Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202224011**
Release Date: 6/17/2022

CC:FIP:BR1:SMWARD
POSTU-119464-19 &
POSTU-109057-20

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 597.05-01, 197.00-00, 166.00-00

date: March 10, 2022

to: Area Counsel (Area 4)
(Large Business & International)
Attn: Harold Dantes-Castillo, Attorney, CC:LBI:4:MIA

from: Robert Martin
Senior Technician Reviewer, Branch 6
(Financial Institutions & Products)

---

subject: Recoverability of Misreported Section 597 Income from Closed Years

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

LEGEND

Taxpayer	=
Failed Bank	=
REIT	=
Agency	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Year 1	=

Year 2	=
Year 3	=
Year 4	=
Year 5	=

ISSUE

Whether Taxpayer, which acquired Failed Bank in Year 2 as part of a section 597 Taxable Transfer for which Taxpayer mistakenly included income in closed years due to erroneous computations under section 1.597-5(d)(2)(iii) of the Income Tax Regulations (the "Time-Barred Section 597 Income"), may recover the Time-Barred Section 597 Income in open tax years by increasing its adjusted basis in certain mortgage servicing rights (the "MSR") that Taxpayer alleges it acquired from Failed Bank, and by claiming deductions under section 166 or 197 of the Internal Revenue Code (the "Code") with respect to the MSR.

CONCLUSION

Taxpayer is not entitled to the deductions claimed with respect to the MSR under section 166(a) or section 197 because Taxpayer's misreporting of the Time-Barred Section 597 Income does not increase adjusted basis in the MSR. Taxpayer's argument repeats an argument that Taxpayer made previously (i.e., that the Time-Barred Section 597 income created basis that Taxpayer could recover in subsequent taxable years). The Service rejected that argument in prior advice. See Field Attorney Advice Memorandum 20180601F (October 25, 2017) (the "FAA").

Moreover, Taxpayer has not established that it is entitled to a deduction under section 166(a) because it has not established that the MSR constitutes bona fide "debt" that became worthless in Year 3, nor has Taxpayer established that it is entitled to an amortization deduction under section 197 with regard to the MSR because Taxpayer has not established that it held the MSR as a section 197 intangible in Year 5 or any subsequent year.

FACTS

I. The Year 2 Taxable Transfer

Taxpayer was a bank for purposes of section 581(a) for all relevant tax years in issue. Taxpayer's misreporting of the Time-Barred Section 597 Income has its genesis in Taxpayer's acquiring, in Year 2, certain assets and liabilities of Failed Bank, which was then under the receivership of Agency. This Year 2 acquisition (hereinafter, the "Year 2 Taxable Transfer") was expressed in a standard Purchase and Assumption Agreement ("P&A") that incorporated two loss-share agreements (each an "LSA" and collectively, "LSAs") whereby Agency agreed to reimburse Taxpayer for losses on certain "covered assets." The LSAs constituted "Federal Financial Assistance" under section 597(c) and section 1.597-1(b), and the Year 2 Taxable Transfer was a "Taxable Transfer" for purposes of section 1.597-5(a).

A. The Purchase and Assumption Agreement (P&A)

The P&A reflects the typical terms and conditions of a standard Agency purchase and assumption agreement. With few exceptions, Taxpayer acquired "all right, title, and interest of the [Agency] in and to all of the assets (real, personal, and mixed, wherever located and however acquired) of the Failed Bank whether or not reflected on the books of the Failed Bank as of [the Date Failed Bank was closed]." In consideration for its acquisition of Failed Bank's assets, Taxpayer accepted many of Failed Bank's duties, obligations, and liabilities, including liability for Failed Bank's deposits in the amount of Amount 1. Among the acquired assets were all the outstanding shares of stock in REIT, which the P&A reflects as a subsidiary of Failed Bank. REIT in turn held loans (the "REIT Loans") that, Taxpayer represents, were covered under the LSA.

Taxpayer asserts that the MSR (explained in further detail below) held by Failed Bank was among the assets that it acquired as part of the Taxable Transfer. Neither the MSR nor the REIT Loans are mentioned expressly in the P&A.

