Savings and loan associations -- Their first year under the Revenue Act of 1962

Robert R. Woodson
Savings and Loan Associations—Their First Year under the Revenue Act of 1962

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SINCE enactment of the Revenue Act of 1962, income taxes have become one of the most discussed topics in the savings and loan industry. Although subject to income taxes since 1962, very few associations had ever paid taxes because of the formula that was allowed by the statutes for computing the addition to the Reserve for Bad Debts. The addition under the old formula was measured by the difference between 12 per cent of the savings accounts at the end of the year and the surplus, reserves, and undivided profits at the beginning of the year. Therefore, with the tremendous growth experienced by the savings and loan industry during the past few years, very few Associations have had to pay income taxes. The Revenue Act of 1962 has brought about a new era for Savings and Loan Associations—an era in which the “tax effect” of transactions becomes an important factor in managerial decisions.

With the first year of operations under the Revenue Act of 1962 nearing an end, I should like to review briefly some things that will concern you between now and the time your 1963 Federal income tax return is filed.

COMPUTATION OF TAXABLE INCOME

A problem that practically all Associations will encounter before the books are closed for the year and financial statements are published will be the computation of the estimated tax liability. The computation will entail certain adjustments common to most associations that must be made in order to arrive at the taxable income figure. The two illustrations on pages 350 and 351 will show what some of these adjustments are and how they will ultimately be shown in the tax return.

The starting point in determining taxable income is, of course, to arrive at the income shown by the books. The first adjustment shown in Illustration 1 is to eliminate the deduction for insurance premiums on the lives of officers and employees where the Association is the beneficiary of the policy. This adjustment is required of all
taxpayers, not just Savings and Loan Associations. The next adjustments are for nontaxable income and other adjustments for tax purposes not recorded on the books. Dividends on stock of the Federal Home Loan Bank acquired before March 28, 1942 and income earned on the prepayment to the secondary reserve of the Federal Savings and Loan Insurance Corporation are not subject to tax.

In July 1963 the United States Savings and Loan League received a private Ruling from the Internal Revenue Service to the effect that the income earned on the prepayment would not be considered income until such time as it is applied against regular insurance premiums or otherwise becomes available to the Association. This Ruling applies regardless of whether the Association is on the cash or the accrual basis of accounting.

The last adjustment shown is for the contribution carryover from the years 1961 and 1962. This situation would exist where an Association had no taxable income in the two previous years and was unable to deduct the contributions made in those years.

These are not all the adjustments that may be necessary but illustrate some of the more common ones. If an Association defers income from service fees, an adjustment would be needed since normally the fees would be taxable in the year of receipt. Some Associations may decide to use different methods of depreciation for tax and book purposes and, therefore, a depreciation adjustment may be necessary. Any number of situations may arise to cause depreciation for tax purposes to differ from amounts recorded on the books.

BAD DEBT RESERVE DEDUCTION

These adjustments having been made, the taxable income before the allowable addition to the Bad Debt Reserve has been computed, and a position has been reached for computing the addition to the bad-debt reserve for tax purposes. Briefly, you will recall that an Association may take a deduction for additions to bad-debts reserves as follows:

1) An amount determined to be a reasonable addition to the reserve for losses on nonqualifying loans (an Association will probably have to determine a loss factor based on past experience to arrive at this addition), plus

2) An amount determined to be a reasonable addition to the reserve for losses on qualifying loans computed more than likely under what is generally referred to as the "60 per cent of taxable
income" method or the "3 per cent fill-up" method. There is also the experience method, but no Associations in this area are likely to use it.

Illustration 1 assumes that the Percentage of Taxable Income Method (or, as it is generally called, the 60-per-cent-of-taxable-income method) would give the greater deduction. After deducting the addition to the Bad Debt Reserve, taxable income figure is reached. At this point there should be deducted the net gain on sale of government bonds, section 1231 assets, and capital assets held more than six months. This is done to arrive at the taxable income subject to ordinary income tax rates. After computing ordinary income, the applicable rates are merely employed (30 per cent on the first $25,000 plus 52 per cent on income above $25,000). Then the capital gains tax rate of 25 per cent is applied to the net capital gain. The two figures so computed are added together to arrive at the total tax liability.

