Excise Tax Advisory

Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

ETA 3224.2021 Issue Date: May 12, 2021

Taxability of Shared Loss Payments from FDIC

Purpose	This Excise Tax Advisory (ETA) addresses the taxation of shared loss payments received by a bank from the Federal Deposit Insurance Corporation (FDIC). The scope of this ETA is limited to the shared loss payments described in the following section and should not be applied in other situations.
What is a shared loss payment?	For the purpose of this ETA, a shared loss payment is a payment from the FDIC to a bank, pursuant to a loss share agreement entered into in a purchase and assumption transaction, based on the FDIC's obligation under the agreement to guarantee losses incurred on the acquired assets. The FDIC's agreement to guarantee losses is provided to the acquiring bank at the time the acquiring bank purchases a failing bank's assets from the FDIC and in exchange for assuming the failing bank's outstanding liabilities.
Allocation of shared loss payment between gross income and reduction of purchase price	Shared loss payments received by a bank from the FDIC may include a portion that represents gross income and a portion treated as a reduction in the purchase price of the acquired assets. As a result, the payment must be allocated between the receipts of gross income and the reduction to the basis of the acquired assets. The portion of the loss share payment allocated to gross income, which is subject to B&O tax (unless an exemption applies), includes any portion of a shared loss payment received by the bank that is attributable to: − Interest accruing after the acquisition date; − Expenses related to a sale of assets secured by acquired loans; or − Other business activities representing or affecting income derived after the acquisition date. The remaining portion of the shared loss payment is treated as a reduction to the purchase price of the acquired assets and is accounted for in the calculation of net

gains from the sale of loans secured by real property (but not less than zero) to determine the amount of gain included in the bank's gross income subject to B&O tax.

Calculation of net gain realized from disposition of assets covered by shared loss payments

Gross income from the gain on disposition of the assets covered by the shared loss agreement is calculated by subtracting the bank's reduced basis in the assets from the amount received from the sale or disposition of the assets.

The bank's reduced basis is calculated as follows:

- The acquiring bank's initial basis in the assets less the portion of a shared loss payment allocated to the assets.
- The initial basis is the assets' fair market value (i.e. amount the acquiring bank paid for the assets), not the unpaid principal balance of the assets or the failed bank's book value.
- If the fair market value of each asset is not readily apparent because the purchase price must be allocated among many assets, an acquiring bank may use the following acceptable method to allocate the purchase price among the assets:

  Step 1: Calculate the guaranteed value for each asset acquired in the transaction. For example, for each asset covered by a shared loss agreement that guarantees losses up to 80% of the failed bank's book value, the guaranteed value will be 80% of the failed bank's book value.
  Step 2: Calculate the combined guaranteed value of all assets acquired.
  Step 3: Subtract the combined guaranteed value of all assets from the combined purchase price for all assets.
  Step 4: Allocate the amount from Step 3 (difference between the combined guaranteed value and combined purchase price of all assets) among all of the assets proportionally to their guaranteed value.
  Result: The purchase price allocated to each asset shall be the asset's guaranteed value determined in Step 1 plus the amount proportionally allocated to the asset in Step 4.

The net gain on the disposition of loans is netted with like-kind loans in accordance with RCW 82.04.080(2), WAC 458-20-146 *National and state banks, mutual savings banks, savings and loan associations and other financial institutions*, WAC 458-20-14601 *Financial institutions—Income apportionment (*for periods prior to June 1, 2010), and WAC 458-20-19404 *Financial institutions – Income apportionment* (for periods after June 1, 2010).

Example

Acquiring Bank purchases from the FDIC all assets and assumes all liabilities of Failed Bank for $10,000,000.

As part of the purchase and assumption agreement, the FDIC and Acquiring Bank enter into a loss share agreement in which FDIC agrees to reimburse Acquiring Bank for 80% of losses (e.g., foreclosure sale losses, short sale losses, modification losses, charge-off losses, etc.) on the acquired assets. For calculation of the shared loss payments, the FDIC allows Acquiring Bank to include certain reimbursable expenses, including fees for attorneys, appraisers, and other reasonable and necessary expenses paid to a third party for the usual, prudent and lawful management of the assets.

