APPEALS INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY:	**Savings & Loan**
ISSUE:	**Supervisory Goodwill**
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Settlement Guideline
Supervisory Goodwill

ISSUES

1. Whether supervisory goodwill is covered by I.R.C. § 597.

2. Whether taxpayers can establish a tax basis in supervisory goodwill.

3. Whether taxpayers are entitled to losses under I.R.C. § 165 with respect to supervisory goodwill based upon worthlessness, abandonment or confiscation.

4. Whether taxpayers are entitled to depreciation or amortization deductions under I.R.C. § 167 with respect to supervisory goodwill.

COMPLIANCE DIVISION POSITION

1. Supervisory goodwill is a creature of regulatory accounting and is not financial assistance provided by the Federal Savings and Loan Insurance Corporation under § 406(f) of the National Housing Act. Therefore, supervisory goodwill does not qualify as "money or other property" under § 597.

2. Taxpayers cannot establish that they have a tax basis in supervisory goodwill because, generally, thrift acquisitions were tax-free transactions and the taxpayers took a carryover basis in the acquired assets. Consequently, no basis was assigned to regulatory intangibles such as supervisory goodwill at the time of the acquisitions. Further, the taxpayers' assertion of tax basis on Forms 1120X is insufficient to establish that tax basis in supervisory goodwill exists.

3. Since taxpayers cannot establish that tax basis in supervisory goodwill exists, they are not entitled to § 165 losses based upon worthlessness, abandonment or confiscation. Moreover, even if a taxpayer were able to establish a tax basis in supervisory goodwill, that taxpayer must affirmatively establish that it met the other requirements of § 165 for the loss as claimed in the tax years for which the amended returns were filed.

4. Taxpayers cannot establish a tax basis in supervisory goodwill and, therefore, they are not entitled to deductions under § 167 for depreciation or amortization with respect to supervisory goodwill. Even if a taxpayer could establish a tax basis in supervisory goodwill, that taxpayer must affirmatively establish that it satisfied Newark Morning Ledger's requirements before it would be entitled to such deductions. However, even if a taxpayer could satisfy all of the requirements with respect to supervisory goodwill, the taxpayer is not entitled to deductions under § 167 with respect to supervisory goodwill that result from the

taxpayer's use of an amended return to effectuate an impermissible retroactive change in method of accounting.

TAXPAYER POSITION

1. Taxpayers take the position that supervisory goodwill qualifies as other property for purposes of § 597 and is a form of financial assistance provided by the Federal Savings and Loan Insurance Corporation under § 404(f) of the National Housing Act. As such, the asset was properly excluded from gross income pursuant to § 597(a).

2. Taxpayers take the position that § 597 applies to provide a source from which basis can be said to derive.

3. Taxpayers argue that they are entitled to claim a loss under § 165(a) in the year in which their supervisory goodwill was abandoned, deemed worthless, or confiscated. Further, even though taxpayers may have filed lawsuits against the Federal government for damages relating to the loss of the use of supervisory goodwill, any damages ultimately received do not constitute "compensation" derived for a "claim for reimbursement" within the meaning of Reg. §1.165-1(d)(2)(i). Furthermore, taxpayers argue there was no reasonable prospect of recovery even though lawsuits may have been filed.

4. As an alternative to their argument under § 165, taxpayers claim entitlement to amortization deductions under § 167. Taxpayers claim that they have an ascertainable tax basis in supervisory goodwill and that this asset has a limited useful life that could be ascertained with reasonable accuracy. The enactment of FIRREA established a useful life for supervisory goodwill that could be reasonably and accurately measured. Taxpayers argue that the enactment of FIRREA and the promulgation of regulations by the Office of Thrift Supervision phasing out the use of supervisory goodwill on a sliding scale basis from 1990 through 1994 altered the indeterminate life of the tax asset.

DISCUSSION

Background/Facts

The Savings & Loan Crisis of the 1980s

For a more detailed discussion of the origins of the Savings & Loan crisis and its impact on regulatory accounting issues involving insolvent institutions, see United States v. Winstar Corporation, et al, 518 U.S. 839, 844-858 (1996), and the sources cited therein.[1] The following discussion summarizes the salient facts for purposes of framing the tax issue denominated as "supervisory goodwill."

1 All subsequent references to Winstar are to the Supreme Court's opinion unless otherwise noted.

The Federal Home Loan Bank Board ("FHLBB" or "Bank Board") was created in 1932 by the Federal Home Loan Bank Act to channel funds to the savings and loan ("thrift") industry for loans on houses and for preventing foreclosures on them. The FHLBB required that thrifts maintain adequate capital reserves as a cushion against losses. The Federal Savings & Loan Insurance Corporation ("FSLIC") was created in 1934 by the National Housing Act to insure deposits and regulate the thrift industry. The FSLIC, upon appointment, was authorized to act as receiver or conservator for a defaulted insured institution.

In the late 1970's and early 1980's, high interest rates created a crisis in the thrift industry. High interest rate payments to depositors on short-term obligations exceeded low interest rate revenue from long-term home mortgages. Hundreds of thrifts found themselves facing insolvency. At the beginning of the crisis, the FSLIC, as insurer, provided financial assistance in the form of cash to failing thrifts and their acquirers. Later in the crisis when the FSLIC's funds began running short, the FSLIC provided a combination of cash and notes in an effort to keep thrifts from failing. Further into the crisis, when the FSLIC itself struggled with the insolvency of the savings and loan insurance fund, an accounting arrangement known as "supervisory goodwill" was developed to minimize the amount of cash outlay by the FSLIC to resolve institutions in receivership.

The FHLBB encouraged healthy thrifts and investors to take over failing thrifts through "supervisory mergers". The principal inducement for these mergers was an understanding that the acquisitions would be subject to a "special accounting treatment" that would help the acquiring institution to meet its capital reserve requirements. The FHLBB allowed these supervisory mergers to be accounted for under the purchase method of accounting where the assets and liabilities were recorded using fair market value. Under the purchase method of accounting, any excess of the purchase price (including liabilities assumed) over the fair market value of the identifiable assets acquired was designated as goodwill. The resulting goodwill in these supervisory mergers was generally referred to as "supervisory goodwill."

When the acquiring thrifts assumed liabilities that exceeded the fair market value of the assets acquired, these supervisory mergers gave rise to a deficit or negative net worth. FSLIC did not have sufficient cash in many cases to make up these deficits. To alleviate the insolvent condition presented in many of these mergers, the acquiring thrifts were allowed to use "special accounting treatments" either in lieu of direct financial assistance or in addition to direct financial assistance. One of the special accounting treatments allowed by the FHLBB permitted the resulting thrifts to count the supervisory goodwill for purposes of meeting their reserve/regulatory capital requirements and to amortize it for regulatory purposes over the applicable period used by the acquirer for book under GAAP (up to 40 years maximum).

