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# Mirror, Mirror on the Wall: When a Liability Is an Asset

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The concept of "assets" and the concept of "liabilities" are both ubiquitous in the Internal Revenue Code, but we generally think of these categories as mutually exclusive -- an asset is an asset, and a liability is a liability. Occasionally, though, a case arises in which this dichotomy breaks down and a financial position that appears to fit into one of the categories finds its way mysteriously into the other, or as has sometimes been said, "My liabilities are my greatest asset." The Tax Court recently faced such a situation in *Federal Home Loan Mortgage Corp. v. Commissioner*, 121 T.C. No. 13 (Sep. 29, 2003).

The Federal Home Loan Mortgage Corporation ("FHLMC") was founded by Congress in 1970 for the purposes of purchasing residential mortgages and developing and maintaining a secondary market in conventional mortgages. For the first part of its history, FHLMC was exempt from Federal income taxation.

Matters changed with the enactment of the Deficit Reduction Act of 1984, in which Congress provided that FHLMC would become subject to the income tax on January 1, 1985. However, in order to provide an appropriate transition from tax-exempt to taxable status, the 1984 Act included a special rule, under which the adjusted basis of any asset held by FHLMC on January 1, 1985, would be the higher of that asset's adjusted basis under the ordinary tax rules for determining adjusted basis -- very generally, cost minus accumulated depreciation or amortization -- or the asset's fair market value on January 1, 1985.

On January 1, 1985, FHLMC was the debtor, that is, it had incurred liabilities, under various financing arrangements, including notes and bonds payable, subordinated debt consisting of capital debentures and zero coupon bonds, collateralized mortgage obligations, and guaranteed mortgage certificates. At the times that these liabilities had been incurred, interest rates were lower than they were on January 1, 1985. Thus, from the perspective of FHLMC, these liabilities constituted "favorable financing" -- the fair market value, on January 1, 1985, of FHLMC's obligation to make payments on these liabilities was less than their respective face amounts.

It was clear that, under ordinary tax rules, FHLMC, as a debtor under financial arrangements that it itself had issued, had no basis in its "favorable financing." (By contrast, as to FHLMC's creditors, the holders of the notes, debentures, that FHLMC had issued, those financial instruments clearly were assets that did have a basis in the creditors' hands.)

However, FHLMC contended that its "favorable financing" constituted an intangible "asset" in which it was entitled to a fair market value basis under the transition rule contained in the 1984 Act. FHLMC further contended that it was entitled to deductions for amortization of this "favorable financing asset."

The Internal Revenue Service challenged FHLMC's entitlement to such amortization deductions. The Tax Court's opinion describes the primary basis for the IRS's view several times in ways that are not quite verbally or conceptually identical, stating variously that the IRS contended that "petitioner's [FHLMC's] favorable financing arose from fortuitous interest rate fluctuations, is not an asset, and is not amortizable as a matter of law," that the differential between market rates of interest and contract rates of interest "is not an asset, it is 'fortuitous,' and it is 'not a function of an expenditure,'" and that "petitioner's favorable financing represents a 'liability,' not an 'asset,' ... [so that] petitioner 'is attempting to adjust, for tax purposes, the asset side of its balance sheet to account for an overstatement in fair market value terms of its liabilities.'" In any event, the Tax Court viewed as its primary concern the determination of whether the favorable financing "can constitute an 'asset' for purposes of [Internal Revenue Code] section 167(a)."

Under section 167(a) and the Treasury Regulations and case law interpreting it, an intangible asset may be the

subject of a depreciation or amortization allowance if it will be of use in the taxpayer's business for only a limited period, the length of which can be estimated with reasonable accuracy. The taxpayer must prove the existence of each of the factual predicates for the allowance of a deduction, including that the asset is used in the taxpayer's business and that it has a value that diminishes over an ascertainable period of time. The Code and Regulations do not define the term "asset."

The Tax Court began its analysis by considering whether or not the favorable financing constituted "something of value" on January 1, 1985, the relevant valuation date. Although the IRS, by agreeing that "there is a measurable economic value associated with the right to use money," might be said to have conceded the point, the Tax Court nevertheless conducted an independent analysis of the matter, based both on prior case law and on what it viewed as the economics of the situation.

In a famous 1984 gift tax case, *Dickman v. Commissioner* (465 U.S. 330 (1984)), the Supreme Court held that an interest-free loan of cash constituted a gift of the reasonable value of the use of the money lent. In reaching this conclusion, the Supreme Court asserted that, "[T]he right to use money is plainly a valuable right, readily measurable by reference to current interest rates."

This precedent was consistent with the Tax Court's view that an obligor whose cost of money is lower than current market rates "stands in a better position than other borrowers that finance at the current market rates of interest" and enjoys a "valuable economic benefit in terms of the cost savings that can be achieved in financing income-producing activities ... [for which benefit] a third party would pay a premium if the favorable financing were included as part of a purchase transaction." Thus, the favorable financing did constitute "something of value" on January 1, 1985.