The loss share agreement provides that the loss is calculated as follows for (a) a loss on foreclosure, (b) a loss from restructuring, and (c) a loss from short sale:

(a) The **foreclosure loss** is the difference between the unpaid principal balance (plus reimbursable expenses and interest) after the last paid installment and the total cash recovery;

(b) The **loss from restructuring** is the difference between the unpaid principal balance (plus reimbursable expenses and interest) prior to loan modification and the Net Present Value (NPV) of the estimated cash flows as calculated under the agreement assuming no default or prepayment until end of the loan term;

(c) A **short sale loss with no preceding loan modification** is the difference between the unpaid principal balance (plus reimbursable expenses and interest) and the total cash recovery.

A **short sale loss after a loan modification** is the difference between the NPV of projected cash flows at the time of the modification (plus principal payments after the modification and reimbursable expenses and interest) and the total cash recovery.

Among the assets transferred are three promissory notes secured by real estate. At the acquisition date, the promissory notes had a book value in the hands of Failed Bank equal to the following remaining principal balances:

- Note A: $100,000
- Note B: $200,000
- Note C: $300,000

The total remaining principal balance at the acquisition date of all other assets acquired equals $11,000,000.

<u>Allocation of purchase price among assets</u>

Step 1:
The guaranteed values of the acquired assets is as follows:

- Note A: $80,000 (80% of $100,000)
- Note B: $160,000 (80% of $200,000)
- Note C: $240,000 (80% of $300,000)
- Other assets: $8,800,000 (80% of $11,000,000)

Step 2:
The total combined guaranteed value of all assets is $9,280,000 (80% of $11,600,000), which is the sum of the guaranteed values in Step 1 above.

Step 3:

The purchase price of $10,000,000 minus the $9,280,000 guaranteed value of the acquired assets is $720,000.

Step 4:
The $720,000 amount is ratably allocated among the assets. The allocation is calculated for each Note as follows:

- Note A: ($80,000/$9,280,000) * $720,000 = $6,207
- Note B: ($160,000/$9,280,000) * $720,000 = $12,414
- Note C: ($240,000/$9,280,000) * $720,000 = $18,621
- Other assets: ($8,800,000/$9,280,000) * $720,000 = $682,759

Result:
The guaranteed value calculated in Step 1 plus the amount allocated among the assets in Step 4 for each asset:

- Note A: $80,000 + $6,207 = $86,207
- Note B: $160,000 + $12,414 = $172,414
- Note C: $240,000 + $18,621 = $258,621
- Other assets: $8,800,000 + $682,759 = $9,482,759

Promissory Note A (Foreclosure loss)

Acquiring Bank receives proceeds of $85,000 from a foreclosure sale.

- At the time of the foreclosure sale, and after $20,000 in principal payments were received after acquisition the remaining principal balance of the loan equals $80,000.
- Related to the foreclosure sale, Acquiring Bank incurs reimbursable expenses (e.g., foreclosure costs, title search, filing fees, property protections costs, inspection, attorney's fees, etc.) totaling $8,000 and accrues $2,000 of interest.

Allocation of Loss Share Payment for Foreclosure Loss on Promissory Note A
Under the loss share agreement, the FDIC's required payment is based on a $5,000 loss ($85,000 foreclosure proceeds – $80,000 principal balance-$8,000 expenses - $2,000 interest). Thus, the FDIC payment due is $4,000 (80% of the $5,000 loss) allocated as follows:

- Because the reimbursable expenses and interest exceed the amount of the loss, the $4,000 loss sharing payment is applied ratably between the reimbursable expenses and interest (80% reimbursable expenses and 20% reimbursable interest).
- $3,200 (80% of $4,000) of this loss sharing payment is attributable to reimbursable expenses and is included in Acquiring Bank's gross income.
- $800 (20% of $4,000) of the loss sharing payment is attributable to interest accrued after the acquisition and is included in Acquiring Bank's gross income.

Calculation of Net Gain for Promissory Note A
Based on the allocation of the total purchase price among assets, Acquiring Bank paid $86,207 (see calculation of this allocation above) for the asset and received

principal payments of $20,000 after acquisition, resulting in a basis of $66,207. Acquiring Bank has a gain of $18,793 on the foreclosure of Promissory Note A after subtracting the basis of $66,207 from $85,000 in proceeds, as shown in the table below.

Promissory Note B (Loan Modification & Short Sale After Modification)

The loan is modified, reducing the interest rate for the borrower.