The supervisory goodwill was generally recorded as an amortizable asset on the balance sheet of the acquiring institution for financial book purposes, and the institution then amortized the supervisory goodwill for both financial book and regulatory purposes. The supervisory goodwill was taken into account in determining whether the thrifts had sufficient capital reserves to meet regulatory requirements. Capital reserves, expressed as a percentage of total assets, serve as a cushion against losses. By allowing the supervisory goodwill to be accounted for in this manner, thrifts that otherwise would have been impaired or insolvent for regulatory purposes remained in compliance. Thus, as pointed out in the Coordinated Issue Paper ("CIP"), supervisory goodwill represented a form of "regulatory forbearance" that relieved taxpayers of otherwise applicable regulatory capital requirements.[2]

In 1989, Congress noted that this special accounting treatment actually worsened the thrift crisis. In August 1989, Congress enacted the Financial Institutions Reform, Recovery & Enforcement Act, Pub. L.101-73 ("FIRREA") which phased out, over a five-year period, the thrifts' ability to count supervisory goodwill for the purpose of meeting regulatory capital reserve requirements. Beginning in 1989, the thrift capital requirements were generally revised to reflect the elimination of supervisory goodwill by December 31, 1994. In some cases, a thrift may have written off the balance of the supervisory goodwill prior to 1994.

As a result of the change in law, many financial institutions immediately fell out of compliance with regulatory capital requirements, subjecting them to seizure by thrift regulators. Over one hundred financial institutions filed actions against the United States ("U.S.") asserting that the government breached contractual promises to allow thrifts to count supervisory goodwill for the purpose of meeting regulatory requirements. The breach of contract issue reached the Supreme Court in Winstar. The Court held that the U.S. was contractually obligated to permit financial institutions to use special accounting treatments with regard to their acquisitions of failing thrifts pursuant to agreements with the federal thrift regulatory agencies. The Court further held that the U.S. breached those contractual obligations when the agencies barred the use of those methods pursuant to FIRREA. The Court remanded the Winstar case to the Court of Appeals for the Federal Circuit for further proceedings to determine the appropriate amount of damages. (At the time of the writing of this guideline, there were over one hundred Winstar-type damage claim cases (hereafter "damage claim cases") pending in either the Court of Appeals for the Federal Circuit or the Court of Federal Claims.)

Subsequent Tax Claims

At the time of the supervisory mergers, the acquiring thrifts did not assign any tax basis to the supervisory goodwill. The mergers were treated for federal income tax purposes as nontaxable reorganizations pursuant to § 368(a)(1) and the acquiring thrifts took a carryover basis in the acquired assets of the insolvent thrifts pursuant to § 362. The

[2] The CIP suggests that the tax analysis contained therein applies, generally, to other regulatory rights such as the right to operate branches across state lines.

carryover tax basis of these assets generally exceeded the fair market value of the assets.[3] In many cases, shortly after the mergers, the acquiring institutions either sold the assets at a loss for tax purposes, or wrote them off for tax purposes.

On original tax returns, taxpayers did not record any supervisory goodwill as a tax asset attributable to the acquisition.

On amended returns, some taxpayers have claimed that the contractual "right to use" the purchase method of accounting, along with the resultant purchased goodwill, results in a tax asset also denominated as supervisory goodwill. Taxpayers believe that this tax asset of supervisory goodwill qualifies as other property for purposes of § 597. Under § 597, financial assistance received from the FSLIC in a supervisory merger is not includible in income, nor is a reduction in basis of other assets required.

These tax claims are premised on the theory that the supervisory goodwill recorded for book purposes by the acquiring thrift on the acquisition of a failing thrift should have been assigned a tax basis. Taxpayers state that a tax basis for supervisory goodwill has been established through the mechanics of § 597. Taxpayers typically claim an abandonment loss occurred as a result of the enactment of FIRREA which phased out the ability to count supervisory goodwill for purposes of calculating regulatory capital. In most cases, the abandonment loss has been claimed for tax year 1994. In some instances, taxpayers have claimed they are entitled to amortization deductions over the useful life of the asset.

Legal Analysis

Issue (1) Whether supervisory goodwill is covered by I.R.C. § 597
and
Issue (2) Whether taxpayers can establish a tax basis in supervisory goodwill[4]

The Nature of Supervisory Goodwill

The Supreme Court recognized that regulatory and statutory accounting gimmicks played a principal role in the thrift crisis. See Winstar at 845 and 846 (referring to H.R. Rep. No. 101-54, pt. 1, pp. 297-298). Supervisory goodwill is the product of such accounting gimmicks. But, supervisory goodwill, even though the offspring of such accounting gimmicks, produced real financial accounting and regulatory consequences of benefit for the acquiring thrifts, mainly because they were allowed to use supervisory goodwill to meet regulatory capital requirements. Thus, the right to treat supervisory goodwill as regulatory capital had real value to the acquiring thrifts that booked it for financial and regulatory purposes. At footnote 6 of the Winstar decision, supervisory goodwill is described from a regulatory perspective "as kind of the engine that made this

[3] Since the carryover tax basis of the assets acquired presumably exceeded the fair market value of such assets, it would appear that any purchased goodwill was reflected in the higher tax basis.
[4] For discussion purposes, Issues (1) and (2) can be combined. Taxpayers acknowledge that in order to establish tax basis, § 597 must apply to supervisory goodwill.

transaction go . . . [b]ecause without it, there wouldn't have been any train pulling out of the station, so to speak."

Following are various excerpts drawn from the Winstar opinion that describe the nature of supervisory goodwill and its significance to the thrift industry:

> Because FSLIC had insufficient funds to make up the difference between a failed thrift's liabilities and assets, the Bank Board had to offer a "cash substitute" to induce a healthy thrift to assume a failed thrift's obligations. [Pages 849, 850.]
>
> [T]he treatment of supervisory goodwill as regulatory capital was attractive because it inflated the institution's reserves, thereby allowing the thrift to leverage more loans (and, it hoped, make more profits). [Page 851.]
>
> Indeed, the rationale for recognizing goodwill stands on its head in a supervisory merger: ordinarily, goodwill is recognized as valuable because a rational purchaser would not pay more than assets are worth; here, however, the purchase is rational only because of the accounting treatment for the shortfall. [Citation omitted.] In the end, of course, such reasoning circumvented the whole purpose of the reserve requirements, which was to protect depositors and the deposit insurance fund. As some in Congress later recognized, "[g]oodwill is not cash. It is a concept, and a shadowy one at that. When the Federal Government liquidates a failed thrift, goodwill is simply no good. It is valueless. That means, quite simply, that the taxpayer picks up the tab for the shortfall." [Citation to the Congressional Record omitted.] [S]ee also White 84 (acknowledging that in some instances supervisory goodwill "involved the creation of an asset that did not have real value as protection for the FSLIC"). Pages 854-855.
>
> "[To] a considerable extent, the size of the thrift crisis resulted from the utilization of capital gimmicks that masked the inadequate capitalization of thrifts." [Citation omitted.] [Page 857.]
>
> In the present case, the Government chose to regulate capital reserves to protect FSLIC's insurance fund . . . . The regulation thus protected the Government in its capacity analogous to a private insurer, the same capacity in which it entered into supervisory merger agreements to convert some of its financial insurance obligations into responsibilities of private entrepreneurs. In this respect, the supervisory mergers bear some analogy to private contracts for reinsurance. [Footnote omitted.] [Page 894.]

