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ONE TAX PIECE OF THE SAVINGS AND LOAN CRISIS: CAN THE FEDERAL HOME LOAN BANK BOARD USE THE INTERNAL REVENUE CODE TO BAIL OUT THE AILING SAVINGS AND LOAN INDUSTRY?

*Beverly I. Moran**

I. INTRODUCTION

IN *Cottage Savings Association v. Commissioner*[1] the Sixth Circuit delves into a little known aspect of the savings and loan crisis—the attempt by the Federal Home Loan Bank Board to use the Internal Revenue Code ("Code") to help bolster its failing constituent thrifts. In the course of its analysis, the Sixth Circuit must articulate the requirements for transforming an economic loss into a deductible tax loss. In reaching its conclusion, the Sixth Circuit finds itself at odds with the Tax Court,[2] the District of Columbia Circuit,[3] the Fifth Circuit,[4] and, at least to some extent, with two district courts as well.[5]

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1. 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

2. *See* Leader Fed. Sav. & Loan Ass'n of Memphis v. Commissioner, 57 T.C.M. (CCH) 846 (1989); Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990); Federal Nat'l Mortgage Ass'n v. Commissioner, 90 T.C. 405 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990); San Antonio Sav. Ass'n v. Commissioner, 55 T.C.M. (CCH) 813 (1988), *aff'd*, 887 F.2d 577 (5th Cir. 1989).

3. Federal Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580 (D.C. Cir. 1990).

4. San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577 (5th Cir. 1989).

5. *See* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989) and Centennial Sav. Bank, F.S.B. v. United States, 682 F. Supp. 1389 (N.D. Tex. 1988), *aff'd in part and rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

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Not to be outdone, these courts are also in conflict with each other in at least some part of their judgments. That so many learned jurists have reached so many different results on essentially the same set of facts points to the novelty and difficulty of the questions raised. What are the facts that led to such diverse conclusions?

By now, we are all painfully familiar with the catastrophe that faced the savings and loan industry in the late 1970s and early 1980s.[6] Traditionally, the savings and loans earned their incomes by loaning money received as deposits to individuals so that they could purchase homes.[7] As the thrifts approached the 1980s, their portfolios were filled with loans made in an earlier era when home owners paid mortgage rates of eight, six and even four percent. Those rates were sufficient to maintain the thrifts' positive balance sheets as long as the interest the thrifts paid their depositors was lower still. But, with the raging inflation of the late 1970s, the thrifts were faced with depositors who demanded interest at ten and twelve percent. Of course, mortgage rates during that period had climbed to as high as eighteen percent, but there were not enough takers at the higher rates to avoid a hemorrhage of dollars from the thrifts' coffers. There was simply no way to make money when savers received more from the thrifts for their deposits than the thrifts were taking in from homeowners on their mortgage loans.[8]

Cash flow problems caused by fluctuating interest rates were only part of many factors affecting each thrift's bottom line. Climbing interest rates also reduced the net worth of each thrift's inventory, those low interest loans maintained in each savings

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6. *See* Nash, *Bush Says Savings Bailout May Not Be Enough*, N.Y. Times, Dec. 12, 1989, § D, at 13, col. 1; Reuters, *Banks Lost $744 Million In Quarter*, N.Y. Times, Dec. 7, 1989, § D, at 7, col. 1; Hayes, *U.S. Seeks Buyers for Seized Assets*, N.Y. Times, July 13, 1989, § D, at 5, col. 1; Nash, *Savings Loss is Put at $3.78 Billion*, N.Y. Times, June 22, 1988, § D, at 11, col. 1.

7. *See* Hayes, *More Pain for Texas Thrift Units*, N.Y. Times, Aug. 10, 1987, § D, at 1, col. 6; Berg, *Fixed-Rate Mortgages Held Threat to Lenders*, N.Y. Times, Mar. 10, 1986, § D, at 1, col. 4.

8. *See supra* notes 2-5 for case descriptions of how the savings and loan crisis affected the individual thrifts involved in the litigation before the courts. For more information on the crisis in general, see White, *The S&L Debacle: How it Happened and Why Further Reforms are Needed*, CATO REV. BUS. & GOV'T (Winter 1990).

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and loans' portfolio. This was because no one wanted to purchase loans that paid low interest rates unless the seller was willing to discount the face value enough to make the loan competitive in the high interest market.[9] Hence, along with cash flow problems, the thrifts had to contend with low yield inventories that were rapidly losing value.[10]

To address the challenges described above, some businesses might start by selling off inventory. Inventory sales are attractive because they raise revenues to pay impatient creditors, help the business take funds from losing investments and place them in more productive ventures, and generate tax deductions that create the possibility of even more cash from tax refunds.[11] However, Federal Home Loan Bank Board regulations made this alternative almost impossible for many thrifts.

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9. For example, if Alphonse loaned $100,000 to Barbara at 8% interest, Alphonse would expect to receive $8,000 a year in interest payments (assuming that no principal was paid during the year). So long as interest rates stay at 8%, Alphonse should be able to sell the loan for the full $100,000 principal because the purchaser could not expect to make more from his investment by placing $100,000 anywhere else.

When interest rates rise, however, buying Alphonse's loan becomes less attractive because the prospective purchaser can get more return for his money elsewhere. If interest rates rise to 16%, then the buyer would only want to pay $50,000 for Alphonse's $100,000 loan because he can lend his $50,000 on the open market and receive the same $8,000 a year at 16% that Alphonse now receives on his $100,000 loan.

Of course, although a smart buyer would never pay the full $100,000 in a 16% market, he would be willing to pay something more than $50,000 in order to take into account the fact that, over time, he would receive not only interest but also $100,000 principal. For purposes of simplicity, this additional factor is not considered in this example.

