not intend for there to be a disparity in the tax treatment of taxpayers with similar facts. In particular the legislative history to the Tax Reform Act of 1969, which modified section 582(c) to provide for ordinary gain and loss treatment on all securities held by a Bank (as opposed to capital gain for certain debt instruments), supports the position that ordinary treatment for all Lenders is appropriate.

the legal vehicle operating structure for no reason other than to avoid capital asset treatment of loan receivables originated in the ordinary course of business. Examination of the relevant tax attributes of loans originated in the ordinary course of business reveals that, under current interpretation of section 1221(a)(4), there is almost total conformity in character between the items of income and deduction and the ordinary treatment of the loan receivables. The Proposed Regulation would cause a mismatch between those items of income and expense arising out of a loan receivable and the gain or loss on sale or disposition of a loan receivable in many circumstances, as illustrated below.

	Current law		
Item of Income or expense	**§582(c) Bank**	**§475 Dealer**	**Finance Company**
Interest income	Ordinary	ordinary	ordinary
Fee income	Ordinary	ordinary	ordinary
Interest expense	Ordinary	ordinary	ordinary
Loan origination expense[10]	Ordinary	ordinary	ordinary
Credit Losses on Balance Sheet Loans	Ordinary	ordinary	ordinary
Sale of Portfolio Loans	Ordinary	ordinary	ordinary
Foreclosure of Balance Sheet Loans	Ordinary	ordinary	ordinary
Sales of Balance Sheet Loans to factors/collection agencies	Ordinary	ordinary	ordinary
Agency/secondary market sales	Ordinary	ordinary (MTM)	ordinary
Sales to REMIC/ SPCs	Ordinary	ordinary (MTM)	ordinary
Asset/liability hedging	Ordinary	ordinary	ordinary

	Proposed Regulation		
Item	**§582(c) Bank**	**§475 Dealer**	**Finance Company**
Interest income	Ordinary	ordinary	ordinary
Fee income	Ordinary	ordinary	ordinary
Interest expense	Ordinary	ordinary	ordinary
Loan origination expense[11]	Ordinary	ordinary	ordinary
Credit losses on Balance Sheet Loans	Ordinary	ordinary	ordinary
Sale of Balance Sheet Loans	Ordinary	capital	capital
Foreclosure of Balance Sheet Loans	Ordinary	capital	capital
Sales of Balance Sheet Loans to factors/collection agencies	Ordinary	capital	capital
Agency/secondary market sales	Ordinary	ordinary (MTM)	capital
Sales to REMIC/ SPCs	Ordinary	capital (Balance Sheet Loans); ordinary (MTM loans)	capital
Asset/liability hedging	Ordinary	capital/ordinary	capital/ordinary

[10] Except broker fees incurred on loan originations.
[11] Except broker fees incurred on loan originations.

As described in the examples below, excluding loan receivables from the scope of section 1221(a)(4) would cause similarly situated taxpayers to suffer dissimilar treatment. Further, the exclusion of loans and other receivables originated in the ordinary course of business from the scope of section 1221(a)(4) will itself create the character mismatch that the Service and Treasury intend to avoid. This, we think, will fuel rather than dissipate tax controversy.

C. The Proposed Regulation Would Create Inconsistent Results Based Solely Upon the Type of Entity That is Selling a Loan Receivable

The Proposed Regulation will create inconsistencies among similarly situated taxpayers based on the type of seller, rather than the attributes of the loan receivable. This is best illustrated by the following examples. (See Appendix for description of lending activities.)

- *Example 1*. An operator of a nation-wide network of home improvement centers ("Merchant") finances its sales of inventory and services to the public through credit sales, installment sales or other deferred payment plans. Those receivables clearly would fall within the section 1221(a)(4) exception. Gain or loss on the sale or disposition of those receivables would be ordinary in character under the Proposed Regulation.

- *Example 2*. Merchant (described in *Example 1*) is a member of an affiliated group of companies including a bank described in section 582(c) ("Affiliated Bank"). Affiliated Bank issues credit cards in the name of Merchant solely to finance retail purchases by consumers in Merchant's home improvement centers. Under the Proposed Regulation, credit card receivables originated by Affiliated Bank would not fall within section 1221(a)(4), although Affiliated Bank would receive ordinary treatment on sales or dispositions of those receivables pursuant to section 582(c).