ILLUSTRATION 1
COMPUTATION OF ESTIMATED INCOME TAX LIABILITY

Net income per books (After deducting dividends) $125,000
Adjustments to Determine Taxable Income:
Additions:
   Insurance premiums on lives of officers or employees where the Association is the beneficiary ................................................................. 500
Total ................................................................. 125,500
Deductions:
   Dividends on stock of Federal Home Loan Bank issued before March 28, 1942 ................................................................. $ 600
   Income earned on prepayment to the secondary reserve of The Federal Savings and Loan Insurance Corporation ..................... 650
   Contribution carryover from 1961 and 1962 .................................. 1,000 2,250
Taxable income before addition to bad-debt reserve 123,250
Reasonable addition to reserve for bad debts (60% of taxable income) ................................................................. 73,950
Net taxable income ................................................................. 49,300
Deduct net capital gains ................................................................. 10,000
Net taxable income subject to ordinary income rates $ 39,300
Tax at ordinary income rate (52% of $39,300 less $5,500) .................. $ 14,936
Tax on capital gain (25% of $10,000) .................................................. 2,500
Total estimated tax liability ................................................................. $ 17,436
Amount to be used as estimate ................................................................. $ 18,000

TAX LIABILITY IN FINANCIAL STATEMENTS

Now that the estimated tax liability has been computed, it would probably be better to round this figure to the nearest $1000 for statement purposes. This determination is, after all, only the estimated
liability, and when the tax return is actually prepared additional adjustments to book income may be discovered. Assuming the Association is on the accrual basis of accounting, the estimated tax liability should then be recorded on the books. For Associations making monthly accruals, the estimated liability already recorded should be adjusted to the amount computed.

When the actual tax liability is determined on the tax return, the over-accrual or under-accrual will be reflected in Schedule M of the return. This adjustment and the others previously discussed are shown by Illustration 2 (below) as they would appear in the tax return.

**ILLUSTRATION 2**

**FEDERAL SAVINGS AND LOAN ASSOCIATION**

**RECONCILIATION OF TAXABLE INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS**

**FOR THE YEAR ENDED DECEMBER 31, 1963**

<table>
<thead>
<tr>
<th>Line No.</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Earned surplus and undivided profits at end of preceding taxable year</td>
<td>$100,000</td>
</tr>
<tr>
<td>2</td>
<td>Taxable income before net operating loss deduction and special deductions</td>
<td>49,700</td>
</tr>
<tr>
<td>4</td>
<td>Other nontaxable income:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dividends on stock of the Federal Home Loan Bank acquired before March 28, 1942</td>
<td>600</td>
</tr>
<tr>
<td></td>
<td>Income earned on prepayment to Secondary Reserve of the Federal Savings and Loan Insurance Corporation</td>
<td>650</td>
</tr>
<tr>
<td>6</td>
<td>Carryover of contributions from 1961 and 1962</td>
<td>1,000</td>
</tr>
<tr>
<td>8</td>
<td>Total of lines 1 to 7</td>
<td>$151,950</td>
</tr>
<tr>
<td>11</td>
<td>Federal income and excess profits taxes</td>
<td>17,436</td>
</tr>
<tr>
<td>13</td>
<td>Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary</td>
<td>500</td>
</tr>
<tr>
<td>17</td>
<td>Other unallowable deductions:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Overaccrual of income taxes</td>
<td>564</td>
</tr>
<tr>
<td>20</td>
<td>Total of lines 9 to 19</td>
<td>18,500</td>
</tr>
<tr>
<td>21</td>
<td>Earned surplus and undivided profits at end of the taxable year (Line 8 less line 20)</td>
<td>$133,450</td>
</tr>
</tbody>
</table>

**SCHEDULE M**

For Associations on the cash basis or some hybrid basis of accounting that do not normally make accruals, it would be advisable to consult your accountant about the preferable way of handling your estimated tax liability. Sometimes it may be appropriate to accrue the tax liability; in other cases it may be desirable not to accrue the tax but to indicate that undivided profits are restricted by an amount equal to the estimated tax liability.