10. This article does not discuss the other factors that contributed to the savings and loan crisis, such as the move by thrifts into riskier investment (such as commercial real estate) and the thieving that some thrifts experienced. *See* Stevenson, *Six Indicted in California Savings Case*, N.Y. Times, Apr. 12, 1989, § D, at 1, col. 6; Kilborn, *Reagan Advisers Blame U.S. Policy for Savings Crisis*, N.Y. Times, Jan. 11, 1989, § A, at 1, col. 6; Bartlett, *Bad Real Estate Loans Hurt Northeast Banks*, N.Y. Times, Nov. 15, 1988, § D, at 1, col. 4.

11. Net operating losses allow a taxpayer to use losses in one year to offset gains earned in a prior year, thus generating tax refunds in the loss year. *See* I.R.C. § 172 (1988). For a discussion of the net operating losses, see B. BITTKER & M. MCMAHON, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 15.2 (1988).

In return for the benefit of federally insured deposits, savings and loans were subject to regulation by the Federal Home Loan Bank Board ("FHLBB," "Bank Board," or "Board"). In addition to numerous other requirements, the FHLBB forced each thrift to file semiannual reports on its financial condition in conformity with FHLBB regulations.[12] Under these "regulatory accounting principles" thrifts were required to maintain a predetermined net worth or face closure by the Bank Board.[13]

One component of a thrift's net worth was the value of the loans it maintained. This loan value was established on acquisition and did not change as long as the thrift held the loan and the borrower continued to pay. In other words, so long as the loan was current, the thrift kept the loan on its books at the original acquisition value even when the loan's actual value had substantially declined. If the thrift sold the loan at a deflated price, however, then its net worth declined to reflect the reduced value of its assets. Hence, each sale had the potential to force a closure by lowering the thrift's net worth to below its pre-established floor. As a result of this requirement, the thrifts could not take advantage of the benefits they might have derived from selling their depreciated loans because a sale of the devalued loans would trigger a reduction in net worth which, in turn, might force an FHLBB closure.

As the savings and loan crisis burgeoned, the FHLBB could no longer ignore this dilemma. Its thrifts had heavy economic losses as a result of the general decline in loan values. Yet its own regulations kept the thrifts from taking advantage of these losses. If the thrifts sold the loans they could raise cash if only through tax refunds. But, if the loans were sold, the Bank Board might have to shut the thrifts down. At some point the FHLBB needed to find a solution: How to allow the thrifts to generate tax losses without book losses so that the thrifts could obtain refunds without having to lower their net worth for accounting purposes. The FHLBB's solution was to allow thrifts to swap mortgages amongst themselves. It is these mortgage swaps that

12. FHLBB, ANNOTATED MANUAL OF STATUTES & REGULATIONS § 563c (1990) (Accounting Requirements ¶¶ 1205 to 1209h).

13. 12 U.S.C. § 1425a (1988), *repealed by* Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, title VII, § 716, 103 Stat. 421.

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are the subject of *Cottage Savings Association v. Commissioner*[14] and the other cases cited above.[15]

II. The Mortgage Swaps

The FHLBB needed a way to get cash to its constituent thrifts without violating its own regulations. In order to accomplish both goals, the Bank Board had to comply with the spirit of its regulations while also finding available funds for its thrifts. From the Board's perspective, its net worth regulations were meant to ensure that each thrift maintained an adequate financial position, and this goal was met so long as the thrifts kept their original loan portfolios. This was because those holdings met the regulations' standards when the loans were made, despite the fact that their value had changed over time. On the other hand, an actual sale for less than acquisition value would not provide this assurance because it would force the Board to use the new selling price when calculating a thrift's net worth. In the highly charged banking market, no sale could provide the needed amounts. Thus, the Board could not consider sales because they would change the thrifts' financial positions in a way not approved by the Board's regulations.

At the same time that the market made sales unattractive from a regulatory perspective, it also made them a poor economic choice because the number of potential buyers was limited and the likely selling price was low. Yet, even in hard times there remained at least one attractive cash cow—the United States Treasury. Through the Internal Revenue Service ("Service," or "IRS"), the government would have to give the thrifts substantial tax refunds if the thrifts' economic losses were transformed into deductible tax losses. Unfortunately, at least from the Bank Board's perspective, something more than a mere decline in value was needed to produce a tax deduction. In general, that something more was a sale or exchange of the depressed property, known in tax parlance as a "realization event."[16] Hence, it seemed that the FHLBB was caught in an untenable situation. If the thrifts wanted refunds, they would have to dispose of

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14. 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).
15. *See supra* notes 5 to 7.
16. B. Bittker & M. McMahon, *supra* note 11, ¶ 3.2.

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their loans. But, if they disposed of the loans, their economic condition would change, forcing the Board to reduce their net worth. Thus, the Board needed a way to create a realization event for tax purposes that did not change the thrifts' economic condition under the regulations. To this end, the Board developed the concept of "substantially identical" mortgages.

The Bank Board knew that the Internal Revenue Service would demand a disposition before granting a deduction. Sales were unacceptable because they changed a thrift's economic standing. Most exchanges were also problematic because they threatened to change a thrift's risk of repayment, which the Board saw as tantamount to a change in economic condition.[17] However, trades were tolerable if the exchanged loans carried the same economic risk. With matched risks, the Board hoped to achieve a realization event while avoiding an economic event.

The Board knew that it was possible to match loans by computer. Matched loans could standardize risk, thus leaving thrifts in the same economic condition as before an exchange. Of course, exchanging substantially identical loans would serve no business purpose if thrifts were in the same economic position both before and after the trade. However, the swaps would serve a tax purpose by providing a realization event. Thus, what looked foolish from a business perspective became ingenious tax planning. If the scheme worked, the thrifts would maintain their economic positions while still obtaining large cash infusions from tax refunds.

In its search for substantially identical loans, the Board went about the business of quantifying risk. It determined that there were three types of risks in any loan: credit (the ability to collect on the loan); rate (the future earning potential of the loan); and repayment (the extent of principal repayments and prepayments expected from the loan).[18] It further determined that these risks would coincide if thrifts swapped bundles of loans which met ten criteria. The Board's requirements were that each package of loans would:

17. A changed risk of repayment would result, for example, if a thrift gave up a loan due in 10 years paying 12% for a loan due in seven years paying 8%.