- *Example 3*. A retail vendor ("Retailer") is engaged in the business of selling clothing, furniture, house wares, electronics and miscellaneous goods. An unrelated bank ("Unaffiliated Bank") operates a credit card business through the MasterCard and Visa associations. Unaffiliated Bank also conducts a credit card program ("Private Label") whereby it issues credit cards in the name of Retailer to the public solely for the purpose of financing retail purchases by consumers at Retailer's stores. Unaffiliated Bank absorbs all the economic benefits and burdens of the arrangement, net of a Private Label program fee paid to the Merchant. Unaffiliated Bank retains its MasterCard and Visa credit card receivables as Balance Sheet Loans but sells all receivables arising out of the Private Label program to a non-Bank affiliate for good business reasons. Gain or loss on the sale or disposition of the MasterCard and Visa Balance Sheet receivables by Unaffiliated Bank would be ordinary under section 582(c). Under the Proposed Regulation, the Private Label receivables in the hands of the non-Bank affiliate would not be described in section 1221(a)(4). Consequently, gain or loss on the sale or disposition of those receivables by the non-Bank affiliate would be capital.

- *Example 4*. A travel & entertainment finance company ("Charge Card Issuer") operates a non-revolving credit program to facilitate the purchase of goods and services from participating retail merchants under the terms of which full payment is due from the card holder at the end of a monthly billing cycle. These charge card receivables are obtained directly by Charge Card Issuer from retail customers in exchange for the purchase and sale of goods and services from the participating retail merchants. The receivables arise directly out of the retail merchants' goods and services, and those receivables give rise to ordinary interest and fee income as well as ordinary interest expense and related ordinary deductions. As an alternative to borrowing in the debt markets, Charge Card Issuer sells the receivables to a factoring company to obtain financing for its business. Gain or loss on the factoring sale, ordinary under current law, would be capital under the Proposed Regulation.

- *Example 5*. Bank originates first- and second-lien residential mortgages loans. Gain or loss on sale of these mortgage loans is and would remain ordinary in character under section 582(c).

- *Example 6*. A mortgage lender ("Mortgage Originator") originates first- and second-lien residential mortgages through a non-Bank operating subsidiary of a federally chartered thrift, treated as a Bank under section 582. Mortgage Originator designates a portion of its mortgage loan production for sale to secondary market agencies and investors. Loans sold to the secondary market agencies and investors are marked to market under section 475(a). Other mortgage loans are held as Balance Sheet Loans by the Mortgage Originator in a separate account and are identified as exempt from mark to market under section 475(b). Balance Sheet Loans in default status are sold by the Mortgage Originator pursuant to state foreclosure remedies. Gain or loss on Balance Sheet Loans would be capital under the Proposed Regulation.

- *Example 7*. Mortgage Originator is not a Bank as described in section 582. An affiliated company is a Bank supervised by the Office of the Comptroller of the Currency. Mortgage Originator and Bank are members of an affiliated group of corporations filing a consolidated federal income tax return. Bank and Mortgage Originator are not directly connected by stock ownership and are subject to oversight of different federal banking authorities. Bank makes unsecured personal loans to individuals and gathers consumer deposits in excess of its funding needs. Bank has capital in excess of its business plan that it cannot distribute for regulatory reasons. Mortgage Originator originates residential mortgage loans, some of which it sells to the secondary market, and some of which it holds as Balance Sheet Loans. Management of Mortgage Originator would prefer that a regulator other than the regulator that supervises affiliated Bank oversee its mortgage business assets. Because Bank has excess capital and deposits, it purchases residential mortgage loans from Mortgage Originator. Mortgage Originator is a dealer under section 475 with respect to mortgage loans sold to the secondary market. Under the

Proposed Regulation, mortgage loans held by Mortgage Originator for resale to the secondary market would continue to be marked to market under section 475. Gain or loss on Balance Sheet Loans sold by the Mortgage Originator to the Bank would be capital, while any gain or loss on loans acquired by the Bank from the Mortgage Originator and subsequently sold by Bank would receive ordinary treatment under section 582(c).

