October 31, 1991

COORDINATED ISSUE
COMMERCIAL BANKING
CHARACTER OF GAIN OR LOSS REALIZED ON SALE OF PROPERTY RECEIVED BY BANK IN FORECLOSURE OR WORKOUT

ISSUES

Whether the gain or loss realized on the disposal of

a) real property received through foreclosures or deeds in lien of foreclosures, or

b) securities/equities (stocks, bonds, warrants, etc.) received as part of a workout or restructuring of debt is ordinary income or capital gain or loss.

FACTS, LAW AND ARGUMENT

One of the primary functions of a commercial bank is the making of loans. The interest income generated from these loans is a significant source of a bank's income. Upon default of a loan or continued non payment of interest on a loan, usually one of the following events could occur:

A) When payments are late or the borrower has trouble in meeting the terms, both parties may agree to renegotiate the loan. As part of this renegotiation or workout, the bank could receive stock or securities, warrants or options to purchase stock or securities. In return, the borrower usually pays less interest and has more time to pay the loan.

B) The bank, at time of default on the loan instrument, may acquire the collateral by either a foreclosure or deed in lieu of foreclosure. The property thus acquired is then disposed of by the bank as soon as a sale can be arranged. However, it is not uncommon for the bank to: (a) expend money to "fix up" the property; (b) in the case of uncompleted projects, to expend construction funds to complete; or (c) to rent it out until a purchaser can be found.

The basis of the property is not in question since that is the fair market value determined at the time of foreclosure.

Code 1221 defines a capital asset to be any property held by a taxpayer except certain enumerated items. Of importance here is the exception at Code 1221(1) which provides

basically for the exclusion of three types of property from the capital asset definition: (1) stock in trade, (2) property of a kind which is properly includible in a taxpayer's inventory, and (3) property held previously to sell to customers in the ordinary course of a taxpayer's trade or business.

Revenue Ruling 72-238 (1972-1 C.B., 65) involved a bank which issued mortgage loans as a regular part of its banking business and which foreclosed on a loan. The gain on the foreclosure sale was held to be ordinary income as gain arising from the ordinary operation of the banking business. Reliance was placed on IRC Section 1221(4) and Corn Products Refining Co. vs Commissioner, 350 U.S. 46, 51, 52 (1955) Ct. D. 1787, C.B. 1955-2, 511.

Revenue Ruling 74-159 (1974-1 C.B., 232) brings into play an other aspect of this issue by addressing itself to the purpose for which the bank acquired the property. In arriving at its conclusion it stated:

> "In the instant case none of the properties sold was a rental or income producing property in the hands of the bank. As in the Mauldin and Brown cases, the type and scope of the taxpayer's activities indicate that the taxpayer is in the business of selling such properties to customers in the ordinary course of such business".

Therefore Revenue Ruling 74-159 held that the transactions came under the meaning of Section 1221 of the Code and any gain or loss on the sale thereof is ordinary rather than capital. While the ruling concludes that the property there in question was held primarily for sale to customers in the ordinary course of its trade or business within the meaning of Code 1221(1), the determination was made not as a matter of law but rather rested on a factual analysis, limited to the facts and circumstances of the particular case.

Further, the purpose for acquisition must now be viewed as a starting point in analyzing the issue and may not be viewed as solely determinative. In the case law that follows, each of these cases in substances reduces itself to an examination of the reason for which property is held at the time of disposition.

The Tax Court in Gerard Trust Corn Exchange Bank, 22 T.C. 1343 (1954), addressed the issue as follows:

> The present case cannot be disposed of simply upon the narrow ground that the taxpayer is a bank or a lending institution selling property acquired by foreclosure or by deed in lieu of foreclosure. On the contrary, consideration must be given to other factors which have been recognized as significant. As stated in Maulding v. Commissioner, supra, 195 F. 2d

> at page 716:. There is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must, in the last analysis, rest upon its own facts. There are a number of helpful factors, however, to point the way, among which are the purpose for which the property was acquired, whether for sale or investment; and continuity and frequency of sales as opposed to isolated transactions. *** (citing and reviewing many decisions.)"

Similar statements were made in the case of Albert Winik, supra, 17 T.C., at pages 541-542, 544. Among other cases expressing and applying the same rule are: Martin Dressen, 17, T.C. 1443, 1447, (1952); Thomas E. Wood, 16 T.C. 213, 226 (1951); W. T. Thrift, Sr.,15 T. C. 366, 369 (1950); and Boomhower v. United States, 74 F. Supp. 997 (1947).

Factually, we can imagine several scenarios: The bank acquiring property in a foreclosure or workout may within some reasonably short period of time sell the property. Particularly when dealing with real property which banks are generally precluded from holding as an investment, this situation would probably yield ordinary gain or loss.

A second scenario would have the bank deciding to utilize the property in its basis, e.g., a branch bank or as rental property. It would seem in such a situation the property would be considered as Code section 1231(b) property.

A final scenario is where the bank transfers (in some fashion) property to an investment account. Here, the result would seem to suggest capital treatment.

In essence, it is a question of the facts and circumstances of each individual case. While the purpose for acquisition is not determinative it is, again, our starting point. Factually, it would seem that the banks acquire property in these situations in a transaction that is a normal and regular part of the everyday business of the bank. It is necessary for the bank to establish a change in position, e.g., a shift to an investment account, in order that capital gain treatment be justified.

It should also be stressed that while banks may well establish that their purpose for holding property was investment related, a simple passage of time is not sufficient proof.

EXAMINER'S POSITION

It is clear that regardless of the property involved, any analysis under Code 1221(1) requires a dissection of subjective criteria in order to determine the purpose for which

the property was held. Further, case law has clearly established that such determination is made at the time the property is disposed of and not at the time of acquisition, nor during the holding period. But because this type of property is acquired in the ordinary course of business, a clear investment motive for holding property at time of disposal must be established or the Corn Products doctrine will prevail and ordinary income will result.