B. The Loss-Share Agreements (LSAs)

As explained previously, the P&A incorporates two LSAs. One of these LSAs covered certain "Single-Family Shared-Loss Loans" (the "Residential LSA"). The other LSA covered Taxpayer's assumption of certain commercial and other loans (the "Commercial LSA"). Each LSA included materially identical terms and conditions, which expressly supersede any conflicting terms and conditions in the P&A. Loss sharing was limited to expressly described loans (the "LSA Loans"). Under the LSAs, Agency generally agreed to reimburse taxpayer for Amount 3 of the first Amount 4 of losses on LSA Loans and Amount 5 of any additional losses.

Each LSA required Taxpayer (or an entity in Taxpayer's control) to undertake reasonable efforts to mitigate losses on the LSA Loans. Article III of each LSA makes Taxpayer responsible to the Agency for certain administrative duties with respect to the LSA Loans. Specifically, section 3.1 of each LSA provides that Taxpayer "shall (and shall cause any of its Affiliates[1] to which [Taxpayer] transfers any [Shared Loss] Loans to) manage, administer, and collect the [Shared Loss] Loans while owned by [Taxpayer] or any Affiliate thereof during the term of this [LSA] in accordance with the rules set forth in this Article."

Section 3.2 of the LSA sets forth the rules for Taxpayer in performing its duties under Article III. The Residential LSA required Taxpayer to (among other things) "manage and administer each [identified LSA Loan] in accordance with [Taxpayer]'s usual and

[1]For purposes of section 3.1 (and the LSAs generally), an "Affiliate" of Taxpayer generally includes (among others) any "person" (defined generally as an entity or natural person) who is "directly or indirectly controlling, or controlled by, or under direct or indirect common control with" Taxpayer.

prudent business and banking practices and Customary Servicing Procedures." The Commercial LSA imposed a similar obligation on Taxpayer.

II. The Year 1 Mortgage Servicing Rights

Taxpayer directs our attention to a particular mortgage servicing agreement, dated as of Year 1, between Failed Bank and REIT (the "MSR Agreement"). The MSR Agreement provides that REIT purchased from Failed Bank, for Amount 6 and "other good and valuable consideration," a 100% participation interest in the benefits and obligations of specified mortgage loans (the "MSR Loans").

Failed Bank retained the MSR for the MSR Loans, comprising (1) a duty to service the MSR Loans and (2) a right to a monthly fee equal to a fraction of the average outstanding principal of the MSR Loans. The Fee was determined as the product of (1) the average monthly principal amounts of the outstanding MSR Loans, (2) Amount 7 basis points, and (3) the number of days in the month divided by 365. Assuming a constant outstanding principal, this fee would amount to Amount 7 basis points for each twelve-month period (excluding leap days).

The MSR Agreement defines the MSR Loans as any "obligation of a Borrower(s) to repay [Failed Bank] an amount evidenced by a Promissory Note(s) and other Loan Documents." For this purpose, the MSR Agreement defines "Borrower", "Note" and "Loan Documents" as the borrower, promissory note, and loan documents, respectively, in connection with an MSR Loan.[2] A schedule attached to the MSR Agreement lists the MSR Loans as of the date of the MSR Agreement; that schedule, however, does not list any loans. Taxpayer has not produced any other documentation expressly identifying any MSR Loans that existed and remained outstanding as of the execution of the P&A (or any time thereafter).

The MSR with respect to an MSR Loan terminated no later than upon the discharge of the MSR Loan (if any), but it was also terminable at an earlier date under certain conditions. REIT could, by notice to Failed Bank, terminate the MSR Agreement if (among other things) Failed Bank was placed under receivership, or assigned the MSR without REIT's written consent.[3] The MSR Agreement expressly stated that REIT's right to enforce these provisions (and any other provision) was not waived or otherwise affected by REIT declining to enforce the provisions at an earlier time. As explained above, Taxpayer maintains the MSR was among the assets that it acquired from Failed Bank.