- *Example 8*. Same as *Example 7*, except that the affiliated investor is a non-Bank that acquires all mortgage loans secured by residential real estate in a particular state for capital management reasons. Balance Sheet Loans sold by the non-Bank pursuant to foreclosure remedies or for other reasons would receive capital treatment under the Proposed Regulation.

In the first three examples, accounts receivable (*Example 1*) and loans receivable (*Example 2* and *Example 3*) are obtained directly from the retail consumer in exchange for the purchase and sale of goods or services. There is no logical reason or compelling tax policy concern why the character of gain or loss on a subsequent sale or disposition of those receivables should differ, depending on the tax attributes of the seller (merchant, section 582(c) bank or non-bank affiliate).

In *Example 4*, the accounts receivable would fall within section 1221(a)(4) exception if they were acquired directly by the retail merchants, but not if acquired directly by the Charge Card issuer, even though they arise under factually indistinguishable circumstances. We can see no compelling policy reason why a gain or loss on the sale of these receivables by Charge Card Issuer should result in capital treatment.

Examples 5-8 show the inconsistency in recharacterizing gain or loss on Balance Sheet Loans originated in the ordinary course of business based on the identity of the seller of those loans within a consolidated group and, by extension, a controlled group as defined under section 1563. Write-downs on loans originated in the ordinary course of business uniformly are treated as ordinary under section 166(b) – regardless of whether the holder is a Bank, a section 475 dealer or other corporation not described in those sections. We can think of no policy reason why gains or losses arising out of a foreclosure sale or other disposition of Balance Sheet Loans originated in the ordinary course of business should take on a different character simply because they were transferred to a non-Bank or non-dealer affiliate.

II. THE PROPOSED REGULATION IS VULNERABLE TO LEGAL CHALLENGE

The Proposed Regulation would overturn 40 years of established law. As noted above, it is well settled that mortgage loans (and other debt instruments) originated or acquired in the ordinary course of business are ordinary assets within the meaning of section 1221(a)(4).[12] In *Burbank Liquidating*, as part of the winding down of its business, a savings and loan association (Burbank) sold all the mortgage loans it had originated. The Tax Court squarely considered whether the loans

[12] *See, e.g., Burbank Liquidating, supra*; *FNMA*, *supra*.

originated by Burbank in its trade or business were acquired "for services," thereby bringing the assets within the scope of section 1221(a)(4):

> [We] believe that the mortgage loans made in the ordinary course of its business are "notes receivable acquired for services rendered" and, thus, are ordinary rather than capital assets. Certainly, the business of a savings and loan company could properly be described as "rendering the service" of making loans. Therefore, we hold that [petitioner's] loss on the sale of its loans is deductible as an ordinary loss.[13]

The Service acquiesced to *Burbank Liquidating* and relied upon it in a series of rulings confirming ordinary treatment for loan receivables. For example, in Rev. Rul. 72-238[14] the Service concluded that gain realized in a foreclosure proceeding by a creditor bank that purchases mortgage property at a bid price less than the fair market value of the property is ordinary income. The Service cited with favor the U.S. Supreme Court decision in *Commissioner v. Gillete Transport Motor Co.*[15] for the proposition that the term "capital asset" should be construed narrowly:

> . . . not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and this to ameliorate the hardship of taxation of the entire gain in one year.[16]

In Rev. Rul. 73-538, the Service ruled that a savings and loan, which received notes with a fair market value less than the adjusted basis of mortgage loans in its hands, recognized an ordinary loss.[17] In Rev. Rul. 80-56, the Service determined that a real estate investment trust that engaged primarily in short term financing activities realized ordinary income when the trust bid in foreclosed property for less than its fair market value.[18]

Nearly 30 years after *Burbank Liquidating,* the Tax Court extended the rationale of that case to the secondary market in *FNMA*. After analyzing Fannie Mae's charter and its operations, the Tax Court determined Fannie Mae was providing a service in exchange for the mortgages it acquired and that the mortgages in its portfolio were described within section 1221(a)(4). The decision was reviewed and adopted by the entire court without dissent. The government did not appeal the case. This should have brought finality to the issue.

