



**Joseph R. Alexander**

Senior Vice President and Senior Counsel

Phone 212.612.9234

[joe.alexander@theclearinghouse.org](mailto:joe.alexander@theclearinghouse.org)

January 13, 2010

The Honorable Timothy Geithner  
Secretary of the Treasury  
Office of the Secretary  
United States Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Re: Timing of Deductions for FDIC Prepaid Assessments

Dear Secretary Geithner:

The Clearing House Association L.L.C. (“The Clearing House”), a national association of commercial banks,<sup>1</sup> is writing in regard to tax issues raised by the FDIC’s Final Rule on Prepaid Assessments (“Final Rule”), approved by the FDIC Board of Directors on November 12, 2009. The Final Rule required insured institutions to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012.

This letter focuses specifically on the timing of deductions for 2010 prepaid assessments. We analyze the relevant tax law governing the timing of deductions, including Internal Revenue Code section 461 and Treasury Reg. section 1.263(a)-4. We contrast the Final Rule’s prepaid assessments with fact patterns previously addressed by the IRS in comparable rulings, including Rev. Rul. 80-230. It is our view that 2010 prepaid assessments required by the Final Rule may be deducted in the year of payment, that is, in 2009.<sup>2</sup> We are sharing this analysis in the spirit of full disclosure, to make you aware of this position and our view of the law supporting it.

#### FDIC Final Rule

The Final Rule requires insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. Under the Final Rule, the prepaid assessments for these periods were due and payable on December 30, 2009.

---

<sup>1</sup> Members are ABN AMRO Bank N.V.; Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; UBS AG; U.S. Bank National Association; and Wells Fargo Bank, National Association.

<sup>2</sup> It is assumed that taxpayers are accrual-method calendar-year taxpayers.

For purposes of estimating an institution's prepaid assessments for these periods, the institution's assessment rate is its total base assessment rate in effect on September 30, 2009. In reflection of the FDIC's separate action to increase annual assessment rates by three basis points beginning in 2011, an institution's total base assessment rate for purposes of estimating its assessments for 2011 and 2012 is increased by an annualized 3 basis points beginning in 2011. Further, the third-quarter 2009 assessment base, for purposes of these calculations, is increased quarterly at a 5% annual growth rate through the end of 2012.

The FDIC will continue to calculate quarterly risk-based assessments for the fourth quarter of 2009 and beyond, taking into account actual deposit growth and other factors, and will apply the prepaid assessments against these amounts. These assessment calculations could result in an institution either paying additional assessments during the prepayment period or receiving a refund of prepaid assessments if not exhausted after calculation of the amount due on June 30, 2013.

The prepaid assessments are invoiced explicitly showing the estimated assessment amounts for each quarter of the prepayment period. Thus, the assessment amounts for the four quarters of 2010, for example, are calculated and presented as distinct amounts. For purposes of this letter, the assessment amounts for the four quarters of 2010 are referred to as the "2010 assessments."

#### Section 461

In general, Section 461(a)<sup>3</sup> provides that the amount of any deduction or credit shall be accounted for in the taxable year, which is the proper taxable year under the method of accounting used in computing taxable income. For an accrual method taxpayer, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which (1) all events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred.<sup>4</sup> The first two requirements are referred to as the "all events" test.<sup>5</sup> Moreover, a taxpayer is not considered to have met the all events test any earlier than when economic performance occurs.<sup>6</sup> Thus, all three requirements must be met in order for a liability to be considered incurred and a taxpayer to take the liability into account.

#### *Requirement 1: Establish the fact of the liability*

The first requirement under the all events test is that the taxpayer must have a "fixed" liability. The courts and the IRS have addressed how various liabilities become fixed and determinable for purposes of the all events test.

---

<sup>3</sup> All section references are to the Internal Revenue Code of 1986, as amended, and all "Prop. Reg. section," "Temp. Reg. section," and "Treas. Reg. section" references are to the proposed, temporary and final Treasury regulations, respectively.