Supervisory goodwill was significant to an acquiring institution for two reasons. First, the acquiring institution was permitted by thrift regulators to count supervisory goodwill toward its reserve requirements. This treatment inflated the thrift's reserves, allowing the thrift to leverage more loans. Second, the regulators allowed the goodwill to be amortized over a long period (40 years in some cases). The long write-off period allowed an acquiring thrift to seem more profitable than it in fact was. See Winstar at 850-851.

Statutory Framework & Legislative History of § 597

Section 597 was added to the Code by § 244 of the Economic Recovery Tax Act of 1981, P.L. 97-34 (Aug. 13, 1981). Section 597 has been amended a number of times since 1981. Generally, for the tax years in which supervisory goodwill is an issue, § 597(a) provided as follows:

> (a) Exclusion from Gross Income. --- Gross income of a domestic building and loan association does not include any amount of money or other property received from the Federal Savings and Loan Insurance Corporation pursuant to section 406(f) of the National Housing Act (12 U.S.C. sec. 1729(f)[5]), regardless of whether any note or other instrument is issued in exchange therefore.

Section 597(b) provided:

> (b) No reduction in Basis of Assets. --- No reduction in the basis of assets of a domestic building and loan association shall be made on account of money or other property received under the circumstances referred to in subsection (a).

Section 246(c) of the Act made § 597 of the Code applicable "to any payment made on or after January 1, 1981."

Under § 406(f) of the National Housing Act (as amended by the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469 (Oct. 15, 1982)), the FSLIC was authorized to provide assistance to insured thrift institutions that encountered severe financial conditions. Specifically, in order to prevent the default of such institutions, the FSLIC was authorized "to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured institution." 12 U.S.C. § 1729(f)(1). The FSLIC, in order to facilitate a merger or consolidation of an insured institution as defined by statute, was further authorized: to purchase any such assets or assume any such liabilities; to make loans or contributions to, or deposits in, or purchase the securities of, such other insured institution; and to guarantee such other institution against loss. See 12 U.S.C. § 1729(f)(2).

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[5] Section 1729(f) was repealed in 1989 by FIRREA. The repeal coincided with major changes made by FIRREA including the replacement of the FSLIC by the Federal Deposit Insurance Corporation ("FDIC"), and the replacement of the FHLBB by the Office of Thrift Supervision ("OTS").

Section 1729(f) of 12 U.S.C. does not make any reference to “supervisory goodwill” or “favorable regulatory consideration allowing goodwill to be counted as an asset for regulatory capital purposes”. The terms “loans”, “deposits”, “purchase”, and “contributions” reflected in the statute suggest that Congress intended for financial assistance to mean payments of money or money equivalents (such as promissory notes).

The legislative history to § 244 of the Act supports a conclusion that § 597 covers only financial assistance such as payments of money or money equivalents. The Conference Report supporting the enactment of Section 597 states:

> Under present law, contributions to capital by nonshareholder[s] are excluded from the income of a recipient corporation (see 118), but the basis of property is reduced by such contribution (sec. 362(c)).
>
> The bill excludes from income of [an insured thrift] all money or property contributed to the thrift institution by [the FSLIC] under its financial assistance program without reduction in basis of property. The amendment applies to assistance payments whether or not the association issues either a debt or equity instrument in exchange therefore . . . .

H.R. Conf. Rep. No. 97-215, 97th Cong., 1st Sess. 284 (1981).

There is nothing in the congressional reports to indicate that the term “money or other property” includes favorable regulatory treatment of supervisory goodwill.

Some Taxpayer Arguments

Notwithstanding that neither the statute nor the congressional reports say anything about § 597 applying to supervisory goodwill, taxpayers’ position is that supervisory goodwill does qualify as other property. Taxpayers argue that § 597(a) does not contain exclusions for certain types of property, and that the IRS was not given by statute any regulatory authority to limit or carve out exceptions for certain types of property.

In some instances, the statement has been made by taxpayers that supervisory goodwill was **contributed** to acquiring or acquired institutions to induce and facilitate the acquiring institution’s participation in supervisory mergers. This characterization of supervisory goodwill having been **contributed** (thus equating the **contribution** of supervisory goodwill to a **contribution** of, for example, cash or notes) is misleading. The regulatory agencies did not have a storehouse of available goodwill to contribute to an acquiring institution during a supervisory merger. Supervisory goodwill was not something that could have been transferred from an agency to a taxpayer. Supervisory goodwill, in and of itself, did not constitute a contract. Supervisory goodwill by itself was the excess of the fair market value of liabilities over the fair market value of assets acquired as determined under the purchase method of accounting. Without the use of the special accounting treatment (that is, the ability to count the goodwill toward reserve requirements and long term amortization), the goodwill recorded for book purposes would have been of little use to an acquiring thrift.

Taxpayers also argue that the FSLIC and the FHLBB used supervisory goodwill to guarantee acquiring institutions against loss. A guaranty is normally thought of as a pledge by which one person commits to the payment of another's debt or the fulfillment of another's obligation in the event of default. The contractual right to count supervisory goodwill in meeting capital reserve requirements fell far short of a commitment to pay the debts of the acquiring institution. If supervisory goodwill constituted a guaranty as the taxpayer argues, the widespread use of it would likely have aggravated the thrift crisis far sooner. Congress ultimately eliminated the use of supervisory goodwill arrangements with the enactment of FIRREA. It is hard to view supervisory goodwill as a guaranty when it has been characterized by others as a "shadowy concept" and an "accounting gimmick."

Taxpayers also may characterize supervisory goodwill as being similar to net worth certificates because the supervisory goodwill was used in supervisory mergers for the same reasons that net worth certificates were used: to induce healthy institutions' participation in supervisory mergers, to provide assistance to increase the acquired thrift's net worth, and to minimize any losses to the acquiring institution as a result of the acquired thrift's poor financial condition. Net worth certificates represented a promise by the FSLIC to pay money to the acquiring institution at some future date. Supervisory goodwill required no future payment of money by FSLIC. While it is agreed that both were used to induce healthy institutions' participation in supervisory mergers, there is a large difference between money and a note on the one hand and a "special accounting treatment" on the other. The fact that both affected capital reserve requirements is not determinative as to whether supervisory goodwill is property within the meaning of § 597.