18. San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 580 (6th Cir. 1989) (citing FHLBB Mem. R-49 (June 27, 1980)).

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1. involve single-family residential mortgages,
2. be of a similar type (for example, conventionals for conventionals or adjustables for adjustables),
3. have the same stated maturity (e.g., thirty years),
4. have identical interest rates,
5. have similar remaining terms to maturity,
6. have aggregate principal amounts within the lesser of 2 1/2 percent or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the exchange, and
10. have all security properties for both sides of the transaction in the same state.[19]

When these ten standards were met, the Board would not require a recalculated net worth but, with luck, the Internal Revenue Service would allow the deductions and grant the refunds.

Shortly after the Bank Board issued its Memorandum R-49 setting out the scheme described above, many thrifts began trading substantially identical mortgages.[20] After the trades, the thrifts reported losses equal to the difference between their original acquisition values and the fair market values of the loans they received. These losses were then used to apply for substantial tax refunds. All of these refunds were denied by the Internal Revenue Service, which claimed that the exchanges did not meet Congress' requirements for creating deductible losses.[21]

III. The Internal Revenue Service Denies the Deductions

The Internal Revenue Service did not look kindly on the mortgage swaps. In fact, it refused to allow loss deductions as a result of the trades. By disallowing the deductions, the Service negated the sought-after tax refunds. The reason for the Service's resistance is easily understood if we acknowledge its view of income taxation.

19. *Id.* at 579.
20. *Id.* at 580.
21. *Id.*

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Economic reality and tax reality do not always coincide. For example, an economist would tell us that a person has income when he holds property originally purchased for $100 which is now worth $100,000.[22] Most of us would agree with the economist and find that the person is significantly wealthier than when he began. For the most part, however, our income tax system would leave this taxpayer unscathed because, in general, income taxation is transaction driven. Hence, when there is no transaction, there is no tax even when the investment's value increases in the taxpayer's hands.[23] Further, even in this transaction-driven system, there are times when taxpayers can dispose of property and still avoid or defer a tax.[24] For the Service, our transaction-driven tax system means that taxpayers hold most of the cards when it comes to tax planning because they control both the deals they enter into and when those deals are made. Without some limit on this taxpayer control, manipulations would rule the system.

The amulet protecting the Service from taxpayer manipulation is the economic consequences associated with most investments. The Service hopes these monetary risks will discourage taxpayers from engaging in purely tax motivated transactions. Yet, if economic risk serves as a shield, mortgage swaps come dangerously close to an IRS nightmare—tax benefits without economic risk. A swap of substantially identical mortgages gives thrifts complete control over their taxation by creating tax benefits without economic disincentives. To avoid this result, the Service developed a rationale for denying the deductions based on the Code's requirements for allowing losses.

IV. The Code Requirements for Deductible Losses

Under the Code, three events are required before an economic loss becomes a tax loss. The three events are realization,[25] recognition,[26] and allowance.[27]

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22. H. Simons, Personal Income Taxation 50 (1938).

23. There are exceptions to this general rule. For example, original issue discount bonds and market discount bonds are sometimes taxed on increases in value even without realization. I.R.C. §§ 1272-1273, 1276 (1988).

24. For a discussion of the deferral or exclusion of gain see B. Bittker & M. McMahon, *supra* note 11, ¶¶ 5, 27 (gifts and nonrecognition transactions).

25. I.R.C. § 1001(a) (1988); Treas. Reg. § 1.1001-1(a) (as amended in 1967).

26. I.R.C. § 1001(c).

27. *Id.* § 165.

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All realized losses are recognized unless the Code specifically avoids recognition.[28] Therefore, so long as the swaps effect realization, recognition follows as a matter of course. Because there is no Code section that denies recognition to mortgage swaps,[29] the IRS challenge to the thrifts' deductions is based on the concepts of realization and allowance.

V. Realization

Income taxation rarely tracks economic increases and decreases in wealth because economic sea changes present difficult timing issues.[30] For example, how would we tax the fluctuating value of a share that is quoted at $25 at 10 A.M., $23 at noon and $30 at closing? Instead of tracking economic performance, and in deference to its transaction model, the Code gives the taxpayer three hurdles to jump in order to convert his economic loss into a tax loss. Hence, a loss must be (1) realized before it is (2) recognized and (3), finally, allowed as a deduction.

Given the importance of realization, one would expect that the Code would define the concept precisely. Yet, realization is only briefly discussed in Treasury regulation 1.1001-1(a), which tells us that "gain or loss . . . from the exchange of property for other property *differing materially* either in kind or in extent, is treated as income or as loss sustained."[31] Further, little has been written on the topic,[32] and most of the realization cases

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28. *Id.* § 1001(c).

29. Section 1031 provides nonrecognition treatment for like kind exchanges. However, the section does not apply to exchanges of bonds, notes or evidences of indebtedness. *Id.* § 1031(a)(2)(B)-(C). Section 1091 provides nonrecognition when substantially identical stock or securities are traded within 30 days, but this section does not reach mortgage exchanges either. *Id.* § 1091(a).

30. Helvering v. Horst, 311 U.S. 112, 115-16 (1940).

31. Treas. Reg. § 1.1001-1(a) (1953) (emphasis added).

32. For a general discussion of the realization requirement, see B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶ 5.2 (2d ed. 1989) and the cases and articles discussed therein. For a recent article on realization, see White, *Realization, Recognition, Reconciliation, Rationality and the Structure of the Federal Income Tax System*, 88 Mich. L. Rev. 2034 (1990). For a discussion of realization in the mortgage swap area from the perspective of the taxpayer's attorney, see Bacon, *S&L Loan Swaps at the Supreme Court: Ripple Effects*, 49 Tax Notes 1121 (Dec. 3, 1990); Lusby, *Loan Swaps: On the Road to Proper Tax Treatment*, Legal Bull. 155 (July 1988); LeFevere, *Tax Treatment of Reciprocal Mortgage Sales*, 31 Tax Mgmt. (BNA) 167 (June 4, 1990); Comment, *Reciprocal Mortgage Sales: A Question of Realization*, 41 Baylor L. Rev. 135 (1989).