<sup>4</sup> Treas. Reg. section 1.461-1(a)(2)(i).

<sup>5</sup> Section 461(h)(4).

<sup>6</sup> Section 461(h)(1).

In *United States v. General Dynamics Corp.*,<sup>7</sup> an accrual method taxpayer self-insured its liability for its employee medical care plan. The taxpayer established a reserve at the end of the year for its obligation to reimburse employees for medical care already received by the employees from third parties, but for which reimbursement claims had not yet been filed. The Supreme Court held that the last event necessary to fix the liability was submission of a claim form by an employee, not receipt of medical care, and thus the first prong of the all events test was not met because the last event necessary to fix that liability had not occurred by the end of that year. The Supreme Court reasoned that the filing of a claim was not a mere technicality, but a condition precedent to liability on the part of the taxpayer.

On the other hand, conditions subsequent will not prevent an accrual of a deduction. In *United States v. Hughes Properties*,<sup>8</sup> the Supreme Court addressed whether a casino taxpayer could deduct an accrued liability for progressive jackpot amounts shown on payoff indicators on progressive slot machines at the end of its taxable year. Pursuant to state law, registered jackpot amounts as shown on the payoff indicators were recorded daily and could not be reduced until the jackpot was paid. The Court held that the last event fixing the casino's liability was the last play of the slot machine before the end of the casino's tax year, because that event fixed the jackpot amount irrevocably under state law. The Court rejected the IRS argument that the liability was not fixed because the casino would have no liability if it went out of business or gamblers ceased playing its machines, apparently regarding such possibilities as conditions subsequent. Thus, the Court held that the all events test was met and the casino could accrue the amount of the jackpot guaranteed for payment on progressive slot machines even though the winning pull had not occurred and the jackpot had not been won by the end of the tax year.

The question of whether the possibility of obtaining a refund with respect to a liability that is otherwise fixed postpones the deduction has been addressed on multiple occasions. In an IRS General Counsel Memorandum, counsel stated:

... for purposes of the all events test, if the ability to obtain a refund of a disbursement is in the control of the payor, or if the refund requirement exists when the amount is disbursed, the transfer is to be regarded as a deposit rather than a payment. If the ability to obtain a refund is beyond the control of the payor and the refund requirement is contingent when the amount is disbursed, the disbursement is not a deposit even if it is reasonably certain to be refunded.<sup>9</sup>

Following a similar reasoning, the court in *Midwest Motor Express, Inc. v. C.I.R.*<sup>10</sup> stated, in determining when a retrospective premium accrued, that the fact that a settlement might result in an adjustment that would entitle the taxpayer to a refund in the future did not affect or postpone the accrual of the premium expense. The court found that the taxpayer's liability for payment of an additional retrospective premium was controlled by the insurer's establishment of a reserve for specific claims that had already been incurred and that while the settlement of

---

<sup>7</sup> 481 U.S. 239 (1987).

<sup>8</sup> 476 U.S. 593 (1986).

<sup>9</sup> GCM 38901 (February 12, 1982).

<sup>10</sup> 27 T.C. 167 (1956), *aff'd on other issues*, 251 F.2d 405 (9th Cir. 1958).

such claims might result in an adjustment that would entitle the taxpayer to an additional refund in the future, this uncertainty did not preclude the fact of the liability.

Similarly, in *Louis S. Cohn Co. v. C.I.R.*,<sup>11</sup> the Board of Tax Appeals concluded that an amount accrued and paid as insurance premium is a proper deduction in the year of payment although the premium was refunded in the following year on the cancellation of the contract. The Board reasoned that the taxpayer's obligation to pay the insurance premium existed at year-end and the cancellation of the insurance contract in the subsequent year does not affect the deduction in the earlier year.