Taxpayers also argue that the total or face amount of the supervisory goodwill is automatically the amount of such "property" eligible for exclusion under § 597. Taxpayers' argument does not distinguish the face amount of the supervisory goodwill from the value of the **ability** to use such face amount toward capital reserve requirements. The ability to use the amount of supervisory goodwill toward capital reserve requirements and the ability to amortize the amount was the contractual obligation that the Winstar court addressed.

Taxpayers note that contract rights held by a taxpayer ordinarily constitute "property" for income tax purposes. The Service does not necessarily disagree with this statement. The threshold question, however, is whether the contract right to count supervisory goodwill for regulatory capital is "other property" for purposes of § 597. A second question concerns the value of this contract right.

FHLBB vs. FSLIC

Because the FSLIC had insufficient funds to make up the difference between a failed thrift's liabilities and assets, the special accounting treatment was offered as a "cash substitute" to induce a healthy thrift to assume a failed thrift's obligations. The CIP states:

> Supervisory goodwill, however, resulted from grants of regulatory forbearance by the FHLBB, not the FSLIC. [Footnote omitted.] Even though the FSLIC was authorized to enter into assistance agreements in connection with the acquisitions at issue, it was the FHLBB from whom taxpayers sought and received permission to use the purchase method of accounting and to count any resulting goodwill towards their regulatory capital requirements as supervisory goodwill. Thus, supervisory goodwill is also not covered by § 597 because it was not provided by FSLIC.

The CIP says that a comparison of two sections of the Economic Recovery Tax Act of 1981 support treating the FSLIC and the FHLBB as separate entities. Section 241 of the Act states that for purposes of § 368(a)(3)(D) relating to agency receivership proceedings involving financial institutions, the term "Board" means the FHLBB or the FSLIC. On the other hand, section 244 which deals directly with § 597, refers only to the exclusion from gross income of money or other property received from the FSLIC.

Taxpayers refer to language in the Winstar decision to rebut Compliance's position. At page 890, the Court states:

> There is no question . . . that the Bank Board [the FHLBB] and FSLIC had ample statutory authority [to promise] to permit respondents to count supervisory goodwill and capital credits toward regulatory capital and to pay respondents' damages if that performance became impossible. The organic statute creating FSLIC as an arm of the Bank Board, 12 U.S.C. § 1725(d) (1988 ed.) (repealed 1989), generally empowered it "[t]o make contracts" [Footnote omitted] and § 1729(f)(2), enacted in 1978, delegated more specific powers in the context of supervisory mergers.

Also at page 890, the Court states:

> Nor is there any reason to suppose that the breadth of this authority was not meant to extend to contracts governing treatment of regulatory capital. . . . [And,] there is no serious question that FSLIC (and the Bank Board acting through it) was authorized to make the contracts in issue.

Taxpayers rely on this language in the Winstar opinion in arguing that the FSLIC was authorized to offer cash substitutes, such as the special accounting treatment, to healthy thrifts in the context of the supervisory mergers.

Taxpayers also cite to12 U.S.C. § 1730h(d) as support for the idea that Congress specifically recognized the FSLIC's authority to permit thrifts to count supervisory goodwill toward capital requirements when it modified the National Housing Act in 1987. Section 1730h(d), prior to repeal in 1989, stated:

> No provision of this section shall affect the authority of the [FSLIC] to authorize insured institutions to utilize subordinated debt and goodwill in meeting reserve and other regulatory requirements.

This statutory provision, although enacted in 1987, refers specifically to the FSLIC's authority in authorizing insured institutions to use goodwill in meeting reserve and other regulatory requirements. Whether the FHLBB, the FSLIC, or the two combined were authorized to offer the cash substitute is not entirely clear. At page 850 in Winstar, the Court recognizes that, because the FSLIC lacked sufficient funds, "the Bank Board had to offer a 'cash substitute' to induce a healthy thrift to assume a failed thrift's obligations." In these types of cases, however, the FHLBB ratified the merger and incorporated a resolution into a "Supervisory Action Agreement." The resolution referred to a stipulation that any goodwill arising from the transaction shall be determined and amortized in accordance with FHLBB Memorandum R-31b (the "Memorandum"). The Memorandum permitted the acquiring institution to use the purchase method of accounting and to recognize goodwill as an asset subject to amortization.

The statutory provision at issue, § 597, refers only to the FSLIC. Congress could have easily added the FHLBB to the language in the statute. A logical explanation for the exclusion of the FHLBB from the statute is that, at the time the statute was enacted in August 1981, the FSLIC was authorized to make loans, deposits, contributions, and provide other forms of financial assistance but was not otherwise empowered to provide regulatory relief from the FHLBB's established capital requirements. Alternatively, supervisory goodwill may not have been perceived as a "cash substitute" in August 1981.

Whether supervisory goodwill was authorized by the FSLIC or the FHLBB is not entirely clear. The Supreme Court's language and § 1730h(d) of the National Housing Act noted above appear to support the idea that the FSLIC authorized acquiring institutions to count supervisory goodwill toward capital requirements. See Winstar at 891.

Is Supervisory Goodwill "Other Property" for Purposes of § 597?

Whether the FSLIC or the FHLBB authorized the use of supervisory goodwill seems less important than whether the special accounting treatment qualifies as financial assistance pursuant to § 597. Section 597 refers to financial assistance received from the FSLIC, and the applicable provision under title 12 generally refers to "loans, deposits, purchases, and contributions." The failure of either statutory provision (or its relevant legislative history) to include the "special accounting treatment" at issue here as a form of financial assistance places the taxpayer at a disadvantage on the issue of whether supervisory goodwill is covered by § 597.

The amount of supervisory goodwill recorded by an acquiring institution (i.e. liabilities in excess of assets on a fair value basis) was the computational result of the merger being accounted for under the purchase method of accounting. Supervisory goodwill does not resemble a “loan”, “deposit”, “purchase”, “contribution”, or “guarantee” as those terms are used in § 597. Neither is the special accounting treatment a loan, deposit, purchase, etc. Whether the special accounting treatment is “other property” within the meaning of § 597 is questionable. Even if it were, it is unlikely that the value of the special accounting treatment equals the amount of supervisory goodwill recorded by the acquiring institution.