The Tax Court then turned to the key issue -- whether this "something of value" was an "asset" for purposes of section 167(a). The Court determined that favorable financing could be an "asset," analogizing it to a "deposit base" attributable to "core deposits." "Core deposits" are the low-cost accounts (regular savings and checking accounts, etc.) that provide a bank with a reasonably stable, relatively low-cost source of funds that can be invested in loans and other income-producing assets, and a "deposit base" is the "intangible asset that arises in a purchase transaction representing the present value of the future stream of income to be derived from employing the purchased core deposits of a bank."

A deposit base had been found, in a series of cases involving bank acquisitions beginning in 1988 with *Citizens & S. Corp. v. Commissioner* (91 T.C. 463 (1988), aff'd, 919 F.2d 1492 (11th Cir. 1990)), to be an intangible asset amortizable for tax purposes, even though it did not have a sufficiently separate identity to be transferable outside of the context of a transfer of the bank's entire business.

The Tax Court felt that FHLMC's favorable financing was much like a deposit base, in that each involved the use of borrowed money at below-market rates and each provided a less expensive means of generating income and contributing to the profitability of a business. Just as an acquiror of a bank would pay a premium for the target's deposit base, an acquiror of a company like FHLMC with favorable financing would be willing to pay a similar premium. The fact that a deposit base related to a bank's relationship to its customers, while favorable financing did not involve FHLMC's relationship with its customers, was viewed by the Tax Court as less important than the fact that each type of intangible related to a relationship between a taxpayer and its creditors.

The Internal Revenue Service contended that the analogy to a deposit base should not be dispositive, because a deposit base had been found to be amortizable in cases in which there had been some sort of overall purchase or acquisition transaction and in which the parties claiming amortization had incurred costs to acquire the deposit base. By contrast, in FHLMC's case, the favorable financing for which amortization was being claimed was "self-created," in the sense that FHLMC itself, rather than a predecessor-in-interest whose assets were being acquired by FHLMC, had entered into the financial arrangements that bore below-market interest rates on January 1, 1985. Moreover, FHLMC had not incurred any costs with respect to the creation of the favorable financing that would result in a "cost basis" under ordinary tax accounting principles.

The Tax Court, however, viewed these factual differences as immaterial. Although, as a historical matter, the cases establishing the principle that a deposit base could be amortized had arisen in the context of corporate acquisitions, in which the amount of amortizable basis was determined by the taxpayer's cost, neither of those factors was relevant in FHLMC's case. By Congressional fiat, expressed in the transitional rule contained in the 1984 Act, FHLMC was entitled to amortize a fair market value (rather than a cost) basis in any assets owned on January 1, 1985, however and whenever they may have been acquired.

The Tax Court felt that another analogy -- to an interest in a favorable leasehold -- also supported the conclusion that FHLMC's favorable financing was amortizable. A favorable leasehold represents a lessee's right to use another person's property at below-market rental rates, just as FHLMC's favorable financing represented a right to use another person's cash at below-market interest rates. It is well-settled that a taxpayer's basis in a favorable leasehold can be amortized, and the court felt that the same result should follow in the case of favorable financing.[1]

**Additional Arguments**

At the conclusion of its opinion, the Tax Court disposed in rather summary fashion of some additional arguments made by the Internal Revenue Service. In response to the contention that FHLMC was impermissibly attempting to amortize a "liability" under section

167(a), the court reiterated its conclusion that in fact a separate "asset" did exist to which section 167(a) could apply. Similarly, the fact that an amortization or other deduction might not be available to FHLMC under the rules governing the tax treatment of interest expense and original issue discount with respect to "liabilities" was irrelevant, as the present case involved an "asset" that was not subject to those rules. Finally, the court was "not concerned" with the fact that FHLMC had not -- and, perhaps, under generally accepted accounted principles, could not have -- reflected favorable financing on its financial statements as a separate asset.

While the facts in this case and the existence of a special statute aimed at the tax treatment of this one taxpayer may make it a bit of a sport, there are some important principles here to be borne in mind. Tax treatment will not necessarily be governed by the colloquial meaning of terms such as "asset" and "liability." Rather, analysis needs to be done to determine whether what appears to be even the simplest of financial positions or arrangements can be broken into smaller components, some of which may be eligible for a favorable tax treatment inapplicable to the arrangement as a whole.

There can be no certainty that, in any particular future case, a court will apply precisely the same mode of analysis applied here to FHLMC's favorable financing, but this case will always serve as a reminder of the importance of looking at the facts creatively in maximizing tax benefits.

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[1] There are a number of cases that have considered the amortization issue from what might be described as the creditor/lessor perspective. For example, the Tax Court (and most of the other courts that addressed the same issue) concluded that a premium paid by a purchaser of real property by reason of an existing lease with above-market rents could not be amortized over the lease term (*see*, *e.g*., *Midler Court Realty, Inc. v. Commissioner*, 61 T.C. 590 (1974), aff'd, 521 F.2d 767 (3d Cir. 1975)). (The Internal Revenue Code was amended in 1993 to confirm the result reached in these cases.) Given this line of authority, it might be argued by analogy that where the terms of a lease or financing create value in the lessee or debtor position, that value should not be separately amortizable where, for example, property is acquired subject to pre-existing financing at a below-market rate.

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