In Rev. Rul. 80-230,<sup>12</sup> the IRS held that a bank at year-end could not accrue for a semi-annual assessment payable to the Comptroller of the Currency because the liability was not fixed as of year-end. In the facts of the ruling, the semi-annual assessment for the first six months of 1979 was based on a calculation involving the total assets of the bank as of December 31, 1978. The payment of the amount was not due until January 31, 1979. The IRS ruled that all the events determining the fact of the liability occurred at the earlier of the beginning of the period to which the assessment related (i.e., January 1, 1979) or the due date of the payment. Thus, the IRS held that the events determining the fact of the liability had not occurred as of December 31, 1978.

Similarly, the IRS in a 1999 technical advice memorandum (TAM)<sup>13</sup> held that a bank could not deduct in Year one an FDIC insurance assessment paid in Year one with respect to insurance coverage for Year two. While the bank was required to determine the assessment amount for Year two by December 1, Year one, payment was not due until January 31, Year two. In the absence of an obligation to pay the assessment any earlier, the IRS ruled that the last event fixing liability was the January 1, Year two, existence of deposits owned by the taxpayer requiring insurance coverage.

By contrast, the IRS in a 2004 TAM<sup>14</sup> held that a casino's required prepayments of licensing fees were fixed and incurred when paid for purposes of the all events test. The licensing fees were based on gross revenues, and the required prepayments were based on estimates of gross revenues, with a "true-up" mechanism that retrospectively reconciled estimated and actual gross revenues. The IRS ruled that the prepayments were not in the nature of deposits.

Finally, in Rev. Rul. 2007-3,<sup>15</sup> the IRS concluded that the all events test was not met in two factual scenarios where the taxpayer's contracts, for services and for insurance to be provided in the following year, were executed on December 15, 2006, and required payment on January 15, 2007. In the IRS's view, the first event that occurred to establish the fact of the taxpayer's liability in either situation was that the payment was due under the respective contract; as such, the first prong was not met until 2007.

---

<sup>11</sup> 12 B.T.A. 1281 (1928).

<sup>12</sup> 1980-2 C.B. 169.

<sup>13</sup> TAM 199924060.

<sup>14</sup> TAM 200440023.

<sup>15</sup> 2007-1 C.B. 350.

With respect to the FDIC prepaid assessments under the Final Rule, all events that establish the fact of the liability for payment of the 2010 assessments occur in 2009. The insured institutions received FDIC invoices in December 2009 and the assessment amounts were due and payable on December 30, 2009. Accordingly, the event that fixes the liability for the 2010 assessments occurs on December 30, 2009.

The situation at hand is distinguishable from the fact patterns in Rev. Rul. 80-230, the 1999 TAM, and Rev. Rul. 2007-3. Those fact patterns were marked by a lack of any legal obligation to make a payment by year-end. In the 1999 TAM, the IRS referenced the definition of “liability” under Treas. Reg. section 446-1(c)(1)(ii)(B), which provides that “amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.” In Rev. Rul. 80-230, the 1999 TAM, and Rev. Rul. 2007-3, taxpayers were not allowed to accrue a liability in a year in which there was no legal obligation to make payment. Unlike those cases, taxpayers under the Final Rule have a legal obligation to prepay the 2010 assessments in 2009.

The fact that a portion of the 2010 assessments might eventually be returned to the taxpayer should not affect or postpone the fact of the liability of the 2010 assessments. Following the reasoning in *Midwest Motor Express*<sup>16</sup> and *Louis S. Cohn*,<sup>17</sup> conditions subsequent, such as the possibility of a refund in a future year, should not preclude the accrual of a liability. Accordingly, it is reasonable to conclude that taxpayers have an absolute obligation to prepay the 2010 assessments in 2009 irrespective of the possibility that a portion of the assessments might be refunded in a subsequent year.

#### *Requirement 2: Reasonable accuracy*

The second requirement of the all events test is that the amount of the liability must be determinable with reasonable accuracy. This prong of the all events test focuses on whether the facts on which the calculation is based are established at the end of the tax year, not whether the computation can be made at that time.<sup>18</sup> The fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year.<sup>19</sup> Furthermore, if an amount is accrued based on a reasonable estimate, any difference shall be taken into account in the later year when the exact amount is determined.<sup>20</sup>

Under the Final Rule, the 2010 assessments are computed using the institution’s assessment rate for the third quarter of 2009, adjusted quarterly for an estimated 5% annual growth rate in the assessment base through the end of 2012. Thus, as of the end of 2009, there is

<sup>16</sup> *Supra* footnote 10.