Taxpayers observe somewhat incidentally that if supervisory goodwill received by an acquiring institution from the FSLIC had not been excluded from gross income under § 597, such property would have been taxable. We do not necessarily agree with this observation. Although under § 61 gross income means all income from whatever source derived, in a number of cases the creation of property rights under a government regulatory arrangement has not resulted in gross income to the recipient. This is true even though in some cases, the rights are transferable, have an ascertainable value, and are acquired at no cost or for a negligible fee. See, for example, GCM 39606 (Feb. 27, 1987) (opining that the receipt of airport takeoff and landing rights is not an event that results in the realization of gross income). The GCM posits that the value of rights conferred by a governmental body in furtherance of government regulatory policies does not give rise to taxable income. Whether agreements between the FHLBB/FSLIC and acquiring institutions that furthered the regulators’ duty of requiring thrifts to maintain adequate capital reserves could give rise to gross income is highly questionable. In our opinion, § 597 was not intended to create income with respect to an item that otherwise would not have been an item of gross income within the meaning of § 61. We do not agree that supervisory goodwill would have been viewed as an income item in the absence of § 597.

Taxpayers’ position is that the face amount of the supervisory goodwill booked by the acquiring institution represented its fair market value. As mentioned earlier, the amount of goodwill resulting from a supervisory merger represented the excess of the fair market value of the liabilities over the fair market value of the assets of the acquired thrift. This figure was a **negative** net worth figure that appeared on the asset side of the balance sheet, but it certainly wasn’t an asset in the traditional sense. It wasn’t something that could have been independently transferred or sold in the marketplace. It also wasn’t something that could have been acquired independently of the merger. The figure represented a plug on the balance sheet and, in our opinion, there is little rationale for saying that the fair market value of such an item was equal to the amount booked.

Taxpayers state that it was widely known in the thrift industry that supervisory goodwill was a valuable intangible that could be obtained in the context of supervisory mergers.

It is irrational, say taxpayers, to think that acquiring institutions would have been willing to assume millions of dollars of excess liabilities without receiving something of value in return. Thus, they argue, the government created supervisory goodwill as a “cash substitute” and intended that it take the place of cash, notes, and other financial assistance that the FSLIC was unable to provide.

The valuable asset was not so much the supervisory goodwill, the negative net worth figure, but the right to use the special accounting treatment and the right to count supervisory goodwill toward capital reserve requirements. Yet, taxpayers’ position equates the value of these rights to the full amount of supervisory goodwill. If the acquiring institution had a choice of receiving cash or an equal amount of supervisory goodwill, it is irrational to think that the acquirer would have preferred the supervisory goodwill. The right to use the special accounting treatment and the right to count supervisory goodwill toward regulatory capital requirements were of some value to an acquiring institution in the context of a supervisory merger. See Winstar at 850.

A review of some of the pending litigation involving Winstar damage claim cases is helpful with respect to the issue of whether supervisory goodwill, or more precisely the right to use supervisory goodwill to meet capital reserve requirements, had a value equal to its face amount. Various plaintiffs have filed suit against the U.S. government in connection with the breach of contract issue.[6] The Court of Federal Claims and the Court of Appeals for the Federal Circuit have determined that supervisory goodwill represented a bargained-for promise from the government that had real economic value. For example, in Glass v. U.S., 47 Fed. Cl. 316 (2000), the Court of Federal Claims awarded $2,100,000 in damages to the plaintiff-intervenor FDIC, as successor to the breach of contract claims of the defunct thrift. The Court of Federal Claims concluded that this was the value of the supervisory goodwill capital destroyed by the government’s breach. On appeal, the Court of Appeals for the Federal Circuit reversed the lower court’s decision and vacated the damage award on the ground that the FDIC lacked standing to intervene in the case. U.S. v. Glass, 258 F.3d 1349 (July 24, 2001). Although a final outcome has not yet been reached in this case, the proceedings involving the valuation of supervisory goodwill are informative.

The face amount of supervisory goodwill in Glass was about $6,400,000 at the date of the contract, or acquisition date. Plaintiff FDIC’s economic expert, Dr. Arnold Heggestad, testified at trial that the cash value of supervisory goodwill is less than 100% of its face because, first, the goodwill becomes less as it is amortized and, second, goodwill is not negotiable or transferable, it cannot be invested, and it has no potential to increase. He determined that the value of the goodwill at the date of contract was about $2,500,000. He determined the value by calculating the amount of direct cash assistance the FSLIC would have had to provide in place of the supervisory goodwill. The benefit of having supervisory goodwill on the books is that it provides cash

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[6] Plaintiffs include acquiring institutions, shareholders of failed institutions and, in some cases, the FDIC, as successor in interest to some of the acquiring institutions that went into receivership as a result of FIRREA.

flow. The replacement of cash flow is what Dr. Heggestad's model sought to replicate using the hypothetical of a preferred stock issuance. The government, as defendant in the case, argued that the replacement cost of an asset is not necessarily related to the value of the asset to the company. In the FDIC's Memorandum in Support of Its Cross-Motion for Summary Judgment on Selected Damage Issues and in Opposition to Defendant's Motion for Summary Judgment, the FDIC noted that the defendant's expert in another damage claim case (referred to as Glendale), Dr. Ruback (who was dropped before trial), "first articulated the basic approach to valuing goodwill that the FDIC's expert, Dr. Heggestad, is presenting in this case."

Information from the damage claim cases is somewhat helpful in that the courts have generally concluded, in the context of a breach of contract action, that the true economic value of supervisory goodwill is not equal to the face amount booked by the acquiring institution. Tax claims filed by taxpayers in connection with the alleged worthlessness of supervisory goodwill have been filed for the face amount of goodwill that resulted from the merger transactions. The drafter is unaware of any tax claim where the taxpayer has supported such tax claim with an expert opinion or valuation of the goodwill at the date of contract.

There were other things that acquiring institutions received in supervisory mergers besides the right to use supervisory goodwill to meet capital reserve requirements. Some acquiring institutions received a promise from the FHLBB to refrain from enforcing regulatory capital-ratio requirements for a period of time. This promise has been referred to as forbearance. Some institutions obtained the right to open branches in additional states. It isn't clear whether, at the contract date, these other items could have been separately identified from the concept of supervisory goodwill, or valued independently of supervisory goodwill. In any event, the drafter believes that, generally, such a valuation was not undertaken by taxpayers.

Statement of Financial Accounting Standards # 72

As pointed out by the Supreme Court in Winstar, in some merger transactions involving supervisory goodwill the FSLIC also contributed an amount of cash to assist the merger transaction. The regulators permitted the acquiring institution to count the cash contribution as a permanent credit to regulatory capital. By failing to require the thrift to subtract the cash contribution from the amount of supervisory goodwill generated by the merger, "regulators effectively permitted double counting of the cash as both a tangible and an intangible asset. [Citation omitted.] Capital credits thus inflated the acquiring thrift's regulatory capital and permitted leveraging of more and more loans." Winstar, at 853.