Taxpayer liquidated REIT in Year 3, and Taxpayer maintains that it received the REIT Loans that REIT held at the time.

---

[2]"Promissory Note" is not a defined term in the agreement.

[3] Relatedly, Failed Bank agreed that it would not transfer its MSR without first obtaining REIT's consent.

III. Taxpayer's Reporting and Position(s) after Year 2 Taxable Transfer

In the taxable year it acquired Failed Bank's assets (Year 2), and in each relevant year thereafter, Taxpayer filed a consolidated federal income tax return on behalf of a consolidated group of which Taxpayer is the parent. Pursuant to section 1504(b)(4), REIT was not a member of this consolidated group, and Taxpayer otherwise treated REIT as a separate taxable entity for purposes of applying the REIT qualification requirements under section 856.

Taxpayer represents that it mistakenly reported the Time-Barred Section 597 Income due to it misapplying section 597 and the accompanying regulations to the Year 2 Taxable Transfer. Taxpayer correctly determined the Year 2 Taxable Transfer was a taxable transfer for purposes of section 597, but Taxpayer incorrectly determined that it directly acquired the REIT Loans—instead of the REIT stock—for purposes of section 597. Taxpayer concluded that the REIT Loans were Class II assets, and mistakenly computed acquisition basis in those REIT Loans based on their "highest guaranteed value." See Treas. Reg. § 1.597-5(c)(3)(ii). This, in turn, generated an amount of section 597 income (the "Section 597 Income"), which Taxpayer began including ratably in income over six years, i.e., each of Year 2 through Year 4. See Treas. Reg. § 1.597-5(d)(2)(iii) (requiring acquirers of failed bank assets to account for deemed acquisition basis in excess of acquirer's cost by taking the difference into account as ordinary income over six years). Taxpayer, when it created the account to report the Section 597 Income, did not implement a mechanism to subsequently amortize, depreciate, deduct, or otherwise recover that income.

Taxpayer acknowledges that it should have allocated the purchase price only to those loans that it actually acquired from Failed Bank and its consolidated subsidiaries. Upon recognizing its mistake, Taxpayer requested (and the Service agreed) that Taxpayer was not required to report the remaining six-year portion of the Section 597 Income attributable to open years. Taxpayer did not, however, file a timely claim for refund or credit for the Time-Barred Section 597 Income (i.e., the Section 597 Income that was reported on returns for Year 2 through Year 3).

Taxpayer, having failed to obtain a refund or credit on account of the Time-Barred Section 597 Income, takes the position that such income must be allocated to tax basis in the MSR and is recoverable in a subsequent tax year. The Service rejected a nearly identical argument in the previously-issued FAA, which held that Taxpayer's reporting of the Time-Barred Section 597 Income resulted in a permanent change to Taxpayer's lifetime income, and thus was not a method of accounting for a material item under Treas. Reg. § 1.446-1(e)(2)(ii)(a), and did not give rise to a section 481(a) adjustment that would offset the Time-Barred Section 597 Income. The FAA sets forth the Service's conclusion as follows at p. 7:

> A review of the long-term, lifetime effect on taxable income reveals that the Taxpayer's erroneous inclusion of Section 597 income results in a change to the Taxpayer's lifetime taxable income. The Taxpayer

> acknowledges that it did not implement a mechanism to subsequently amortize, depreciate or deduct its phantom basis and that such basis was used for the sole purposes of measuring the Taxpayer's Section 597 income amount and was ignored for all other tax purposes. Likewise, there is no mechanism by which the Taxpayer may deduct the cost of its phantom basis in an asset it did not acquire. Upon disposition of its banking business, the Taxpayer will not be entitled to a loss stemming from its erroneously included Section 597 income. [Text omitted]. The Taxpayer's reported Section 597 income is an error, not a material item, so that a section 481(a) adjustment is inappropriate.