<sup>17</sup> *Supra* footnote 11.

<sup>18</sup> *Continental Tie & Lumber Corp. v. U.S.*, 286 U.S. 290 (1932).

<sup>19</sup> Treas. Reg. section 1.461-1(a)(2)(ii); See also *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

<sup>20</sup> Treas. Reg. section 1.461-1(a)(3).

a set formula to determine the amount of the 2010 assessments, and the amount of the liability can be determined with reasonable accuracy.

*Requirement 3: Economic performance*

For purposes of the third requirement, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.<sup>21</sup> With respect to specified categories of payment liabilities, including insurance, economic performance occurs when payment is made to the person to which the liability is owed.<sup>22</sup> The liability of a bank to prepay FDIC insurance assessments under the Final Rule would be considered an insurance payment liability for this purpose.

Since the 2010 assessments were payable to the FDIC on December 30, 2009, economic performance occurred in 2009.

Based on the foregoing, the 2010 assessment liability was incurred in the 2009 taxable year and taxpayers may take it into account in the 2009 taxable year.

Treas. Reg. section 1.263(a)-4

Once the three requirements under section 461 have been met with respect to an amount, the question then turns to whether the incurred amount may be deducted currently or must be capitalized.

Certain expenses relating to intangibles are required to be capitalized and deducted ratably over a period of years.<sup>23</sup> However, a taxpayer is not required to capitalize amounts paid to create or to facilitate the creation of any right or benefit for the taxpayer that does not extend beyond the earlier of 12 months after the first date on which the taxpayer realizes the right or benefit or the end of the taxable year after the taxable year in which the payment is made (the “12-month rule”).<sup>24</sup> The regulations provide examples of the liabilities covered by the 12-month rule that include, *inter alia*, insurance, warranty, service contracts, and taxes, licensing or permit fees required by a governmental authority.

With respect to the 2010 assessments under the Final Rule, the question is what constitutes the “benefit period” for purposes of the 12-month rule. The benefit period for the 2010 assessments, presented as four quarterly amounts on the FDIC invoices, is the 12-month period beginning January 1, 2010 and ending December 31, 2010. This period does not extend beyond 12 months after the first date on which an institution realizes the benefit (i.e., does not

---

<sup>21</sup> Section 461(h)(1).

<sup>22</sup> Treas. Reg. section 1.461-4(g)(1). For insurance, see Treas. Reg. section 1.461-4(g)(5).

<sup>23</sup> Treas. Reg. section 1.263(a)-4(b)(1)(i).

<sup>24</sup> Treas. Reg. section 1.263(a)-4(f)(1).

extend beyond January 1, 2011). Further, this period does not extend beyond the end of the taxable year after the taxable year in which the payment is made (i.e., does not extend beyond the end of 2010). Thus, the 12-month rule is met and the 2010 assessments may be deducted in 2009.

\*\*\*\*\*

The Clearing House is sharing this analysis in the spirit of transparency and in order to reduce the potential for any future controversy. Consistent with this analysis, it is our understanding that many banks may elect to apply the 12-month rule and deduct the 2010 assessments required under the Final Rule in 2009. To the extent that you or your staff have any questions, please do not hesitate to contact us.

Very truly yours,

A handwritten signature in black ink, appearing to read "Joseph R. Allen", followed by a horizontal line extending to the right.

cc: Douglas H. Shulman, Commissioner, Internal Revenue Service  
Michael F. Mundaca, Acting Assistant Secretary of the Treasury (Tax Policy)  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
Emily S. McMahon, Deputy Assistant Secretary of the Treasury (Tax Policy)  
Clarissa C. Potter, Deputy Chief Counsel, Internal Revenue Service