To eliminate this double counting of cash, in 1983 the Financial Accounting Standards Board promulgated Statement of Financial Accounting Standards No. 72 ("SFAS 72") which applied specifically to the acquisition of a savings and loan association. In addition to allowing supervisory goodwill to be amortized for book purposes, SFAS 72 also required that financial assistance from regulatory authorities be deducted from supervisory goodwill in order to avoid a double counting of the cash as both a tangible and an intangible asset. See Winstar, at 855. Thus, in 1983, the Financial Accounting Standards Board recognized the distinction between cash and supervisory goodwill. In the context of a supervisory merger, supervisory goodwill was something that had to be adjusted by the amount of financial assistance (i.e., cash) received.

Can Taxpayer Establish Tax Basis Under § 1012?

As the CIP discusses, pursuant to § 1012, the tax basis of acquired property is generally its cost. Absent certain provisions that provide for the tax-free receipt of property, taxpayers generally must include in income the fair market value of property they receive in order to obtain a tax basis in such property.

Some discussion has taken place suggesting that an acquiring entity incurred a cost in the acquisition of a failing thrift, to the extent that liabilities assumed exceeded the value of the assets acquired. The net cost was the excess of liabilities over assets. Such net cost, representing the amount of supervisory goodwill recorded in the transaction, established a tax basis in supervisory goodwill.

This discussion appears to disregard the fact that the acquiring institution was permitted to record the acquisition as a tax-free reorganization under § 368(a)(1) whereby the acquiring institution took a carryover basis in the acquired assets. In such a tax-free reorganization, there appears to be no room for establishing additional basis, unless § 597 applies to the property in question.

Taxpayers generally appear to have abandoned this position.

Issue (3) Whether taxpayers are entitled to losses under § 165 with respect to supervisory goodwill based upon worthlessness, abandonment or confiscation

Under § 165(a), a taxpayer is allowed a deduction for any loss sustained during the taxable year for which the taxpayer is not compensated by insurance or otherwise. The amount of the deduction is the taxpayer's adjusted basis under § 1011 for determining a loss from the sale or other disposition of property. To be allowable as a deduction under § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Treas. Reg. § 1.165-1(b).

If an event occurs which may result in a loss, and in the year of the event there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances. Reg. § 1.165-1(d)(2)(i).

The first position in the CIP is that the taxpayer has not established any tax basis in supervisory goodwill. Therefore, taxpayer does not have a deductible tax loss under § 165(a).

Assuming a taxpayer can establish a tax basis in supervisory goodwill, the CIP says the taxpayer is still not entitled to deduct a loss under § 165 because the taxpayer has not affirmatively established that it met the other requirements of § 165 for the loss as claimed in the tax years for which the amended returns were filed. The taxpayer, according to the CIP, cannot establish the amount of any deductible loss based on worthlessness while that taxpayer is pursuing a Winstar-type damage claim.

Scofield Estate v. Commissioner, 266 F.2d 154 (6th Cir. 1959), aff'g in part and rev'g in part, 25 T.C. 774 (1956), is a leading case involving the "prospect of recovery". The taxpayer in this case sued the original trustees of a trust to recover money they had embezzled from the trust. The taxpayer filed suit in 1935 and did not recover until 1948, 13 years later. The court held that a loss was properly deducted by the trust in the year in which the litigation terminated. There was a possibility of recovery from a bank depositary of trust funds up to 1948, and a further possibility of recovery from trustees. The court said:

> In the absence of such circumstances [that show] such litigation to be specious, speculative, or wholly without merit and that the taxpayer hence was not reasonable in waiting to claim the loss as a deduction, a taxpayer who feels that chance of recovery is sufficiently probable to warrant bringing a suit and prosecuting it with reasonable diligence to a conclusion is normally reasonable in waiting until the termination thereof to claim a Section 23(e) deduction.

The court in Scofield also discussed the substantive merits of the taxpayer's claim, the fact that the taxpayer, an attorney, consulted with senior counsel before instituting the lawsuit, and whether or not the defendants had sufficient assets to pay a judgment.

California Fed. Bank v. United States, 43 Fed. Cl. 445 (1999), aff'd in part and vacated in part, 245 F.3d 1342 (Fed. Cir. 2001), is one example of the many damage claim cases that are pending in either the Court of Federal Claims or the Court of Appeals for the Federal Circuit. In1997, the lower court held on summary judgment in California Fed Bank that the government was liable for breach of contract and referred the case for trial on the issue of damages. In 1999, the lower court awarded the plaintiff almost $23,000,000 in damages as the cost of replacing the regulatory capital lost due to the phase-out of goodwill under FIRREA. The government appealed this result and the appeals court ultimately remanded the case back to the lower court to reconsider the damage award.

There are at least 120 of these suits pending against the government for damages relating to the Winstar litigation. The magnitude of this litigation and the conclusions reached at both the trial court and the appeals court suggest that there was a reasonable prospect of recovery at the time the tax claims were filed. The suits are being prosecuted "with reasonable diligence." The defendant, the U.S. government, has sufficient assets to pay a judgment.

Taxpayers claim there isn't sufficient nexus between the potential damages that may be received by taxpayers and the losses sustained on the worthlessness of the supervisory goodwill. According to taxpayers, the potential damages under the breach of contract claim would compensate taxpayers for losses incurred in no longer being able to count the supervisory goodwill towards minimum capital requirements. In other words, the compensation would be for the loss of benefits that were derived from the asset and not from for the loss of the asset itself.

Taxpayers cite Forward Communications Corp. v. U.S., 608 F. 2d. 485 (Ct.Cl. 1979), as support for the argument that the Winstar claim is collateral to its loss. In that case, the taxpayer, a local television station, claimed a § 165 loss based on termination of its affiliation agreement with the CBS network. Taxpayer was compensated for its loss of the CBS affiliation by increased revenues from affiliation with the ABC network. The Court of Claims held that §165 does not bar a deduction merely because the taxpayer is able to effect an offsetting gain in a different although contemporaneous transaction.

The facts and circumstances in Forward Communications are different from those in the instant situation. Any recovery pursuant to the Winstar claims would compensate the taxpayer precisely for the loss of its right to use supervisory goodwill in meeting regulatory capital requirements. The damage claims and the tax claims originate from precisely the same event – the enactment of FIRREA. The connection between the Winstar-related damage claims and the tax losses claimed by taxpayers is direct and undeniable.

Reasonable Prospect of Recovery at 12/31/94?

The CIP points out that "whether a reasonable prospect for recovery exists is a factual issue, determined upon an objective examination of the facts and circumstances surrounding the loss **as of the close of the taxable year in which the deduction is claimed.**" [Emphasis added]

The tax year for which most of the tax claims have been filed is tax year 1994. FIRREA effectively eliminated by December 31, 1994, the ability of the acquiring institutions to count supervisory goodwill for capital reserve requirements. Taxpayers argue that it was not until 1996 that the Supreme Court held in Winstar that the government breached its contracts when it enacted FIRREA. Until such time as the Supreme Court decided the Winstar case on July 1, 1996, recovery was merely possible, not probable, according to taxpayers.

