Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201311021**
Release Date: 3/15/2013

CC:ITA:B02:
POSTF-137228-11

UILC: 461.06-01, 461.01-06, 263.00-00

date: November 7, 2012

to: Associate Area Counsel
(Large Business & International)

from: Associate Chief Counsel
(Income Tax & Accounting)

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subject: Prepaid FDIC Assessments

This Chief Counsel Advice responds to your request for assistance dated August 9, 2012. This advice may not be used or cited as precedent.

We have reviewed your request and agree with its analysis and conclusions, with some modifications.

LEGEND

Taxpayer =
Banks =
$X =
$a =
$b =
$c =
$d =

ISSUE

Whether part of the prepaid assessment corresponding to the estimated FDIC assessments for the first, second, third, and fourth quarters of 20 is deductable for the taxable year 20 , and whether that part of the prepaid assessment corresponding to the estimated FDIC assessments for the first, second, third, and fourth quarters of 20 is deductable for the taxable year 20 .

CONCLUSION

The prepaid assessment is not deductible for either year because (1) it is part of a capital expenditure that must be taken into account over its useful life, and (2) it does not come within the 12-month rule of § 1.263(a)-4(f)(1) of the Income Tax Regulations.

FACTS

Taxpayer is the parent of a consolidated group of corporations. Among the members of Taxpayer's group are a number of banking subsidiaries (hereafter collectively the "Banks") whose deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The FDIC is a government corporation established by statute that administers a system that insures deposits at member banks and savings associations ("insured depository institutions").

Losses incurred on deposits insured by the FDIC are paid out of the Deposit Insurance Fund ("DIF"). The DIF is funded by assessments levied by the FDIC on insured depository institutions. Amounts assessed are calculated using a risk-based assessment system that applies an institution's assessment rate to the institution's assessment base. An institution's assessment rate is assigned to it by the FDIC and is calculated based on a formula that weighs various factors, such as the institution's CAMELS rating[1] and certain financial ratios and measurements. An institution's assigned assessment rate can change over time. An institution's assessment base is equal to its total deposit liabilities with certain adjustments. Assessments are assessed and paid on a quarterly basis. Assessments are paid on the 30th day of the third month following the end of the quarter for which they are paid (*e.g.*, the assessment for the quarter beginning January 1 and ending March 31 is paid on June 30). No later than fifteen days prior to the payment date, the FDIC provides the insured depository institution with a quarterly certified statement invoice showing the amount of the assessment due for the quarter, net of credits or dividends, if any. The quarterly certified statement invoice includes notice of the institution's current assessment rate.

By statute, each year the FDIC is required to designate a reserve ratio. The reserve ratio is the ratio of reserves held in the DIF to the aggregate insured deposits held by all insured depository institutions. Prior to the enactment of the Dodd-Frank Act in July of 2010, the designated reserve ratio could not be less than 1.15 percent nor greater than 1.5 percent. If the actual reserve ratio at the end of a calendar year exceeded 1.5 percent, the excess was to be refunded to the insured depository institutions in the form of a dividend, and if the reserve ratio was between 1.35 and 1.5 percent, half of the excess over 1.35 percent was to be refunded to the insured depository institutions as a dividend.[2]

[1] CAMELS = Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. A CAMELS rating is a method of evaluating the health of a financial institution.

[2] Effective July 21, 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act increased the minimum reserve ratio to 1.35 percent and eliminated both the maximum reserve

In 2009, the FDIC concluded that potential insolvencies of insured depository institutions resulting from the financial crises threatened to deplete the DIF. To restore the DIF to its statutorily mandated reserve ratio and to insure the fund's liquidity, the FDIC undertook a number of actions, among which was instituting a plan requiring insured depository institutions pay a "prepaid assessment." Specifically, on November 17, 2009, the FDIC promulgated 12 C.F.R. § 327.12 (2009) which required each insured depository institution to pay "a prepaid assessment, which shall equal its estimated quarterly risk-based assessments aggregated for the fourth quarter of 2009, and all of 2010, 2011, and 2012." 12 C.F.R. § 327.12(a). The prepaid assessment was required to be paid on December , 20 . The purposes for which the FDIC would use the prepaid assessment were explained as follows:

> Prepaid assessments shall only be used to offset regular quarterly risk-based deposit insurance assessments payable under this subpart A. The FDIC will begin offsetting regular quarterly risk-based deposit insurance assessments against prepaid assessments on March 30, 2010. The FDIC will continue to make such offsets until the earlier of the exhaustion of the institution's prepaid assessment or June , 20 . Any prepaid assessment remaining after collection of the amount due on June , 20 , shall be returned to the institution. If the FDIC, in its discretion, determines that its liquidity needs allow, it may return any remaining prepaid assessment to the institution prior to June , 20 .

12 C.F.R. § 327.12(e).

For purposes of calculating their estimated assessments for the fourth quarter of 20 and for 20 , 20 , and 20 , insured depository institutions were required to use their assigned assessment rates as in effect on September 30, 2009, and assume a percent annual growth in deposits. 12 C.F.R. § 327.12(b)(2)&(3). Paragraph (h) of the regulation provided that in the event an institution's insured status terminated or the institution failed, the unused portion of its prepaid assessment would be returned to the institution or the institution's receiver as the case may be. 12 C.F.R. § 327.12(h). Paragraph (f) of the regulation provided that an insured depository institution could enter into an agreement to transfer (although not pledge) any portion of the institution's prepaid assessment to another insured depository institution. 12 C.F.R. § 327.12(f).

For a number of reasons, an insured depository institution's actual assessment for a given quarter during the prepayment period could be either more or less than the amount estimated for that quarter. Additionally, if the FDIC determined that the DIF had sufficient liquidity, it could return unused prepaid assessments to the insured depository institutions. Accordingly, an institution might either have to make additional payments

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ratio and the requirement to refund excess reserves.

for the prepayment quarters or receive a refund of a portion of its prepaid assessment. As explained in the preamble to the final regulations:

> Events during the prepayment period, such as slower deposit growth or changes in CAMELS ratings, may cause an institution's actual assessments to differ from the pre-paid amount. Assessment billings will account for events that occur during the prepayment period and may result in an institution either paying assessments in cash before the prepayment period has concluded or ultimately receiving a rebate of unused amounts. . . .
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> Requiring prepaid assessments does not preclude the FDIC from changing assessment rates or from further revising the risk-based assessment system during 2009, 2010, 2011, 2012, or thereafter, pursuant to notice-and-comment rulemaking under 12 U.S.C. § 1817 (b)(1). Prepaid assessments made by insured depository institutions will continue to be applied against quarterly assessments as they may be so revised until the prepaid assessment is exhausted or the prepayment is returned, whichever comes first.
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> The FDIC will begin to offset prepaid assessments on March 30, 2010, representing payment of the regular quarterly risk-based deposit insurance assessment for the fourth quarter of 2009. Any prepaid assessment not exhausted after collection of the amount due on June 30, 2013, will be returned to the institution (rather than December 30, 2014, as provided in the proposed rule). If the FDIC determines its liquidity needs allow, it may return any remaining prepaid assessment to the institution sooner.

Final Prepaid Assessment Regulations, 74 Fed. Reg. 59056-01 (Nov. 17, 2009).

On December , 20 , the Banks paid a prepaid assessment totaling \$X. Of that amount, \$a represented the Banks' aggregate estimated assessments for the fourth quarter of 20 , \$b represented the Banks' aggregate estimated assessments for the first, second, third, and fourth quarters of 20 , \$c represented the Banks' aggregate estimated assessments for the first, second, third, and fourth quarters of 20 , and \$d represented the Banks' aggregate estimated assessments for the first, second, third, and fourth quarters of 20 . The amounts actually assessed for a given quarter for a given Bank generally varied significantly from the estimated assessment for that quarter. Even on an aggregate percentage basis, the variation between the estimated assessments and the actual assessments was significant, with the quarterly aggregate actual assessment as a percentage of the quarterly aggregate estimated assessment varying from a low of percent for the first quarter of 20 to a high of percent for the fourth quarter of 20 .