In Illustration 2 the various adjustments are shown as they
would appear on Schedule M of the return, which is the Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profits. The various adjustments made in arriving at net taxable income would appear in Schedule M as follows:

<table>
<thead>
<tr>
<th>Line No.</th>
<th>(U.S. Corporation Income Tax Return—1963)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Other nontaxable income:</td>
</tr>
<tr>
<td></td>
<td>Dividends on stock of the Federal Home Bank acquired before March 28, 1942 $600</td>
</tr>
<tr>
<td></td>
<td>Income from prepayment to Secondary Reserve of the Federal Savings and Loan Insurance Corporation $650</td>
</tr>
<tr>
<td>6</td>
<td>Adjustments for tax purposes not recorded on books:</td>
</tr>
<tr>
<td></td>
<td>Contributions carryover from 1961 and 1962 $1,000</td>
</tr>
<tr>
<td>13</td>
<td>Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary $500</td>
</tr>
<tr>
<td>17</td>
<td>Other unallowable deductions:</td>
</tr>
<tr>
<td></td>
<td>Over-accrual of income taxes $564</td>
</tr>
</tbody>
</table>

**DIRECTORS' ACTION ON BAD DEBT RESERVE PROVISION**

Having discussed how the income tax liability is computed and recorded, let's now discuss several other items to be considered between now and the end of the year. An extremely important item is the year-end resolution to determine the reasonable addition to the Reserve for Bad Debts. A resolution adopted by the Association's directors is the proper way to reflect the Association's determination of what the reasonable addition should be. The resolution should be written in such a way as to allow not only the amount as originally determined but any future amounts that might become available as the result of any adjustments to taxable income made by the Internal Revenue Service. This is especially important where the 60-per-cent-of-taxable-income method is used. We have found several instances where the resolution has been neglected and, in one instance, not even included in the minutes. Although you may not be directly concerned with the writing of the resolution, it would be helpful at least to determine that it has been written.
OTHER YEAR-END ACTION

Before the end of the year, most Associations will probably want to review their investment portfolio to determine if there are any gains that they might want to realize or losses they should recognize. Now that most Savings and Loan Associations will be paying income taxes they will probably find it advantageous to follow the practice of recognizing their losses in one year and realizing their gains in another, owing to the special treatment allowed Savings and Loan Associations in deducting net bond losses in full. Another factor that might tend to make some Associations want to recognize bond losses this year is the possibility of a rate reduction in 1964. Each Association should do some figuring to see which is the best course to follow. To make decisions based on assumptions not supported by computations could prove to be unwise.

Under the Revenue Act of 1962, loans will have to be classified as between qualifying and nonqualifying loans. Current loans and loans at January 1, 1963 should be tentatively classified, pending issuance of regulations by the Internal Revenue Service.

Property acquired by foreclosure should be segregated by year of acquisition, since foreclosures after December 31, 1962 are to be treated differently under the new Revenue Act. Regulations to be issued by the Internal Revenue Service we hope will answer some of the many questions that have arisen in the handling of foreclosures under the Revenue Act of 1962.

Some Associations must now give consideration to the filing of a declaration of estimated Federal income tax. Any corporation that can reasonably expect its income tax liability to be more than $100,000 must file a declaration and pay 50 per cent of the tax in two installments. For calendar-year Associations, the payments must be made on September 15 and December 15. For fiscal-year Associations the declaration and payment must be made on the 15th day of the ninth month and the 15th day of the final month of the taxable year.

A private ruling received by the United States Savings and Loan League from the Internal Revenue Service was mentioned earlier. In addition to ruling on the treatment of income earned on the prepayment to the secondary reserve of the Federal Savings and Loan Insurance Corporation, the Internal Revenue Service also ruled that the prepayments could not be deducted as an expense until such time
as they are used to pay regular premiums, transferred to the primary reserve of the FSLIC, or "otherwise" removed from the control of the Association.

In September 1963, the Supervising Agent of the Federal Home Loan Bank Board informed the Associations that the Federal Insurance Reserve Accounts as previously established on the books need not be distributed in order to conform to income tax requirements. Associations may leave their accounts in the general ledger as they were previously and use these general ledger accounts as control accounts for any subsidiary accounts that might be established to conform the reserve to income tax requirements.

On September 30, 1963, the Internal Revenue Service issued Revenue Ruling 63-207, pertaining to the new definition of a domestic Building and Loan Association. The Service ruled essentially that where an Association sells or exchanges assets it had on hand at the beginning of its first taxable year after October 16, 1962, for the sole purpose of meeting the "percentage-of-asset requirement" of the definition, such sale or exchange will not be taken into account in determining "whether substantially all" of the business of the Association consists of acquiring the savings of the public and investing in loans. In addition, this Ruling also stated that for taxable years ending before the issuance of final regulations, reasonable doubts will be resolved in favor of the taxpayer in determining the category into which any particular asset may fall.