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date back to the 1920s.[33] As a result of this lack of guidance, mortgage swaps force us to revisit this old and well established concept.

A. *Realization Theories*

The mortgage swap strategy has spawned two realization theories. Both theories acknowledge that a true economic loss is required for realization, i.e., that the property must have actually declined in value. Both theories also agree that a transaction is needed to create a tax loss. This transaction model avoids the timing problems created by reliance on economic loss alone by providing an event that fixes the time to determine tax consequences. Where the theories diverge is on whether realization requires only an economic loss followed by a disposition or whether a third step is also needed. That third step is an exchange of materially different properties.

1. *Economic Loss Followed by Disposition (Fixed Transactions)*

For the Sixth Circuit,[34] one district court,[35] and a minority of the tax courts,[36] only two steps are required for realization: an

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33. *See* Marr v. United States, 268 U.S. 536 (1925) (stock in corporation of one state exchanged for stock in another corporation from a different state); Weiss v. Stearn, 265 U.S. 242 (1924) (corporate reorganization and admittance of new shareholders); Cullinan v. Walker, 262 U.S. 134 (1923) (corporate reorganization and transfer of stock); Rockefeller v. United States, 257 U.S. 176 (1921) (two corporations form a separate corporation); United States v. Phellis, 257 U.S. 156 (1921) (trade of stock and assets between New Jersey and Delaware corporations); Eisner v. Macomber, 252 U.S. 189 (1920) (stock dividends); Mutual Loan & Sav. Co. v. Commissioner, 184 F.2d 161 (5th Cir. 1950) (bond exchange); Girard Trust Co. v. United States, 166 F.2d 773 (3d Cir. 1948) (exchange of municipal bonds); Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948) (same); Schoenberg v. Commissioner, 77 F.2d 446 (8th Cir. 1935) (purchase of stock by controlled corporation followed by sale to controlling shareholder), *cert. denied*, 296 U.S. 586 (1936); C.M. Hall Lamp Co. v. United States, 97 F. Supp. 481 (E.D. Mich. 1951) (bond exchange); West Missouri Power Co. v. Commissioner, 18 T.C. 105 (1952) (same); Horne v. Commissioner, 5 T.C. 250 (1945) (sale and repurchase of a seat on the stock exchange); Hanlin v. Commissioner, 38 B.T.A. 811 (1938), *aff'd*, 108 F.2d 429 (3d Cir. 1939).

34. Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

35. First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

36. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

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economic loss followed by a disposition through which the taxpayer relinquishes his control over the property. As Judge Smith tells us in *First Federal Savings & Loan Association of Temple v. United States* ("*Temple*"): "First, one asks the question, 'Has Temple suffered a real economic loss, or more specifically, has Temple experienced a change in the net worth of the asset(s) in question?' . . . Second, one asks, 'Has there been a sale or other disposition of the property which has declined in value?'"[37]

This limit on realization to economic loss followed by disposition has two justifications. Courts that adopt the narrow view believe that the Code supports their position. For them, the language of Treasury regulation 1.1001-1(a) simply tells us how to calculate a loss without providing for additional conditions.[38] Taxpayers assert a second justification for limiting the question to a search for dispositions: The disposition test provides a bright line for taxpayers, courts, and the Service in accordance with the administrative needs which first led to the realization concept.[39]

2. *Material Difference*

While some courts are content to limit realization to an economic loss followed by a disposition, other courts seek something else besides. They too want an actual decline in value

37. 694 F. Supp. at 239-40.

38. As Judge Cohen stated:

> [The] regulation could have, but does not state that income or loss is only sustained upon "exchange of property for other property differing materially either in kind or in extent"; prior regulations containing such a requirement have not been carried forward in the current regulation; and the converse of a true statement is not necessarily true. Respondent contends that the regulation means that the gain or loss realized from the exchange of property for other property *not* differing materially either in kind or extent is *not* treated as income or loss. I believe that the regulation deals with *computation* of gain or loss and not with whether gain or loss will be realized or recognized.

Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 403 (1988) (Cohen, J., concurring) (emphasis in original) (citations omitted). *Accord* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 240 (W.D. Tex. 1988); Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848, 852 (6th Cir. 1989).

39. Bacon, *supra* note 32, at 1122.

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followed by an exchange, but only if the exchange is of materially different properties. What "material difference" means, and why it should serve as a necessary aspect of realization, is the subject of this section.

a. *Material difference as economic substitution*

One problem with the material difference concept is that the term does not have the same meaning for all those who have looked at the issue. For some, material difference asks whether there is economic identity between the traded properties at the time of the exchange.[40] Using this standard, material difference under the Code cannot coexist with the substantially identical mortgages created under FHLBB Memorandum R-49. As explained by Judge Smith:

> When it is established that Memorandum R-49's very purpose for existing was to fashion a transaction that involves the exchange of what are in essence economic substitutes for one another . . . it becomes almost ludicrous to suggest that R-49 loans are at the same time "substantially identical" for financial accounting purposes and "materially different" for tax accounting purposes. . . . The economic reality here is that loans which meet the criteria of Memorandum R-49 are economic substitutes for one another . . . .[41]

b. *Material difference limited by fungibility*

Other courts are less exacting in their use of the material difference standard. For them, all that is required for material difference is that the exchanged properties not be identical, fungible commodities.[42] Under this standard, there is no material difference when Farmer A exchanges 1,000 bushels of Kansas

40. Centennial Sav. Bank, F.S.B. v. United States, 682 F. Supp. 1389, 1398-1400 (N.D. Tex. 1988), *aff'd in part and rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990); First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 242-48 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

41. 694 F. Supp. at 245.