The Supreme Court decision, however, was not the first victory for the plaintiffs in the breach of contract litigation. The Winstar litigation began almost immediately after FIRREA was enacted. In July 1990, the Claims Court held that summary judgment on the liability question was precluded because a genuine issue of material fact remained. 21 Ct. Cl. 112. In April 1992, the Claims Court denied the government's motion for dismissal or summary judgment, finding that a binding contract existed between the parties which the government breached by enacting FIRREA. 25 Ct. Cl. 541. In July 1992, the Claims Court granted the plaintiffs' motions for summary judgment because the government breached its contracts with them. 26 Cl. Ct. 904. In May 1993, the Court of Appeals for the Federal Circuit reversed and remanded. 994 F. 2d 797. But in August 1995, on rehearing en banc, the Court of Appeals reversed the panel decision and affirmed the Court of Federal Claims. 64 F. 3d 1531. Certiorari was then granted in January 1996.

The Winstar plaintiffs were successful throughout, with the exception of a short period of time from May 1993 to August 1995.

Subsequent to the Supreme Court's opinion in Winstar, taxpayers began filing amended returns claiming tax losses with respect to supervisory goodwill. Although the claims are for 1994 and subsequent tax years, the claims were not actually filed until 1996 at the earliest. In other words, at the time claims were filed, the Supreme Court had decided the contract breach issue and had remanded for damages. It would appear that at the time taxpayers filed these claims, there was a reasonable prospect of recovery. At the end of 1994, there may have been somewhat less of a prospect of recovery. But given that plaintiffs were successful almost throughout, except for a short period of time that included December 31, 1994, it would appear that there was a reasonable prospect of recovery even at the end of 1994. It isn't clear whether the filing of the tax claim in a year subsequent to 1994 would tend to mitigate the principle that "reasonable prospect for recovery" should be determined upon the facts and circumstances as of the close of the taxable year in which the deduction is claimed.

Did Worthlessness Occur in 1994?

Even if taxpayers are capable of establishing a tax basis for supervisory goodwill under § 597, some fact patterns raise an additional question of whether taxpayers have claimed losses in the proper tax year, notwithstanding that there may have been a reasonable prospect of recovery.

When FIRREA was enacted in 1989, the amount of supervisory goodwill that could be used to meet regulatory capital requirements was greatly reduced. FIRREA required thrifts to satisfy three new minimum capital standards: "tangible" capital, "core" capital, and "risk-based" capital. 12 U.S.C. § 1464(t). As a result of FIRREA, supervisory goodwill could no longer be included in satisfying minimum "tangible" capital. The amount of supervisory goodwill that could be included in satisfying "core" capital decreased each year and was entirely phased out on December 31, 1994. Supervisory goodwill could be used to maintain "risk-based" capital, but for this purpose FIRREA limited its amortization to a period of no more than 20 years.

As a result of FIRREA, many thrifts **immediately** fell out of compliance with capital requirements and became subject to seizure. The three plaintiffs in the Winstar case fell out of compliance well before December 31, 1994. See Winstar v. U.S., 64 F.3d 1531 (1995). Winstar fell out of compliance as soon as the FIRREA capital requirements became effective, and was placed in receivership by the Office of Thrift Supervision in May 1990. Statesman likewise fell out of compliance immediately and was placed in receivership in July 1990. Glendale fell out of compliance with the risk-based capital standard in March 1992. 64 F.3d at 1539.

Assuming a taxpayer can establish that it has a tax basis in supervisory goodwill, that a § 165 loss is allowable, and that there was no reasonable prospect of recovery when the taxpayer fell out of regulatory compliance, the ensuing tax loss may have been in a tax year prior to 1994.

Abandonment

The CIP addresses the taxpayer's claim that it is entitled to an abandonment loss under § 165, following FIRREA. The CIP concludes that the taxpayer is not entitled to an abandonment loss because the taxpayer does not have any tax basis in supervisory goodwill. However, even if the taxpayer can establish a tax basis, there must be an affirmative act of abandonment; the mere diminution in the value of property is not enough to establish an abandonment loss. Neither FIRREA's statutory provisions nor the government's subsequent regulatory curtailment of the ability to use supervisory goodwill to meet the taxpayer's capital requirements constitutes an affirmative act of abandonment by a taxpayer.

Taxpayers contend that the enactment of FIRREA did not merely reduce the value of supervisory goodwill. FIRREA rendered the asset completely and irrevocably worthless.

Once again, a distinction must be made between the face amount of supervisory goodwill booked, and the proper value of the right to use the face amount to meet capital reserve requirements. It would appear that FIRREA effectively eliminated by December 31, 1994 the ability of the acquiring institutions to count supervisory goodwill for capital reserve requirements.

Confiscation

The CIP also addresses the taxpayer's claim that it is entitled to a § 165 loss because the government allegedly confiscated its property as a result of the FIRREA changes. The CIP concludes that taxpayers pursuing Winstar-type contract claims have a reasonable prospect of recovery for contract damages. No further position was stated in the CIP regarding the confiscation nature of the loss.

Whether the alleged loss is characterized as a worthlessness, abandonment or confiscation loss seems immaterial. The crucial factor is whether there was a reasonable prospect of recovery.

Issue (4) Whether taxpayers are entitled to depreciation or amortization deductions under I.R.C. § 167 with respect to supervisory goodwill

This issue appears to have been raised by taxpayers as an alternative to the position that a loss is allowable under § 165. Taxpayers believe that supervisory goodwill has an ascertainable basis as a result of the application of § 597 and further argue that, as a result of the enactment of FIRREA, the asset has a limited useful life.

The CIP first concludes that taxpayers are not entitled to depreciation or amortization because taxpayers lack a tax basis in supervisory goodwill. However, even if taxpayers can establish a tax basis, the CIP concludes, based on the regulations under § 167, that taxpayers are not entitled to depreciation or amortization because no such deduction is allowable for residual goodwill. Moreover, a mere diminution in value, even over an identifiable period (such as the 5 year phase out of the right to count supervisory goodwill towards certain regulatory capital requirements) does not suffice to establish a limited useful life for a residual intangible such as the regulatory accounting asset of supervisory goodwill.

Treasury Regulation § 1.167(a)-3 reads, in part, as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

The threshold question is whether supervisory goodwill was goodwill in the traditional sense, or whether it was an identifiable intangible asset that could have been valued separate from that traditional goodwill and amortized over a determinable useful life. We discuss above that taxpayers have not established the real economic value of the right to use supervisory goodwill to meet regulatory requirements that might be embedded in the face amount of supervisory goodwill.