Where the courts have clearly interpreted the statute, we believe they are unlikely to approve reversal of a settled construction of the law by interpretive regulation. The Supreme Court has held that regulations are invalid if they are contrary

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[13] 39 T.C. at 1009.
[14] 1972-1 C.B. 65.
[15] 364 U.S. 130 (1960).
[16] 364 U.S. at 134.
[17] 1973-2 C.B. 298.
[18] 1980-1 C.B. 154; *see also* Rev. Rul. 80-57, 1980-1 C.B. 157.

to prior judicial interpretation of the plain and unambiguous provisions of the statute. *See, e.g., Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Services*, 125 S. Ct. 2688, 2700 (2005). Section 1221(a)(4) is not ambiguous. It provides that "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered" are not capital assets. It does not limit the provision to particular classes of "accounts or notes receivable" or specific types of "trade or business" or certain "services rendered." The lack of any Congressional action with respect to the interpretation of section 1221(a)(4) after *Burbank Liquidating* and *FNMA* should be regarded as significant evidence of ratification of such decisions.

Furthermore, we are not aware of any significant abuses or questionable application of section 1221(a)(4) to loan receivables acquired in the ordinary course of business. In view of the lack of ambiguity calling for interpretive clarification by the Service or any documented examples of abuse, we believe that the Proposed Regulation is likely to be viewed by the courts as an unauthorized attempt to rewrite a well settled construction of a tax statute.

III. OVERTURNING 40 YEARS OF SETTLED TAX LAW IS UNWISE TAX POLICY

A. Sound Tax Policy Favors Consistent Application of Generally Understood Tax Principles

The Preamble to the Proposed Regulation states that the Treasury and IRS have concluded that the current application of section 1221(a)(4) to accounts and notes receivable acquired in exchange for loans is unsound as a matter of tax policy. However, the Preamble does not indicate why the government believes that the current, settled construction of section 1221(a)(4) is unsound. The government has not identified, and we are not aware of, any abuses of ordinary income treatment on sales or disposition of Balance Sheet Loans. We believe that sound tax policy favors consistent ordinary treatment for all of the core business assets of a business enterprise.

The capital loss limitation inherent in the Proposed Regulation is most appropriate in situations where a taxpayer has the ability to pick loss assets selectively from a group of marketable securities while deferring gain recognition on built-in gain assets. This condition might exist in the case of a portfolio of equity investments but is not present in the case of Balance Sheet Loans held by a Lender. The lending business does not raise the same risk of tax avoidance. Lenders hold the vast bulk of their loans as Balance Sheet Loans. Because of the small individual loan dollar amounts, residential mortgage, student, auto and credit card receivables do not lend themselves to piece-meal sale or disposition because selective sales simply are uneconomic. Moreover, loan receivables subject to prepayment risks, such as mortgages, tend to decrease in value in a rising interest rate environment. In a declining rate environment, there is no corresponding gain because the prepayment feature tends to prevent the debt from trading at a meaningful premium. Consequently, there is no potential tax policy abuse to be corrected.

On the other hand, the Proposed Regulation artificially distinguishes between Lenders that originate loans through Banks and those that originate through non-Bank

entities, such as operating subsidiaries of Banks or non-Bank affiliates. Inconsistent treatment of similarly situated taxpayers will, at best, serve as a trap for the unwary. Worse, the distinction could create opportunities for tax-motivated transactions. Artificial distinctions are unwarranted and do not constitute sound tax policy.

B. Overturning Settled Law Will Create Significant Business Issues for Affected Taxpayers

The Proposed Regulation would create significant business issues for loan originators. Some lenders will be forced to change their operations or legal structures, which could lead to a change in regulator, additional expense and increased state income tax liability. As discussed below in IV., the tax treatment of hedging activities would be significantly impacted, including transitional matters that are not addressed in the Proposed Regulation.[19] Other lenders could be placed at a significant competitive advantage or disadvantage in the marketplace. The uncertainty as to the validity of the Proposed Regulation could lead to significant financial statement impact for publicly traded financial services organizations subject to FASB Interpretation No. 48 (FIN 48).