42. San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 586 (5th Cir. 1989).

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spring wheat for Farmer B's 1,000 bushels of Kansas spring wheat,[43] *but, there is material difference* when Bank A and Bank B exchange substantially identical mortgages. For the courts that use the fungible commodity standard, substantially identical mortgages for FHLBB regulatory accounting purposes are not identical, fungible commodities because the mortgages have different obligors and are secured by different properties.[44]

Although FHLBB Memorandum R-49 sought to standardize each thrift's risk in a number of ways, it could not change the fact that each loan was to different homeowners and was secured by a unique piece of property. True, at the time of the exchange each loan was current and all the properties were located in the same states. However, those similarities could not ensure that each home would retain its value or that each borrower would continue to pay on his mortgage loan. These disparities became apparent when the loans did not perform in exactly the same way after the exchanges. For the courts that use the fungible commodity approach, these changes in performance are predictable proof that the swapped mortgages are not identical.[45] Thus, courts that adopt the fungible commodity approach to the material difference standard have no problem holding that mortgage swaps trigger realization.

VI. Evaluating the Realization Theories

Clearly, the fixed transaction view of realization clashes with the material difference requirement, whether that standard compels us to look at economic substitution or the more limited fungible commodity criterion. This conflict leads to the question: Which realization theory is best suited to our income tax system?

A. The Fixed Transaction Approach Is Too Limited

The fixed transaction approach places no limits on realization through meaningless exchanges. Rewarding meaningless exchanges is a serious flaw because it allows taxpayers to manipulate our

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43. *Id.* at 583.

44. Federal Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580, 584 (D.C. Cir. 1990); San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 587 (5th Cir. 1989).

45. 896 F.2d at 584; 887 F.2d at 587.

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tax system's transaction model. To illustrate this point, let us return to the farmers holding spring wheat. Assume that in April the market for wheat has fallen, although it is expected to pick up next year. Farmer A decides to store his wheat until it increases in value, at which point he will sell it and register a profit. Farmer A has no tax loss this year. Instead, he has to live with the economic decline in his property's value until he sells the grain. Further, if the price of wheat actually rises next year, Farmer A will have a gain instead of a loss, which will force him to pay tax instead of receiving a refund.

Using the fixed transaction approach without the additional material difference requirement, Farmers B and C trade their crops in April and claim a tax loss.[46] They use this tax loss to decrease their taxable income and apply for and receive a tax refund. When the market for wheat increases in January, they sell their grain at a profit and pay tax on the gain.

What is it about these two transactions that requires different tax treatment? The answer is nothing. The transactions are too similar to produce different tax results. The trade between Farmers B and C is a meaningless exchange which should not produce a tax loss. Because there is no significant difference between Farmers A, B, and C they should all receive the same tax treatment. Yet, the fixed transaction model requires disparate treatment because Farmers B and C have exchanged their fungible commodities and Farmer A has not.

One argument in support of the fixed transaction approach to realization is that section 1001(a) is merely a computation section with no effect on realization.[47] This assertion misses an important part of the history of the material difference model. Even if the regulations are wrong and the Code itself fails to articulate a separate material difference standard, case law dating back to the 1920s supports a material difference requirement for realization.

The classic case in this regard is *Eisner v. Macomber*,[48] in which the Supreme Court prevented the Service from taxing

46. This example is based on the Fifth Circuit's analysis in San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 583 (5th Cir. 1989).

47. Cottage Sav. Bank Ass'n v. Commissioner, 90 T.C. 372, 403-04 (1988) (Cohen, J., concurring), *rev'd*, 890 F.2d 848, 850-52 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

48. 252 U.S. 189 (1920).

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gain derived from a stock dividend. There the taxpayer maintained her same percentage ownership in the company, although she had many more stock certificates. When, as part of a reorganization, shareholders exchanged certificates in Corporation A for the same ownership interest in Corporation B, and B continued A's business and remained in the same state, the Court once again found no realization.[49] In both of these cases, the taxpayers were in the same position before and after the exchange. True, they held different pieces of paper, but those papers continued to represent their unchanged interests in the same underlying assets. In contrast, where taxpayers received shares in a new company which was incorporated in a different state, the Court found material difference and taxed the gain because each state's unique laws created distinct shareholder rights and obligations.[50] All these decisions, and many more like them, rest on the view that, in an exchange, a taxpayer must receive something different from the thing transferred before realization occurs.[51]

B. The Economic Substitute Theory Is Too Broad

The economic substitute approach to material difference asks us to look at the risks associated with each investment. This technique also overrides the transaction model of income taxation. For example, trading an A.T.& T. bond for an I.B.M. bond is not a meaningless exchange because the taxpayer has received something substantially different for the property he tendered in return.[52] Yet, it is possible that each bond shares the same rating for economic risk. Using the economic substitute view of material difference, this exchange does not create a realization event because one bond is an economic substitute for the other. This is true even though the taxpayer has not engaged in a meaningless transaction. Yet, a transaction-based tax system should be able to distinguish between the wheat swap and the

49. *Id.* at 193. *See also* Weiss v. Stearn, 265 U.S. 242 (1924) (no realization when reorganized corporation substantially maintains corporate identity).

50. Marr v. United States, 268 U.S. 536, 541 (1925).

51. *See supra* note 33 for cases discussing material difference standard.

52. This example is based on the Fifth Circuit's analysis in San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 590 (5th Cir. 1989).

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bond swap. Otherwise, transactions become useless as a trigger for income taxation.

C. *The Fungible Commodity Approach Is the Correct Standard*

Of the three theories, the use of fungible commodities as a way of defining material difference is the best approach to the realization dilemma. On the one hand, it maintains the integrity of transactions as the trigger for taxation because any exchange, except an exchange of identical property, will suffice to trigger realization. On the other hand, it protects the tax system from manipulation through meaningless exchanges by prohibiting trades of fungible commodities.

In addition to maintaining our transaction model of income taxation, the fungible commodity standard also survives general objections to the material difference standard. Thus, in contrast to the economic substitute model, this approach provides a bright line test for taxpayers, courts, and the Service.