SETTLEMENT GUIDELINES

In our opinion, a Settlement Guideline must take into account three significant issues:

- Whether the true economic value of supervisory goodwill for tax purposes was the face amount claimed by the taxpayer, or some lower amount

- Whether the right to use supervisory goodwill to meet regulatory capital requirements represents "other property" within the context of § 597

- Where a damage claim was filed, whether there was a reasonable prospect of recovery as of the close of the taxable year in which the loss deduction was claimed

Valuation

The first significant issue concerns the valuation question surrounding the concept of supervisory goodwill. It is important to draw a distinction between what has been referred to as the "face amount of supervisory goodwill" and the value of the "right to use supervisory goodwill" to meet capital reserve requirements. The face amount of supervisory goodwill represented the excess of the value of the liabilities over the value of the assets of a failing thrift. It represented the negative net worth of a failing thrift and, as such, it did not represent an asset in the traditional sense. It was a bookkeeping entry used to implement the purchase method of accounting in the context of a supervisory merger. The face amount of supervisory goodwill, when viewed in and of itself, offered no real asset value to an acquiring thrift.

The "special accounting treatments" associated with supervisory goodwill were, on the other hand, contract rights or bargained-for-promises from the government that had a measure of economic value. The special accounting treatments included: (1) the right to use the face amount of the goodwill to meet capital reserve requirements, and (2) the right to amortize, for regulatory accounting purposes, the face amount over a longer period of time thus allowing the acquired thrift to seem more profitable than it really was.

As the damage claim cases demonstrate, the value of the right to use the special accounting treatment was necessarily less than 100% of the face amount of supervisory goodwill. Various economic experts have testified in the damage claim cases that, because supervisory goodwill was not an asset in the traditional sense, its value to the acquiring thrift was not equal to its face amount. Supervisory goodwill was not a negotiable or transferable asset, nor could it have been invested. It was not the equivalent of cash. It provided the ability to leverage more loans, but ultimately the accounting concept of supervisory goodwill worsened the financial crisis in the thrift industry during the 1980s. See Winstar at 854-955.

The supervisory goodwill tax refund claims that have been filed by taxpayers reflect claimed losses or deductions for the face amount of supervisory goodwill recorded in the regulatory merger transaction. Assuming that taxpayers can establish a tax basis for supervisory goodwill, the economic value to the acquiring institution at the acquisition date of the right to use supervisory goodwill to meet capital reserve requirements and to amortize the amount for book purposes has not been determined. Assuming taxpayers can establish a tax basis, then within the face amount of supervisory goodwill there may be an intangible asset that might be separable from goodwill much like the newspaper subscriber list was found to be separate from goodwill in Newark Morning Ledger Co v. U.S., 507 U.S. 546 (1993). But taxpayers have not, for income tax purposes, ascertained such an intangible asset's value nor determined its useful life.

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Section 597

The second issue to consider is whether the right to use supervisory goodwill represents "other property" within the context of § 597. There are two sub-issues within this overall issue. First, was the right to use supervisory goodwill received from **the FSLIC**? Second, was the right to use supervisory goodwill **other property** within the meaning of § 597?

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The Supreme Court stated:

> There is no question, … that the [the FHLBB] and FSLIC had ample statutory authority to permit respondents to count supervisory goodwill and capital credits toward regulatory capital and to pay respondent's damages if that performance became impossible. The organic statute creating FSLIC as an arm of the Bank Board, 12 U.S.C. § 1725 (1988 ed.) (repealed1989), generally empowered it "[t]o make contracts" and

§ 1729(f)(2), enacted in 1978, delegated more specific powers in the context of supervisory mergers.

Winstar, at 890.

The Court refers to both the FHLBB and the FSLIC as having statutory authority to permit acquiring thrifts to count supervisory goodwill toward regulatory capital. The Court also states that the FSLIC was empowered to make contracts in the context of supervisory mergers.

When Congress amended the National Housing Act in 1987, it enacted § 1730h(d) which states:

> No provision of this section shall affect the authority of the Corporation to authorize insured institutions to utilize subordinated debt and goodwill in meeting reserve and other regulatory requirements.

The "Corporation" referred to in this statute is the FSLIC. Taxpayers have argued that when Congress enacted this statute it must have thought that FSLIC possessed the authority to permit acquiring institutions to use goodwill in meeting reserve requirements.

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Section 597 refers to "any amount of money or other property received from the FSLIC pursuant to § 406(f) of the National Housing Act." Section 406(f) of the National Housing Act describes FSLIC assistance to include making loans, making contributions, purchasing assets, assuming liabilities, and guaranteeing against loss. Each of these actions involves either an immediate or eventual payment of money. An agreement reached between an acquiring thrift and the FHLBB/FSLIC that permitted the thrift the right to use supervisory goodwill for regulatory requirements did not require a current or future payment of money. When a supervisory merger involving the special accounting treatments occurred, the acquiring institution could not have anticipated that the special accounting treatments would be taken away as they were upon enactment of FIRREA. Consequently, on the regulatory merger date, the parties to the regulatory merger, including the acquiring institution and the FHLBB/FSLIC, could not have anticipated that any money would change hands with respect to the thrifts' use of the special accounting treatments. Although the enactment of

FIRREA ultimately resulted in the filing of damage claims, at the time of the acquisitions, the special accounting treatments were not types of property that were backed by the promise of an eventual payment of money by the FSLIC.

The special accounting treatments associated with supervisory goodwill were promises by regulators to protect the viability of the acquiring thrifts. These regulatory promises, referred to by the Supreme Court as a substitute for cash, were not in fact cash equivalents.

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If a damage claim case has not been filed, the ISP Coordinator should be contacted for further advice.

Summary

The risk factors outlined above must be converted into a computational proposal. The taxpayer must prevail on all significant issues in order to achieve success on the overall issue of its entitlement to a tax refund.

First, the taxpayer must convince a court of the value of the right to use
supervisory goodwill to meet certain regulatory capital requirements.
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Second, the taxpayer must convince a court that § 597 applies to the right to use supervisory goodwill to meet regulatory capital requirements.

Third, if the taxpayer has filed a damage claim, the taxpayer must convince a court that there was a tax loss and that there was no reasonable prospect of recovery at the time the loss was claimed.

Where a settlement is reached, and some measure of tax loss is allowed in a specific taxable year, the settlement should be accompanied by a closing agreement that disposes of these issues for all taxable years.

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If the facts of a particular case do not follow the scenario above, the ISP Coordinator should be contacted for further advice.

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Furthermore, the taxpayer should make available documentary evidence to support the facts. The following documents and substantiation are generally a part of a typical supervisory merger:

- Assistance agreement
- Forbearance agreement
- Merger Agreement
- Substantiation of the recording of supervisory goodwill for book purposes
- Substantiation of the amortization of supervisory goodwill for book purposes
- Schedules showing how supervisory goodwill contributed to meeting capital reserve requirements both before FIRREA and after FIRREA
- Substantiation of book write-off of supervisory goodwill