Relying on the 12-month rule of § 1.263(a)–4(f)(1), Taxpayer, through a Schedule M adjustment, claimed a deduction of $b on its 20 return for the portion of the prepaid assessment attributable to the Banks' estimated assessments for the first, second, third, and fourth quarters of 20 .[3] Taxpayer similarly claimed a deduction on its 20 return for the portion of the prepaid assessment attributable to the Banks' estimated assessments for the first, second, third, and fourth quarters of 20 .

LAW AND ANALYSIS

Section 461(a) of the Internal Revenue Code provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides that under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. *See also* § 1.446-1(c)(1)(ii)(A).

A liability is not incurred, and therefore is not deductible, until all three prongs of the test (fact of liability, amount of liability, and economic performance) are satisfied. However, the fact that a liability is incurred in a given taxable year does not necessarily mean that it is deductible in that year. Paragraph (a)(2)(i) of § 1.461-1, quoted above, goes on to provide:

> (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance). Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. . . . As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)), and may later affect the computation of taxable income through deprecation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary.

[3] Taxpayer also claimed on its 20 return a deduction of $a for the portion of the prepaid assessment attributable to the estimated assessments for the fourth quarter of 20 .

Likewise, the requirement that a liability not be deducted prior to the year in which it is incurred is not altered by the fact that liability otherwise comes within the 12-month rule. Treas. Reg. § 1.263(a)-4(f)(6) ("In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year . . .").

As Taxpayer paid the full amount of the prepaid assessment on December 30, 2009, Taxpayer's liability was incurred on that date. The prepaid assessment liability may not be taken into account as a deduction for either year (20 or 20) because it is part of a capital expenditure that must be taken into account over its useful life, and it does not come within the 12-month rule of § 1.263(a)-4(f)(1).

I. <u>The Prepaid Assessment Must Be Capitalized</u>.

Although the prepaid assessment was a liability incurred by Taxpayer in 20 , the portion thereof attributable to the estimated assessments for 20 would not be deductible in 20 , nor would the portion thereof attributable to the estimated assessments for 20 be deductible in 20 . The reason is the prepaid assessment must be capitalized, both because it was an "amount paid to created an intangible" and because it was "an amount paid to create a separate and distinct intangible asset." Section 1.263(a)-4(b)(1)(ii)&(iii).

Section 1.263(a)–4(b)(1)(ii)&(iii) provides that a taxpayer must capitalize, *inter alia*:

> (ii) An amount paid to create an intangible described in paragraph (d) of this section;
> (iii) An amount paid to create or enhance a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section;

The prepaid assessment falls within both subparagraphs (b)(1)(ii) and (b)(1)(iii). Paragraph (d) of § 1.263(a)–4 provides that except as provided in paragraph (f) (relating to the 12-month rule discussed below) "a taxpayer must capitalize amounts paid to create an intangible described in this paragraph (d)." Among the intangibles that are described in paragraph (d) and which therefore must be capitalized are prepaid expenses, certain memberships and privileges, and certain rights obtained from a governmental agency. Section 1.263(a)–4(d)(3)(i) states in part that a taxpayer must capitalize prepaid expenses. Section 1.263(a)–4(d)(4)(i) states in part that a taxpayer must capitalize amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization. Section 1.263(a)–4(d)(5)(i) states in part that a taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights … or other similar rights granted by that government agency.

Subparagraph (d)(3)(ii) provides two examples of prepaid expenses that must be capitalized, the first of which is as follows –

> *Prepaid insurance.* N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The $10,000 is a prepaid expense and must be capitalized under this paragraph (d)(3).