Another objection to the material difference view of realization is that it destroys the meaning of section 1001(c), which requires recognition unless a Code provision specifically provides otherwise. For those who support this view, if section 1001(a) already prevents realization for trades of non-materially different properties, then other nonrecognition provisions (such as the wash sale rules of section 1091 and the like kind exchange rules of section 1031) are "an absurd effort in futility."[53] After all, why would Congress create several nonrecognition provisions when realization was already in place to prevent tax consequences? This interpretation of section 1001(a) is based on an inappropriate reading of the material difference standard.

The material difference standard is not a super realization provision. Rather, this minimum measure provides the floor (instead of a ceiling) for judging transactions. Thus, for example, using the identical property approach, the material difference standard would not prevent realization when a taxpayer trades a copyright of *Beloved*[54] for a copyright of *The Spook Who Sat*

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53. First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 247 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).
54. T. MORRISON, BELOVED (1987).

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by the Door,[55] because novels are not fungible commodities. Yet, this swap would receive nonrecognition under section 1031 as an exchange of like kind properties.[56]

VII. Allowance as a Requirement for a Loss Deduction

If realization requires material difference and material difference is the opposite of economic substitution, then the attempted deductions must fail because the exchanged mortgages cannot be both substantially identical and materially different. However, under the other two realization theories, there is still some hope of achieving a deduction.

Thus, if all realization requires is a fixed transaction, as asserted by the tax court minority,[57] the *Temple* district court,[58] and the Sixth Circuit,[59] then realization is achieved because the exchanged mortgages actually declined in value and were disposed of in fixed transactions.[60] Further, recognition is also accomplished because Code section 1001(c) tells us that realized losses are always recognized unless the Code specifically provides otherwise.[61]

Using the fungible commodity test of realization, the mortgage swaps also meet the first two criteria for obtaining a tax loss. Realization is accomplished because: (1) the exchanged mortgages actually declined in value; (2) the thrifts disposed of the depreciated debts in bona fide transactions; and (3) the traded properties were materially different, as demonstrated by the fact that each loan was made to distinct borrowers who provided unique security.[62] Here too, recognition follows realization under Code section 1001(c).

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55. S. Greenlee, The Spook Who Sat by the Door (1990).

56. Prop. Treas. Reg. § 1.1031(a)-(c)(3), 55 Fed. Reg. 17,635 (to be codified at 26 C.F.R. pt. 101) (proposed Apr. 26, 1990).

57. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 403-04 (1988) (Cohen, J., concurring), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

58. 684 F. Supp. 230, 242-48 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

59. Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848, 852 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

60. *See supra* text accompanying notes 34-45.

61. I.R.C. § 1001(c) (1988).

62. *See supra* text accompanying notes 42-45.

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Because these two theories find realization in the mortgage swap area, the question now becomes whether the realized and recognized losses are allowed under the Code. To answer this query, we must turn to section 165.

Code section 165(a) tells us that, in general, losses are allowed in the year sustained if not compensated by insurance or otherwise.[63] This section is modified by regulations that state: "Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss."[64] Once again, courts that have looked at mortgage swaps do not agree on what this language means or how it affects the thrifts' ability to receive a deduction.

A. *Section 165 Does Not Apply to the Mortgage Swaps*

The tax court,[65] the *Temple* district court,[66] the District of Columbia Circuit,[67] and the Fifth Circuit[68] all believe that section 165 does not apply to mortgage swaps because, for these courts, section 165 is concerned only with preventing deductions arising from manufactured losses. As long as the traded property has actually suffered a decline in value, section 165 is satisfied. It is only when taxpayers construct illusory losses which lack economic substance that section 165 steps in to disallow the deduction.[69]

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63. I.R.C. § 165(a) (1988).

64. Treas. Reg. § 1.165-2(b) (1953).

65. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 401-02 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

66. First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 248-49 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

67. Federal Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580, 584 (D.C. Cir. 1990).

68. San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 592-93 (5th Cir. 1989).

69. As Judge Smith tells us:

> Section 165 . . . is concerned solely with the truth or reality . . . of a claimed economic loss. It does not speak to the situation, encountered here, where a real economic loss has occurred but the "identifiable event fixing the loss" (the exchange), in effect, simply substitutes economically equivalent assets. . . . In short, Sections 165 and 1001(a) simply were not intended to speak to the aspect of deducting losses presented by this case.

First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 248 n.19 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989).

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For example, suppose a taxpayer is approached by a broker with the following proposal: For a small fee, I will take your cash and invest it in commodities; if the investment increases in value, I will keep the gain; if it declines in value, I will make good on the loss; in the first year, I promise to reduce your taxes by generating deductible tax losses for your account; in the second year, your taxes will also decline as I pass you a capital gain; in any event, your principal is protected.[70]

For those courts that see section 165 as a barrier against *ersatz* loss deductions, this transaction is unacceptable and disallowed. But, for these same courts, the mortgage swaps do not fall to this level of deceit. Instead, the mortgage swaps survive section 165's gauntlet because the trades are of actually depreciated loans. Further, the exchanges are valid because the benefits and burdens associated with each property were actually transferred as a result of the swaps.[71] Thus, if section 165 is concerned solely with the truth or reality of a claimed economic loss, it does not apply where a real economic loss has occurred.[72] As long as the losses exist independent of the transactions, the deduction is allowed.

B. Section 165 Provides an Independent Test for Allowance

While the tax court, the *Temple* district court, the District of Columbia Circuit, and the Fifth Circuit find no need to apply section 165 to mortgage swaps, the Sixth Circuit holds a different view. For the Sixth Circuit, section 165 articulates a concept underlying all loss deduction provisions—that before a loss is allowed the taxpayer must show some business purpose for entering into a transaction.[73] This business purpose is shown not by the taxpayer's motive, but by the economic substance of the transaction.