Taxpayer is now effectively seeking reconsideration of the FAA's conclusion that the Time-Barred Section 597 Income resulted in a permanent difference to Taxpayer's income. Taxpayer previously claimed that the Time-Barred Section 597 Income gave rise to recoverable "phantom" tax basis in the REIT Loans—a claim that the FAA explicitly rejected under the theory that a taxpayer does not, by erroneously including income, obtain basis in property that it did not acquire. Taxpayer now attempts to render the FAA inapplicable by claiming that it has recoverable "phantom" basis in property that Taxpayer in fact acquired. Namely, Taxpayer now claims the Time-Barred Section 597 Income gives rise to "phantom" basis in the MSR, which Taxpayer may recover under section 166(a) for Year 3 or section 197 beginning in Year 5. We continue to agree with the conclusions set forth in the FAA that Taxpayer's erroneous inclusion of Section 597 Income results in a change to Taxpayer's lifetime taxable income, and is not a material item for which a method change or section 481(a) adjustment is appropriate.

LAW AND ANALYSIS

Generally, each tax year stands on its own. Flour Mills Co. v. Commissioner, 321 U.S. 281, 286 (1944); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). If a taxpayer believes it has reported too much income for a prior year, it may submit a claim for refund or credit with respect to that year. See § 6511(a); see also § 6402(a). But Congress has limited the period of time during which such claims may be filed (pursuant to section 6511(b)(1)), and a taxpayer cannot circumvent the period of limitations by deducting in an open tax year a claimed over-inclusion of income from a closed tax year. See, e.g., Commissioner v. Mnookin's Est., 184 F.2d 89, 92-93 (8th Cir. 1950) (observing that mistaken omission from income does not nullify statute of limitations); Brady v. Commissioner, 136 T.C. 422, 428 (2011) (explaining that alleged overpayments in a time barred year cannot be used to offset tax liability in an open year).

1. No Basis Allocable to the MSR, Consistent with the Reasoning of the FAA

Taxpayer claims, as it claimed in the FAA, that the Time-Barred Section 597 Income creates recoverable "phantom" tax basis. Taxpayer distinguishes its present claim from that made in the FAA by now seeking to attribute the "phantom" basis to the MSR, which (unlike the REIT Loans) Taxpayer claims it in fact acquired. We disagree. The FAA correctly explains that the event giving rise to the Time-Barred Section 597 Income occurred in the year of the Year 2 Taxable Transfer, and in a manner that permanently altered Taxpayer's lifetime income. By asserting that its basis in the MSR is increased by the amount of the Time-Barred Section 597 Income, Taxpayer is again arguing that there was no permanent change to Taxpayer's lifetime income—an argument that the Service rejected in the FAA.

Taxpayer's repeated claims for "phantom" basis appear to reflect an unstated plea for equity. Namely, Taxpayer appears to conclude that, if Taxpayer cannot now seek a refund to recover the Time-Barred Section 597 Income by operation of section 6511(a), then the equities dictate that Taxpayer should get some deduction in a later tax year.

The FAA implicitly rejected any plea for equitable basis, and we explicitly endorse that rejection. Basis, like the period of limitations in section 6511, is a statutory construct. See Easson v. Commissioner, 294 F.2d 653, 658 (9th Cir. 1961) (reversing the Tax Court's decision that a literal reading of the Code was improper if it led to the creation of negative basis); see also United States v. Brockamp, 519 U.S. 347, 352-53 (1997) (noting that "the nature and potential magnitude of the administrative problem" created by making an "equitable" exception to section 6511 "suggest that Congress decided to pay the price of occasional unfairness in individual cases (penalizing a taxpayer whose claim is unavoidably delayed) in order to maintain a more workable tax enforcement system"). We cannot permit Taxpayer to create a non-statutory exception to the period of limitations through a recovery of "phantom" basis.