This is consistent with long-standing case law that requires accrual basis taxpayers to capitalize payments for insurance coverage extending substantially beyond the end of the close of the taxable year. *See*, *e.g.*, *Johnson v. Commissioner*, 108 T.C. 448, 487-488 (1997), *aff'd in part and rev'd in part*, 184 F.3d 786 (8th Cir. 1999) (premiums paid for excess loss coverage on vehicle service contracts capitalized to extent allocable to years subsequent to payment); *Higginbotham-Bailey-Logan Co. v. Commissioner*, 8 B.T.A. 556, 577 (1927) (portion of insurance premiums paid for insurance coverage in years subsequent to payment capitalized). It is also consistent with § 1.461-4(g)(8), Example 6(ii), dealing with the all events test, which provides that even when economic performance is met with respect to the payment of an insurance premium, "[t]he period for which the [amount of the premium] is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year."

The prepaid assessment must also be capitalized on the basis that it is an "amount paid to create or enhance a separate and distinct intangible asset." Paragraph (b)(3) of § 1.263(a)–4 defines the term "separate and distinct intangible asset" as:

> [A] property interest of ascertainable and measurable value in money's worth that is subject to protection under the applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restriction imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

The prepaid assessment constitutes a separate and distinct intangible asset as defined by paragraph (b)(3) because it is a fund that, under the applicable FDIC regulations, can revert to the Taxpayer. Treating the prepaid assessment as a separate and distinct asset is also consistent with *Commissioner v. Lincoln Savings and Loan Ass'n*, 403 U.S. 345 (1971), wherein the Supreme Court determined that an analogous FSLIC assessment was a separate asset that must be capitalized.

III. <u>No Part of the Prepaid Assessment is Currently Deductible under the 12-Month Rule</u>.

Taxpayer apparently does not dispute that the prepaid assessment must be capitalized, but rather argues that under the 12-month rule of Treas. Reg. § 1.263(a)-4(f)(1), the portion of the prepaid assessment equal to the estimated assessments for 20 is deductable in 20 , and the portion of the prepaid assessment equal to the estimated assessments for 20 is deductable in 20 . Section 1.263(a)-4(f)(1) provides that:

> Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of –
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> (i) 12 months after the first date on which taxpayer realizes the right or benefit; or
> (ii) The end of the taxable year following the taxable year in which the payment is made.

Thus, in order for the prepaid assessment to be deductible under the 12-month rule, the right or benefit created by the prepaid assessment must not extend beyond the earlier of 12 months after the first date on which the Taxpayer realized the right or benefit (*i.e.*, the date deposit insurance coverage paid for by the prepaid assessment was first in effect) or the end of the taxable year following the year of payment (*i.e.*, December , 20).

The prepaid assessment was available to satisfy any quarterly assessments beginning with that for the fourth quarter of 20 and extending through that for the fourth quarter of 20 . Thus the benefit or right created by the prepaid assessment extended to December 31, 20 , which is well beyond either 12 months after the first date on which Taxpayer realized a right or benefit from the payment (October , 20 , the beginning of the fourth quarter of 2009) or the end of the taxable year following the year of payment (December , 20). The prepaid assessment simply does not come within the terms of the 12-month rule. *See* § 1.263(a)-4(f)(8), Ex. 1 (insurance premium paid on December 1 for 12-months of coverage beginning the following February 1 not deductible under 12-month rule).

The Taxpayer's position is tenable only if the prepaid assessment is treated as 13 separate and distinct advance payments made for the 13 quarters beginning with the fourth quarter of 20 and ending with the fourth quarter of 20 . It is clear from the regulations instituting the prepaid assessment, however, that the prepaid assessment was a single, unitary amount, not a series of separate amounts corresponding to 13 separate quarters. The regulation instituting the prepaid assessment required every insured institution to pay "*a* prepaid assessment, which shall *equal* its estimated quarterly risk-based assessments *aggregated* for the fourth quarter of 20 , and all of 20 , 20 , and 20 ." 12 C.F.R., § 327.12(a)(emphasis added). While the amount of the payment was calculated by reference to the aggregate of the estimated

assessments for 13 quarters, the prepaid assessment was a single amount. The FDIC required, and Taxpayer made, a single payment. The FDIC did not require, and the Taxpayer did not make, 13 separate quarterly payments.[4]