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70. This example is based on the facts of Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988), which is discussed by the Fifth Circuit in San Antonio Sav. v. Commissioner, 887 F.2d 577, 592 (5th Cir. 1989).

71. *See* Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 401-02 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

72. *See* First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230, 248 n.19 (W.D. Tex. 1988), *aff'd*, 887 F.2d 893 (5th Cir. 1989).

73. Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848, 853-54 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

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The Sixth Circuit believes that Congress would not create a tax that both imposes a liability and then allows its own circumvention without resort to some transaction that carries economic consequences.[74] Thus, the economic substance requirement that the Sixth Circuit finds in section 165 is a shorthand definition of business purpose. Would this transaction take place absent tax benefit? Are there times when a taxpayer might swap substantially identical mortgages even if the exchange produced a taxable gain?

Where the taxpayer's economic position remains stable after the transaction, the only purpose for the exchange becomes the desired tax result. In this situation, the loss is not allowed because "we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose."[75] Under this approach, mere decline in value is not enough to force an allowance. Rather, the taxpayer must show that the exchange that created the tax loss might have occurred even in a tax free world. If the thrifts would never swap mortgages absent the tax advantage, then the transactions lack economic substance and are not allowed.

VIII. Business Purpose as a Requirement for Allowing a Loss Deduction

The conflict between the Sixth Circuit and other courts concerning the scope of section 165 raises the question: "Does the Code require a business purpose as a condition for granting the loss deductions?" The answer to that question is yes.

We know for example that, at the very least, the Code favors business deductions over personal deductions. This is the clear meaning derived from contrasting section 162 (which allows deductions for ordinary and necessary business expenses) and section 262 (which disallows deductions for personal, living and family expenses). But why does the Code embody this favoritism?

At least one reason is that legitimate business deductions allow us to avoid taxing people on the funds they expend to earn

74. 890 F.2d at 853-54.

75. *Id.* (quoting Gilbert v. Commissioner, 248 F.2d 399, 410-11 (2d Cir. 1957) (Hand, J., dissenting)).

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income.[76] But, there is another reason as well. We do not want people to completely control their own taxation, as would occur if all expenditures produced deductions. Presumably, business expenses are incurred in an attempt to produce profits. This motivation then provides a failsafe protection against manipulation, because business, by its very nature, carries with it economic risk. To expunge this risk from a determination of tax consequences would completely destroy the government's revenue raising ability by encouraging taxpayers to orchestrate their tax effects at will. A business purpose requirement is needed to avoid this result.

One area where business purpose is fully developed is in the corporate tax arena. In general, corporations are separate taxpayers from their shareholders.[77] This separate taxation creates an opportunity to exploit the tax system by passing income from a shareholder to a corporation or from a corporation to a shareholder. One way that courts avoid this maneuvering is by mandating that corporations serve a business purpose before they are treated as distinct taxpayers.[78] If the corporation serves a business purpose, then the public fisc has its first line of defense—the market with all its hazards and opportunities will keep taxpayers from blithely constructing deductions.

The potential to maneuver is present in the litigated mortgage swaps by virtue of FHLBB Memorandum R-49. By matching loans to the point that they are economic equivalents in the taxpayers' eyes, the Memorandum encourages thrifts to enter into transactions that they would not conceive of for business reasons. Yet, there are numerous objections to applying the business purpose requirement in this area.

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76. We would not, for example, want to tax someone on the cost of his inventory in the following situation: Alphonse purchases a dish for $2 and sells it for $3. By allowing a deduction for the cost of the product, we can limit Alphonse's taxable income to $1 (the profit derived from the sale) rather than to the entire $3 received.

77. H. Abrams & R. Doernberg, Federal Corporate Taxation 1 (2d ed. 1990) (basic premise underlying Subchapter C is that a corporation should be a taxpayer distinct from its shareholders).

78. *See* Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943); Rands, *Organizations Classified as Corporations for Federal Tax Purposes*, 59 St. John's L. Rev. 657 (1985).

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A. *Business Purpose Creates Uncertainty*

One objection to including a business purpose test under section 165 is that this additional factor creates uncertainty because the thrifts cannot know how much economic motivation is needed to meet the standard.[79] This objection assumes that the test sets a high and unduly sophisticated threshold that is difficult to reach. Yet, including the business purpose model within section 165 does not mean that mortgage swaps can never create deductible losses. For example, the business purpose view of section 165 should allow a deduction on the facts presented by *Federal National Mortgage Association v. Commissioner*.[80]

The Federal National Mortgage Association ("FNMA") is a private corporation subject to regulation by the Department of Housing and Urban Development ("HUD"). Its primary function is to provide liquidity for mortgage investments by purchasing mortgages from lenders.[81] Under HUD's regulations, the FNMA was told to reduce the number of loans it held that were secured by rural properties.[82] It was also directed to increase its portfolio of urban mortgages.[83] To accomplish its mandate to support the struggling savings and loan industry, FNMA was attracted to the mortgage swap arena.[84] For business purposes, it also sought ways to increase both its customer base and its holdings of due-on-sale mortgages.[85] All these factors drew FNMA towards mortgage swaps.

The principal market for mortgage swaps was among institutions subject to the Federal Home Loan Bank Board. Thus, although it did not answer to FHLBB regulations, FNMA engaged in swaps of substantially identical mortgages as defined by FHLBB Memorandum R-49. Because much of FNMA's inventory was as depreciated as the debt held by the savings and loans, it claimed deductible losses as a result of the trades. Because those trades involved substantially identical mortgages, the requested refunds fell under the same cloud that darkened the savings and loans.

79. Bacon, *supra* note 32, at 1131.
80. 896 F.2d 580 (D.C. Cir. 1990).
81. *Id.* at 582.
82. *Id.* at 583.
83. *Id.*
84. *Id.*
85. *Id.*

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When presented with these facts, the District of Columbia Circuit accepted the limited view of section 165, which holds that the section's power is restricted to attacking illusory losses.[86] Thus, it allowed the deductions under these circumstances as it would have even if tax benefit was the sole motive for the transaction.[87] Yet, these facts are significantly different from the other mortgage swap cases. Here, FNMA should receive a deduction even using the Sixth Circuit's stricter analysis.