In any event, we do not think that our enforcing a period of limitations is inherently inequitable. The Code's periods of limitations prevent the government and taxpayers alike from being subject to ever renewable litigation of aged facts and the tax items predicated thereon. Discussing the purpose of statutes of limitations generally, the Supreme Court has observed that "[t]he theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them." Ord. of R.R. Telegraphers v. Ry. Express Agency, 321 U.S. 342, 349 (1944); see also Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 301-03 (1946) (citing R.R. Telegraphers in the context of a tax refund suit to explain that it is the role of Congress, not the courts, to create and limit exceptions to the statute of limitations). Creating a non-statutory exception to section 6511 in this case would undermine the government's sound interest in repose in similarly situated cases. Congress apparently thought that the benefit of any such exception could not justify its cost. See Brockamp, 519 U.S. at 352-53. We see no reason to disagree.

2. Taxpayer Has Not Satisfied the Requirements of Section 166 or 197

Taxpayer claims it can deduct an amount up to its basis in the MSR (adjusted upward for the "phantom" basis) because the MSR is: (a) a bona fide debt that became worthless for purposes of section 166(a) in Year 3 when the MSR ceased to exist after REIT's liquidation, or alternatively; (b) an amortizable section 197 intangible continuing through Year 5 and after. Assuming, arguendo, the some or all of the Time-Barred Section 597 Income could be allocated to Taxpayer's basis in the MSR, we disagree that Taxpayer is entitled to deductions under section 166(a) or 197.

a. No Worthless Debt

Taxpayer contends that the "phantom" basis it attributes to the MSR is deductible for Year 3 as a worthless debt deduction, because the MSR is a bona fide debt that became worthless in Year 3. See § 166(a). We reject Taxpayer's claim on its merits[4] because (i) Taxpayer has not established that MSR (or any portion of the MSR) is a bona fide debt, and (ii) Taxpayer has not established that the MSR became worthless in Year 3.

i. No Debt

Section 166(a) does not permit deduction for worthless property except to the extent that the property constitutes bona fide debt. See Treas. Reg. § 1.166-1(c). A mortgage servicing right (like the MSR) is not generally a bona fide debt to the extent it constitutes reasonable compensation for services that the holder is required to perform. See Rev. Rul. 91-46, 1991-2 C.B. 358, 359. However, the Service has treated a mortgage servicing right as having a debt component (i.e., as a stripped coupon from the underlying mortgage under section 1286) to the extent the servicer retains a right to "excess servicing" payments that are not reasonably allocable to services. See Rev. Rul. 91-46, 1991-2 C.B. at 359.

We see no component of the MSR servicing fee that may be treated as excess servicing, and therefore debt. The MSR appears to impose standard servicing duties in return for compensation equal to roughly Amount 7 basis points on outstanding principal. This rate of compensation does not exceed the Service's safe harbor for a reasonable rate, see Rev. Proc. 91-50, sec. 4.02(1), 1991-2 C.B. 778, and Taxpayer has not provided any support for treating the MSR as anything other than fully allocable to reasonable compensation for services.[5] Consequently, we conclude that no portion of the MSR constitutes bona fide debt that could serve as the basis for Taxpayer's claim for a deduction under section 166.

ii. No Worthlessness in Year 3

[4] You have asked whether Taxpayer's claim for refund for Year 3 on account of the bad-debt deduction is timely with respect to Year 3. The claim itself is timely, because Taxpayer filed a return for Year 3, and the claim was filed within seven years from the date prescribed by law for filing the Year 3 tax return (determined without regard to extensions). See Treas. Reg. § 301.6511(d)-1(a)(1)(ii). In any event, we reject Taxpayer's claim on its merits.

[5] Indeed, Taxpayer did not report any amount of the servicing fees allegedly received under the MSR as a stripped coupon under section 1286.

Assuming for purposes of discussion that Taxpayer had established that some portion of the MSR is bona fide debt, we turn to whether section 166 permits Taxpayer to claim a bad debt deduction for Year 3. Section 166(a) allows a deduction for a tax year only if the debt *becomes* wholly or partially worthless within that tax year. Whether (and when) a debt becomes worthless is a factual question for which Taxpayer bears the burden of proof. See Estate of Mann v. United States, 731 F.2d 267, 275 (5th Cir. 1984); see also Treas. Reg. § 1.166-2(a).