More importantly, until the prepaid assessment was exhausted, the whole of it could be drawn upon to satisfy any assessment for any quarter through the fourth quarter of 20 . If the actual assessment due for a given quarter was less than the projected assessment for the quarter, there was no refund of excess; rather the entire remaining balance of the prepaid assessment was available to pay the next quarter's assessment. Conversely, if the actual assessment due for a given quarter was more than the projected assessment for the quarter, the amount paid out of the prepaid assessment was not limited to the estimated assessment for the quarter. Taxpayer would not receive a refund unless the aggregate of the actual assessments was less than the amount of prepaid assessment. The prepaid assessment was not segregated by quarter, but rather was a unitary amount, the whole of which was available to satisfy the assessment for any quarter through the fourth quarter of 20 . The benefit or right created by the prepaid assessment therefore likewise extended through the fourth quarter of 20 . There is no basis upon which to carve out some portion of the prepaid assessment and treat it as a separate payment for 20 or 20 .[5]

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[4] Even assuming that the prepaid assessment should be treated as 13 separate advance payments, it is not clear how the advance payments for 2011 could be deductible in 2010 under the 12-month rule. An amount cannot be deductible under the 12-month rule if the taxpayer's "right or benefit" extends beyond the end of the taxable year following the taxable year in which the payment is made. Section 1.263(a)-4(f)(1)(ii). The right or benefit associated with any advance payments for 20 (deposit insurance coverage during the year 2011) would clearly extend beyond December 31, 20 , the end of the taxable year following the taxable year in which the payment was made.

[5] The preamble to the final regulations show that the FDIC recognized that the prepaid assessment as structured was a unitary amount, no part of which would be currently deductible. The preamble states:

> Many commenters have suggested that the FDIC structure the invoicing and collection of prepaid assessments to maximize the tax benefits to insured depository institutions. This would include working with the IRS to adjust certain tax rules. [footnote discussing Treas. Reg. § 1.263(a)-4(d)(3)(i) omitted] Suggested structures included: allowing institutions to deduct all prepaid assessment in 20 for income tax purposes and invoicing, and collecting prepaid assessments two or three times (in 20 , 20 and/or 20) to allow institutions to deduct prepaid amounts earlier. Subchapter S institutions are particularly concerned with this issue.
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> Under the final rule, institutions will continue to be able to deduct quarterly assessments at least as quickly as they have in the past. The FDIC structured the prepaid assessment requirement for DIF liquidity needs and believes that using prepaid assessments will not result in any worse tax treatment than banks would have absent prepayment.

Even assuming for the sake of argument that the prepaid assessment should be recharacterized as 13 separate prepayments of 13 quarterly assessments, the amounts in question would still not be deductible under the 12-month rule due to the effect of the renewal period provisions of § 1.263(a)-4(f)(5). Section 1.263(a)–4(f)(5)(i) provides that "[f]or purposes of paragraph (f)(1) of this section [the general 12-month rule], the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal." Thus, even if the prepaid assessment is treated as a series of separate quarterly prepayments, the duration of the rights created by any given prepayment will includes all 13 quarters if the facts and circumstances in existence at the time the prepayments were made "indicate a reasonable expectancy of renewal" of the Taxpayer's participation in the deposit insurance system throughout the prepayment period. That there was a reasonable expectancy of renewal necessarily follows from the fact that the FDIC required the Taxpayer, through the mechanism of the prepaid assessment, to prepay an amount equal to the aggregate of the Taxpayer's estimated assessments through the fourth quarter of 20 . In a fundamental sense, renewal was automatic and would happen unless the Taxpayer ceased to be an insured institution. Accordingly, all 13 quarters must be included in the benefit period for each prepayment, and the benefits of the prepayments made for 20 and 20 all extend through December , 20 , thus precluding the prepayments from qualifying for the 12-month rule.

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Please call (202) 622-7900 if you have any further questions.

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Final Prepaid Assessment Regulations, 74 Fed. Reg. 59056-01 (Nov. 17, 2009).