- At the time of the modification, and after $25,000 in principal payments were received after acquisition, the remaining principal balance of the loan equals $175,000.
- The NPV of projected cash flows at the time of the modification is $135,000.
- Acquiring Bank incurs reimbursable expenses (e.g., tax and insurance advances, third-party fees) totaling $1,000 and accrues $2,800 of interest.
- In a later tax period, Acquiring Bank receives proceeds of $85,000 in a short sale after receiving $5,000 in principal payments. Related to the short sale, Acquiring Bank incurs reimbursable expenses (e.g., tax and insurance advances, third-party fees, borrower incentive fees) of $3,000.

Allocation of Loss Share Payment for Restructuring of Promissory Note B

Under the loss share agreement, the FDIC's required payment is based on a $43,800 restructuring loss ($135,000 NPV of projected future cash flows - $175,000 principal balance - $1,000 expenses - $2,800 interest). Thus, the FDIC payment due is $35,040 (80% of the $43,800 loss) allocated as follows:

- $800 (80% of $1,000) of this loss sharing payment is attributable to reimbursable expenses and is included in Acquiring Bank's gross income.
- $2,240 (80% of $2,800) of the loss sharing payment is attributable to interest accrued after the acquisition and is included in Acquiring Bank's gross income.
- The remaining $32,000 is treated as a reduction in the bank's basis in the loan.

Allocation of Loss Share Payment for Short Sale loss on Promissory Note B (after restructuring)

Under the loss share agreement, the FDIC's required payment is based on a $48,000 restructuring loss ($85,000 short sale proceeds **-** $135,000 NPV of projected future cash flows **+** $5,000 principal payments after modification **-** $3,000 expenses). Thus, the FDIC payment due is $36,000 (80% of the $48,000 loss) allocated as follows:

- $2,400 (80% of $3,000) of this loss sharing payment is attributable to reimbursable expenses and is included in Acquiring Bank's gross income.
- The remaining $36,000 is treated as a reduction in the bank's basis in the loan.

Calculation of Net Gain for Promissory Note B

Based on the allocation of the total purchase price among assets, Acquiring Bank paid $172,414 (see calculation of this allocation above), and the $32,000 basis reduction from the loss sharing payment, along with $25,000 in principal payments after acquisition, reduces the basis to $115,414 at the time of the loan modification. At the time of the loan modification, there is no gain, and the reduced basis will apply to future disposition of the note.

For the short sale, the $115,414 adjusted basis after the loan modification is reduced by the $5,000 in principal payments after the modification and by $36,000 from the loss sharing payment related to the short sale, resulting in a basis of $74,414. Acquiring Bank has a gain of $10,586 on the foreclosure of Promissory Note A after subtracting the basis of $74,414 from $85,000 in proceeds, as shown in the table below.

Promissory Note C (Short Sale)

Acquiring Bank receives proceeds of $210,000 in a short sale.

- At the time of the short sale, after $10,000 in principal payments were received after acquisition, the remaining principal balance of the loan equals $290,000.
- Related to the short sale, Acquiring Bank incurs reimbursable expenses (e.g., third-party fees, borrower incentive fees) totaling $4,000, and accrues $6,000 of interest.

Allocation of Loss Share Payment for Promissory Note C

Under the loss share agreement, the FDIC's required payment is based on a $90,000 loss ($210,000 short sale proceeds - $290,000 principal balance - $4,000 expenses - $6,000 interest). Thus, the FDIC payment due is $72,000 (80% of the $90,000 loss) allocated as follows:

- $3,200 (80% of $4,000) of this loss sharing payment is attributable to reimbursable expenses and is included in Acquiring Bank's gross income.
- $4,800 (80% of $6,000) of the loss sharing payment is attributable to interest accrued after the acquisition and is included in Acquiring Bank's gross income.
- The remaining $64,000 is treated as a reduction in the bank's basis in the loan.

Calculation of Net Gain for Promissory Note C

Based on the allocation of the total purchase price among assets, Acquiring Bank paid $258,621 (see calculation of this allocation above) and the $64,000 basis reduction from the loss sharing payment acquisition, along with $10,000 reduction in principal payments after acquisition, reduced the basis to $184,621. Acquiring Bank has a gain of $25,379 on the short sale, as shown in the table below after subtracting the basis of $184,621 from the $210,000 proceeds.