On the other hand, some taxpayers could view the proposed change as a fresh opportunity to take novel capital gain or loss positions that previously may have been viewed as infertile due to the settled nature of the area. This disruption will lead to extensive audit controversy and ultimately to legal challenges of the regulations. In short, rather then eliminating uncertainty and disputes, the area may develop into a hotbed of controversy for years.

IV. GAINS AND LOSSES FROM LOANS AND HEDGES OF THOSE LOANS SHOULD REMAIN ORDINARY

Currently, Lenders treat their loans as ordinary (i.e., non-capital) assets based on 40 years of settled law.[20] Under the applicable tax rules, a taxpayer may obtain tax hedge treatment only for hedge positions established with respect to ordinary assets or liabilities, not capital assets. See Treas. Reg. Sec. 1.1221-2(b).

As described in the appendix, in order to finance their loans, Lenders may borrow deposits, issue commercial paper, medium-term notes or bonds, or securitize loan receivables. These funding sources can be floating-rate or fixed in nature. The interest received on loan receivables may be either floating or fixed. As a result, Lenders ordinarily hedge the risk of interest rate fluctuations in their assets (loans) and liabilities (funding) depending on whether the hedge instruments are more closely associated with the assets or the liabilities by entering into interest rate swaps or other derivatives. Such decisions are typically made by treasury risk management personnel as part of an overall asset and liability risk management process.

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[19] As written, the Proposed Regulation would be effective for loans acquired after the date the finalized regulations are published in the Federal Register. Such an effective date would generate significant systems changes and costs to track loans acquired after the effective date. These burdens would better be addressed through a prospective effective date for loans acquired on or after the commencement of a taxable year and allowing taxpayers sufficient lead in time to fully assess implications.

[20] In some instances, taxpayers have entered into formal or tacit agreements with examination teams.

Under current law, the determination of whether a position is treated as a hedge for tax purposes aligns with the Lender's economic and business objectives for entering into such a position. The timing, but not the character, of any gain or loss realized from a hedge depends on whether the position is treated as a hedge of an asset or a liability. Lenders have established significant systems and processes to identify positions properly as tax hedges and to track gains and losses from such positions. Although on examination the IRS may challenge the taxpayer's timing of certain hedge gains and losses, depending on the facts of the case, there is a general working understanding and acceptance of tax hedge accounting processes.

The Proposed Regulation would require Lenders (other than Banks) to treat Balance Sheet Loans as capital assets. As a result, non-Bank Lenders would not be able to record tax hedge treatment on gains and losses attributable to derivative contracts entered into as hedges against interest rate fluctuations on their loan portfolios. The timing mismatches created by such a rule would lead to significant book-tax differences, administrative burdens and complexities (for Lenders and the IRS), and would frustrate the general clear reflection of income policies.

The transitional implications and costs associated with derivative positions established with respect to loans, some of which may be treated as capital assets under the Proposed Regulation, raise significant complexities and undue burdens on taxpayers and the government. In addition, because certain hedge positions would no longer qualify as hedges for tax purposes per application of the Proposed Regulation to certain loan assets, we are concerned that the IRS on examination may argue that a derivative should be treated as a hedge of a liability rather than of assets – leading to the possibility of whipsaw penalties.[21]

Given the significant potential detriments to taxpayers and the government and the lack of any policy benefits from the Proposed Regulation, we reiterate our view that the Proposed Regulation should be withdrawn.

V. SECTION 475 IS NOT A SOLUTION TO THE CHARACTER MISMATCH CREATED BY THE PROPOSED RULE

Section 475 is not a solution to the character mismatch that the Proposed Regulation would create. Publicly-traded consumer lending financial services organizations generally do not mark their Balance Sheet Loans to market for financial reporting purposes. Because there is no market for individual consumer loans, Section 475 would require an expensive, time-consuming and artificial mark to market valuation on a loan by loan basis at least annually solely for tax purposes. The significant taxpayer costs and administrative burdens in developing and documenting such valuations, along with the IRS personnel time in reviewing and assessing such factual matters, are unnecessary, anti-competitive expenditures of resources. Therefore, as a practical matter, Lenders are unlikely to undertake the extensive process required for section 475 in the absence of a requirement for mark to market for general financial statement income and loss reporting purposes.