Taxpayer maintains that the liquidation of REIT and Taxpayer's receipt of the MSR Loans "extinguished" the MSR and rendered the MSR "worthless." Even assuming that some component of the MSR was debt, the REIT liquidation did not render that debt worthless (for lack of collectability or otherwise). Rather, any debt component of the MSR (i.e., the excess servicing payments) would constitute stripped coupons from the MSR Loans, and any worthlessness regarding stripped coupons from the MSR Loans would depend upon the performance of the MSR Loans. Taxpayer has provided no evidence that the MSR Loans were worthless at any time during Year 3, and, likewise, Taxpayer has provided no evidence that rights to interest coupons stripped from the MSR Loans were worthless during Year 3.

We also question whether the MSR became worthless in a year prior to Year 3. Taxpayer contends the MSR must have had some value during Year 3, because Taxpayer received Amount 2 in service fees from REIT in that year. It is unclear whether those Year 3 servicing fees were paid under the MSR. The MSR Agreement only granted rights to Failed Bank with respect to specifically identified loans, none of which are in fact identified in the MSR Agreement. Nor has Taxpayer provided any other documentation to establish that any loans were subject to the MSR Agreement, much less that any such loans remained outstanding as of Year 3. Lastly, the MSR was apparently cancellable at REIT's election at any time after Failed Bank entered receivership in Year 2.[6] For the foregoing reasons, we conclude that Taxpayer has not established worthlessness of debt for Year 3 with respect to any component of the MSR.

b. No section 197 intangible as of Year 5

"A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible." § 197(a). Taxpayer has not established the MSR

---

[6] Taxpayer appears to believe the Residential LSA somehow renewed the MSR (or otherwise created a new mortgage servicing right) because that LSA "augmented * * * several provisions" of the MSR. But Taxpayer cites just one such "provision," which Taxpayer describes as requiring, "as a condition to entitlement to any loss sharing," that Taxpayer "manage and administer each [Loan subject to loss sharing] in accordance with [Taxpayer's] usual and prudent business and banking practices and Customary Servicing Procedures." And we see no reason why a mortgage servicing *right* is created or supplemented merely because Taxpayer was subjected to a mortgage servicing *obligation* that appears fully compensable by Agency agreeing to share in the losses of the serviceable loans.

constituted a section 197 intangible in the hands of Taxpayer for Year 5 or after.

Mortgage servicing rights may not constitute a section 197 intangible unless they are "acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than [mortgage servicing rights]) constituting a trade or business or substantial portion thereof." § 197(e)(6). Generally, all mortgage servicing rights acquired in the same transaction or in a series of related transactions are treated as a single asset (the pool) for purposes of determining deductions for depreciation and gain or loss on disposition. Treas. Reg. § 1.167(a)–14(d)(2)(i).[7]

We question Taxpayer's section 197 claim for essentially the same reasons that we question Taxpayer's claim that the MSR first became worthless in Year 3. See supra Part 2.a.ii. Taxpayer has not shown the MSR was an outstanding asset as of the Year 2 Taxable Transfer, much less at any later time. See id. Nor does Taxpayer contend that the MSR was treated as part of a pool of mortgage servicing rights acquired in the Year 2 Taxable Transfer, much less that such pool remained outstanding as of Year 5. Cf. Treas. Reg. § 1.167(a)–14(d)(2)(i).[8]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-4451 if you have any further questions.

By: _____________________________
Robert A. Martin
Senior Technician Reviewer, Branch 6
(Financial Institutions & Products)

[7] "If the taxpayer establishes multiple accounts within a pool at the time of its acquisition, gain or loss is recognized on the sale or exchange of all mortgage servicing rights within any such account." Treas. Reg. § 1.167(a)–14(d)(2)(ii).

[8] Taxpayer has not proposed (much less established) that its disposition of the MSR (assuming Taxpayer acquired it) is disregarded in favor of an increase in other adjusted bases that are amortizable and deductible under section 197 for Year 14 or after. Cf. § 197(f)(1)(A). Indeed, Taxpayer has not established any basis in the MSR.

cc: Deputy Division Counsel
(Large Business & International)
Attn: Robin Greenhouse