The total net gain from Promissory Note A and Promissory Note C is $44,175. This gain is netted with other gains and losses from the sale of loans secured by real property during the period, but not to equal less than zero, to determine the amount included in the bank's gross income. The $10,586 gain from the Promissory Note B short sale will be included in the net gains in that subsequent tax period.

ALLOCATION OF PURCHASE PRICE AMONG ACQUIRED ASSETS

	Note A	Note B	Note C	Other Assets	Total
Principal Balance at Acquistion	$ 100,000	$ 200,000	$ 300,000	$ 11,000,000	$ 11,600,000
Guaranteed Value at Acquisition	$ 80,000	$ 160,000	$ 240,000	$ 8,800,000	$ 9,280,000
Proportion of Total Guaranteed Value	0.86%	1.72%	2.59%	94.83%	100%
Portion of Purchase Price Allocated to Asset	$ 86,207	$ 172,414	$ 258,621	$ 9,482,759	$ 10,000,000

CALCULATION OF LOSS FOR LOSS SHARE PAYMENT FROM FDIC

	Note A (Foreclosure)	Note B (Restructuring)	Note C (Short Sale)	Total	Note B (Short Sale after Restructuring)
Principal Balance at Date of Loss Sharing Event	$ 80,000	$ 175,000	$ 290,000	$ 545,000	$ 130,000 [4]
Reimbursable Expenses	$ 8,000	$ 1,000	$ 4,000	$ 13,000	$ 3,000
Reimbursable Interest	$ 2,000	$ 2,800	$ 6,000	$ 10,800	$ -
Gross Reimbursable Balance	$ 90,000	$ 178,800	$ 300,000	$ 568,800	$ 133,000
Foreclosure Sale Proceeds	$ 85,000	$ -	$ -	$ 85,000	
NPV of Projected Cash Flows after Loan Mod.	$ -	$ 135,000	$ -	$ 135,000	
Short Sale Proceeds	$ -	$ -	$ 210,000	$ 210,000	$ 85,000
Total Loss (Gross Reimbursable Balance)	$ 5,000	$ 43,800	$ 90,000	$ 138,800	$ 48,000
Total Loss Share Payment (80% xTotal Loss)	$ 4,000	$ 35,040	$ 72,000	$ 111,040	$ 38,400
Allocated to Reimbursable Expenses (80%)[1]	**$ 3,200** [2]	**$ 800**	**$ 3,200**	**$ 7,202**	**$ 2,400**
Allocated to Reimbursable Interest (80%)[1]	**$ 800** [2]	**$ 2,240**	**$ 4,800**	**$ 7,842**	**$ -**
Allocate remainder to reduce principal/basis	$ -	$ 32,000	$ 64,000	$ 96,000	$ 36,000

CALCULATION OF NET GAIN REALIZED ON LOSS SHARING EVENT

	Note A (Foreclosure)	Note B (Restructuring)	Note C (Short Sale)	Total	Note B (Short Sale after Restructuring)
Purchase Price Allocated to Note (Initial Basis)	$ 86,207	$ 172,414	$ 258,621	$ 9,482,759	$ 115,414
Principal payments after acquisition/modif.	$ (20,000)	$ (25,000)	$ (10,000)	$ (55,000)	$ (5,000)
Principal reduction from Loss Share Payments	$ -	$ (32,000)	$ (64,000)	$ (96,000)	$ (36,000)
Adjusted Basis	$ 66,207	$ 115,414	$ 184,621	$ 366,241	$ 74,414
Proceeds from Disposition of Asset	$ 85,000	$ - [3]	$ 210,000	$ 295,003	$ 85,000
Gain/(Loss)	**$ 18,793**	$ - [3]	**$ 25,379**	**$ 44,175**	**$ 10,586**

[1] Amounts allocated to reimbursable expenses and to interest accrued after acquisition are included in gross income and subject to Washington B&O tax.

[2] Because the loss share payment is less than the reimbursable expenses, it is applied ratably among the reimbursable expenses and interest, and no amount is allocated to reduce principal/basis.

[3] Because Note B is only restructured, there are no proceeds at the time of the loss sharing event. The adjusted basis is used as the initial basis for the subsequent disposition the Note.

[4] For the subsequent short sale of Note B, the principal balance is the NPV of projected cash flows at the time of the modification, less principal payments after the modification.

*****