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[21] *See* Treas. Reg. Section 1.1221-2(g)(1).

VI. EXCEPTION SHOULD APPLY FOR CONTROLLED GROUPS TO BE CONSISTENT WITH THE CONSOLIDATED RETURN REGULATIONS

To the extent that IRS and Treasury believe that note and loan receivables acquired by a lender do not fall within the section 1221(a)(4) exception, we urge IRS and Treasury to provide an exception from capital asset treatment confirming that gain or loss on a note or loan receivable originated in the ordinary course of business by a Bank, section 475 dealer, or other lender retains its ordinary character when transferred to a related party, provided the originator and acquiring affiliate are related within the meaning of section 267(b). This position is consistent with the single entity approach utilized in the consolidated return regulations and used to allocate tax benefits, determine the dividends-received deduction, and apply the related parties' transaction rules.[22]

VII. CONCLUSION

It is the ABA's view, as discussed herein, that account and loan receivables originated or acquired by a Lender in the ordinary course of business and related hedges should continue to be treated as ordinary. Distinctions should not be created among Lenders that originate loans through Banks, non-Bank operating subsidiaries of Banks or other non-Bank affiliates. Any such distinctions would disrupt industry practice and create significant administrative and economic burdens for taxpayers as well as the government without furthering any identifiable tax policy objective.

Thank you for considering our comments. The ABA would welcome an opportunity to discuss the facts, issues and areas of concern described in this letter in more depth.[23] Please feel free to contact me if you have any questions, or would like to arrange a meeting to discuss the Proposed Regulation.

Sincerely,

Francisca N. Mordi

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[22] *See* section 267(f)(2) and Treas. Reg. section 1.267(f)-1 as examples of the application of consolidated return "single entity" principles in a larger controlled group context. In the consolidated group context regarding character determinations, *see* Treas. Reg. Section 1.1221-2(e)(1) ("For purposes of this section [1221], the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation."); Treas. Reg. Section 1.475(c)-1(a)(3)(iii) ("Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) [intra-group customer election], a taxpayer's transactions with other members of its consolidated group are not with customers."); Treas. Reg. section 1.1502-13(c)(7)(ii), example 2 (in applying section 1221(a)(1), all activities of relevant subsidiaries are combined for purposes of considering whether a property is held primarily for sale in the ordinary course of business).

[23] As this letter is being submitted subsequent to other comments on the Proposed Regulation, the purpose is to highlight areas of significant concern in the context of facts not previously discussed.

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APPENDIX

LENDING ORGANIZATIONS OPERATING THOUGH AN AFFILIATED GROUP OF CORPORATIONS

A. Origination

The basic operation of a lending business is fairly straightforward. The Lender raises financing from various sources and originates and/or acquires loans. As described in Section IV. above, financial services organizations also enter into derivative positions to hedge risks. Lenders conduct business through various combinations of bank and non-bank affiliates. For example, a mortgage banker can originate residential mortgages directly through a federal or state chartered bank or thrift ("Bank"); indirectly through entities such as an operating non-bank subsidiary of a Bank or through a mortgage company, the stock of which is not owned by any Bank (a "non-Bank"). The mortgage business could utilize a mix of Bank and non-Bank originators for different mortgage products or loans secured by real estate in different States. Similarly, student loans and auto loans can be made by Banks, by non-Bank operating subsidiaries of Banks and by other non-Bank entities. Credit card loans are made by Banks, while travel and entertainment ("T&E") charge card lines of credit as well as general unsecured, personal loans can be originated by both Banks and non-Banks.

The business decision whether to originate a loan in a Bank or a non-Bank is based on several factors, one of the most important of which is the choice of regulator (Federal Reserve Bank, Office of the Comptroller of the Currency, Office of Thrift Supervision, or State Banking Department) – a choice which is influenced by the regulators' respective statutory powers related to preemption of state lending laws, authority to grant interstate branching rights, and the applicable rules and policies governing credit, asset impairment and risk-based capital standards. The business decision can also be influenced by the existence of a publicly traded minority interest in the lender, joint venture or business alliance arrangements, or by state and local income taxes.

