DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER, ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Addition of Interest Accrued (but Uncollected) while the Taxpayer was an Exempt Organization in the Basis of Property for Purposes of Bad Debt Deductions and Consistency of Position with Treatment of Intangibles

This Field Service Advice responds to your memorandum dated July 26, 1999, received here on July 29, 1999. It is not binding on Examination or Appeals and is not a final case determination. This document may not be cited as precedent.

LEGEND:

Taxpayer =
Year 1 =
Year 2 =

ISSUES:

1. Whether the Taxpayer may include interest amounts it accrued but did not collect while it was a tax-exempt organization in basis of property for purposes of computing its bad debt losses on that property in or after Year 2, when it actually became a taxable entity.

2. Whether there is an inconsistency between application of the position taken on Issue 1 and the position taken in a technical advice memorandum (TR-32-0149-91,

hereinafter "TAM") where this Taxpayer was required to use its ostensibly adjusted basis to calculate any allowable amortization, notwithstanding the requirements of I.R.C. § 1016(a)(2).

CONCLUSIONS:

1. Taxpayer may not increase its basis so as to include interest amounts it accrued but did not actually collect prior to Year 2 while it was a tax-exempt organization.

2. Taxpayer must, under section 1016(a)(2), adjust the basis of capitalized intangible property by the amount of amortization allowable for that property since the asset acquisition date regardless of the fact that Taxpayer did not actually claim any amortization deduction in the years when it was tax-exempt.

FACTS:

Details concerning the creation and operation of Taxpayer are set out at length in the technical advice memorandum cited above. For present purposes, those facts may be summarized here.

Taxpayer was created in Year 1. From its inception until Year 2, it was exempt from all federal, state, and local taxes (other than real property taxes).[1] The issues presented herein revolve around that transition.

In operation, Taxpayer links residential mortgages meeting specific guidelines from a designated group of lenders with the financial capital markets. It accomplishes this objective by buying mortgages from lenders (originators), pooling these obligations, and issuing securities identified with specific pools to the investing public. Taxpayer does not actually orginate mortgages.

Taxpayer obtains mortgages either for cash or for its marketable securities. In connection with certain guarantees it makes with respect to principal and interest payments, Taxpayer acquires some mortgages which are in default. In addition, Taxpayer acquires some mortgages for cash which go into default later. With respect to these properties, Taxpayer claimed bad debt deductions in 1985 and 1986 from foreclosure losses. Included in these claimed losses was unpaid but accrued interest which had accrued prior –when the Taxpayer lost exempt status. The "accrued" interest amounts increased any losses on the

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[1]

foreclosures because Taxpayer added those amounts to its purported basis on the properties foreclosed. These pre-1985 additions to basis by taxpayer were specifically addressed by the TAM and found to be improper since the amounts were never actually returned as income.

LAW AND ANALYSIS:

Issue 1

As you have asked, we have reviewed the position taken in the TAM and requested the technical division to do the same. In both cases, we believe the position set forth therein, i.e., that the accrued unpaid interest should not be added to the basis of property is correct.

Issue 2

Part II of subchapter O of the Internal Revenue Code (Code) sets forth basis rules of general application.

provides no rule or guidance for calculating the adjusted basis for purposes of depreciating intangible property, the adjusted basis must be determined under existing provisions of the Code. The applicable provisions are found in part II of subchapter O,

Under section 1012 of the Code, the basis of property is the cost of such property. The cost basis is then adjusted under section 1016. As it relates to depreciation, section 1016(a)(2) provides that the cost basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of two amounts: the amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or, the amount allowable for the years involved. If the taxpayer has not taken a depreciation deduction in any prior taxable year, the adjustment to the basis of the property for depreciation allowable is to be determined by using the straight-line method of depreciation. Treas. Reg. § 1.1016-3(a)(2).

Thus, if the cost of an intangible asset is capitalized (pursuant to section 263) and added to basis under section 1012, under the plain language of section 1016(a)(2) petitioner must adjust the basis of any intangible property it seeks to depreciate by the amount of depreciation allowable for that asset since acquisition date. This is true regardless of the fact that petitioner did not actually claim any deductions for depreciation in the years when petitioner was not subject to tax. Unlike the analysis in the TAM supporting the position that accrued interest not "returned as income" is excluded from the cost basis of real estate owned for purposes of calculating bad

debt losses under section 166, petitioner is not required to receive a tax benefit before basis is adjusted for allowable, but not taken, depreciation.

The legislative history of section 1016 supports the foregoing proposition. In 1952, the predecessor to section 1016(a)(2) was amended in order to correct a Supreme Court interpretation of an earlier amendment added by the Revenue Act of 1932. The intended purpose of the 1932 amendment was to prevent a taxpayer from claiming a double deduction by requiring any excessive depreciation claimed and subsequently allowed to reduce the basis of the property. However, in Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943), the Supreme Court construed the 1932 amendment to mean that even in the case of a taxpayer who had received no tax benefit from mistakenly claiming excessive depreciation in earlier years now closed, the taxpayer was required to reduce his basis in the depreciable property by that amount. The 1952 amendment, in relevant part, corrected the seemingly unjust interpretation in Virginian Hotel Corp. by providing that the adjusted basis of property is to be reduced by excessive depreciation shown in a return only to the extent that such excessive depreciation resulted in a reduction in the taxpayer's taxes. The determination of whether a deduction resulted in a tax benefit is only necessary when "excessive" depreciation is claimed; when a taxpayer claims an appropriate deduction for depreciation, for basis adjustment purposes, it is immaterial whether the deduction results in a tax benefit to the taxpayer. Consistent with this proposition is the fact that a taxpayer is required to adjust basis in an asset by the amount of depreciation "allowable," even in the case where a taxpayer did not claim any deduction. The legislative history illustrates this point.

> [The] committee continues the provisions of existing law, also included in the House bill, which require that the basis of property shall be reduced in any case by amounts allowable whether or not any tax benefit is derived therefrom.

S. Rep. No. 82-1160, at 3-4 (1952).

> H.R. 3168 [1952 amendment] makes no change in the law with reference to the deduction of allowable depreciation. The law has been, and will remain, that depreciation which was allowable in a prior year must be deducted in computing basis, even though in the light of later events it develops that the depreciation in such prior year was actually less than it was then properly estimated to be. **And this is true regardless of whether depreciation allowable in such prior year had any effect on tax liability in the prior year. Such depreciation must be deducted even though there was no income against which it could be offset.**

97 Cong. Rec. 3798 (1952) (statement of Mr. Camp) (emphasis added).

Thus, in the instant case, the fact that petitioner did not receive a tax benefit from amortization in previous years is not relevant. Depreciation is centered on the concept that property has a limited useful life. Depreciation represents the decline in value of property that occurs over time due to wear and tear, obsolescence, amortization, exhaustion, etc. Assuming petitioner has any amortizable intangible property, the decline in the value of such assets in petitioner's hands began at the time of acquisition or creation, not at the time petitioner became taxable. Accordingly, petitioner is required under section 1016(a)(2) to calculate the allowable depreciation for its intangible assets from the year acquired and adjust the basis of these assets accordingly.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

By: _____
THOMAS D. MOFFITT
Acting Chief
Income Tax & Accounting Branch