B. Financing

Lenders that are members of an affiliated group of companies fund their loans through a variety of overlapping sources. Banks take deposits directly from individual consumers and sometimes obtain wholesale deposits from affiliated or unaffiliated retail brokerage houses. Banks also have access to borrowing from agencies of the Federal government and balance their overnight positions with the Federal Reserve Bank. Bank holding companies and their non-Bank subsidiaries and affiliates borrow term funds from the commercial markets through a combination of commercial paper, notes and bonds. Subject to regulatory restrictions, a non-Bank can fund a portion of its balance sheet by borrowing from Bank affiliates with excess deposits, or borrowing from an affiliate with access to the commercial debt markets. Bank and non-Bank lenders alike may satisfy a substantial portion of their funding

needs by means of direct sales of certain types of loans to investors or through asset-backed securitizations as described in the following section.

C. Sale or Other Disposition of Receivables

Lenders can hold loan receivables on balance sheet to maturity, securitize the loans or sell them. Lenders that originate loan receivables in the ordinary course of business commonly operate under long-term business plans that determine whether and when to: (i) sell loan receivables to particular investors, (ii) securitize the loans in financing arrangements structured as debt for tax, REMICs, or sale for tax securitizations, or (iii) hold the loan receivables on balance sheet to maturity (the last hereinafter described as "Balance Sheet Loans"). These decisions are based on the term and other characteristics of the newly originated loan (e.g., fixed- or floating-rate interest), interest rate forecasts, availability and pricing of deposits and term debt, consumer credit environment, the lender's credit standing, consumer and investor demand, risk-based capital requirements, and state/local income taxes. The mix of direct sales as well as the frequency and structure of securitization activities will vary over time depending on many variables including acquisitions or divestitures of assets and/or legal entities, organic business growth, interest rate movements, capital requirements and dividend plans.

Balance Sheet Loans can be held by the loan originator itself or sold to a Bank or non-Bank affiliate. Balance Sheet Loans are sold to affiliates for a number of business reasons including the risk-based capital adequacy of the originator and purchaser, funding and regulatory criteria related to credit standards, acquisitions or joint ventures, and state and local income taxes. For example, a Bank with deposits in excess of its consumer loans originated through its branch network might purchase one or more categories of real estate mortgage loans from its mortgage banking affiliate.

To illustrate with various loan types, a non-Bank mortgage loan originator might transfer new mortgage loan originations meeting certain criteria to a non-Bank subsidiary specializing in the securitization of mortgage receivables for inclusion in a REMIC, and sell other origination volume meeting specified investor criteria to secondary market agencies like Fannie Mae, Freddie Mac or private investors. Alternatively, the non-Bank mortgage originator may retain Balance Sheet Loans or sell a portion of such loans to a Bank or non-Bank affiliate. Such Balance Sheet Loans may subsequently be included in a securitization transaction depending on the funding needs of the group. Other real estate secured loans such as second-lien mortgages and home equity lines of credit with reduced secondary market appeal may be originated and held by the originating entity as Balance Sheet Loans or sold to a Bank or non-Bank affiliate.

A student loan originator might transfer a portion of its student loan receivables to a bankruptcy remote, special purpose vehicle for securitization purposes. The originator typically would hold the bulk of its student loan receivables as Balance Sheet Loans but student loans can be sold to Bank and non-Bank affiliates.

Credit card receivables originated by a credit card Bank may be held by the Bank as Balance Sheet Loans, sold to a Bank or non-Bank affiliate to retain as Balance Sheet Loans or transferred to a special purpose bankruptcy remote affiliate for securitization. Non-revolving charge card receivables are typically held as Balance Sheet Loans or sold to a third party at a discount in a factoring arrangement. Delinquent credit card account receivables can be sold to collection agencies.

Similarly, an auto loan originator may hold its auto loans as Balance Sheet Loans, securitize the loans or sell them to a Bank or non-Bank affiliate. An auto loan originator may also sell delinquent auto receivables to collection agencies.