FNMA would survive the Sixth Circuit's business purpose test because the swaps satisfied at least some legitimate non-tax related business purpose; apparently, FNMA might well have traded mortgages in a tax free world. Other thrifts might meet this standard as well. Unfortunately, with the exception of the Sixth and D.C. Circuits, courts that have looked at this issue cannot make this determination because the taxpayers did not reveal their business purposes for engaging in the trade if, in fact, there were any.

B. The Business Purpose Test Creates a Super Wash Sale Rule

Section 1091 denies loss deduction where a taxpayer sells or otherwise disposes of "stock or securities" and, within thirty days before or after the event, acquires "substantially identical" stock or securities.[88] Because mortgages are not stock or securities, section 1091 does not apply to the mortgage swaps. By using section 165 to attack these trades, so the argument goes, the Service is creating a new section 1091 without congressional mandate.[89] This contention is further bolstered by reference to section 56(g)(4)(E), which disallows seventy-five percent of all losses resulting from "the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities" when corporations calculate their alternative minimum tax obligations.[90] By disallowing some, but not all, of the losses

86. *Id.* at 584.
87. *Id.*
88. I.R.C. § 1091(a) (1988).
89. Petitioner's Brief at 23-24, Cottage Sav. Ass'n v. Commissioner, No. 89-1965 (Oct. Term 1990) (filed Nov. 15, 1990).
90. *Id.*

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(and then only for purposes of the alternative minimum tax), Congress has shown that it means to allow losses for mortgage swaps under the regular tax.[91]

This position suffers from the same flaws contained in the claim that the inclusion of a material difference facet in the realization requirement is an inappropriate addition to the like kind exchange rule of section 1031.[92] The two rules serve unique purposes that can easily coexist.

Section 1091 is limited to exchanges of securities. Its thirty-day rule evidences Congress' view that shares of stock in the same company are substantially identical within any given thirty-day period. The section does not tell us whether a trade outside the thirty-day period has a business purpose. We can presume that such trades do reflect the taxpayer's read of the economic climate, but the section itself leaves this query to other hands. Further, section 1091, by its very nature, has no application to the mortgage swaps because those debts are not stock or securities, which is all that section addresses.

The resort to section 56 is also unwarranted. First, subsection 56(g)(4)(E) was not in effect at the time the mortgage swaps were made.[93] Further, section 56(g)(4)(E) is limited to debt obligations that have substantially the same effective interest rates and maturities.[94] As pointed out by Judge Cohen, the opposite of a true statement is not always also true.[95] Thus, it does not follow that if section 56 does not attack losses from trades of debt under the alternative minimum tax, then these losses are immune from attack under the regular tax. In addition, section 56(g)(4)(E) relates only to debt obligations that are substantially identical for purposes of interest rates and maturity. Under Memorandum R-49 the swapped mortgages are identical in some eight other aspects as well.[96] This identity makes it

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91. *Id.*

92. *See supra* text accompanying notes 53-56.

93. Section 56(g)(4)(E) was added to the Code in 1986, some six years after Memorandum R-49 first created the mortgage swap market. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

94. I.R.C. § 56(G)(4)(e) (1988).

95. Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372, 403 (1988) (Cohen, J. concurring), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

96. *See supra* text accompanying notes 18-21.

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harder to argue that a business purpose exists for the mortgage exchanges, although such a purpose may well exist in other cases.

C. Including Business Purpose in Section 165 Creates an Administrative Nightmare

The business purpose test might well create an administrative nightmare if that standard was equivalent to an economic substitution test. To force taxpayers, courts, and the Service to determine whether exchanged properties are the same, based on some exalted view of the "market," demands a level of sophistication that is probably beyond each group's ken. However, when we limit the test to its original function—the ferreting out of some legitimate business reason for engaging in the transaction—the problem disappears. In fact, as indicated above, courts have used the business purpose test in the corporate tax area since the 1940s, and the anticipated nightmare has yet to materialize.

D. Applying a Business Purpose Test Under Section 165 Creates a Different Rule for Recognizing Gains Than for Recognizing Losses[97]

This argument is the strangest of all those advanced against the use of the business purpose test, because it fails to acknowledge that the entire Code imposes harsher rules for deducting losses than for taxing gains. Although losses must be realized, recognized, and allowed before they become deductions, gains are taxed based on realization and recognition alone. There is no additional allowance requirement for the taxation of gain. The additional allowance requirement for the deduction of losses reflects Congress' view that taxpayers are more prone to manufacture losses than gains. This is true because losses create deductions and deductions tend to work to the taxpayers' advantage in a way that gains do not. Thus, if a harsher rule for losses than for gains is a flaw in the tax system, that blemish goes far beyond the transactions at issue in the mortgage swap cases.

97. Bacon, *supra* note 32, at 1133.

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IX. Conclusion

In order to deduct a loss, a taxpayer must meet three separate criteria: realization, recognition, and allowance.[98] Although these three conditions are explicitly mandated by the Code, no court has correctly applied all three in the mortgage swap area.

All three tests are needed because each serves a unique purpose in our tax system. Realization provides the proper moment to engage the tax out of the endless series of possibilities created by the sea changes of the economic market. Recognition allows Congress to override its general timing principles when other policies make such a change attractive. Allowance gives Congress the opportunity to restrict deductions that do not further its ideal of an economically based tax system, as, for example, when a transaction serves no business purpose.

The realization standard is misapplied both by those courts who hold that only an economic loss followed by a disposition is needed to effect realization and by those who use material difference as a synonym for economic substitution. The realization standard is neither so narrow nor so broad. Instead, realization is accomplished when property that has actually declined in value is disposed of in a fixed transaction, and the property received in return is not the transferred property's twin.

The allowance standard is misapplied when it is limited to an attack on illusory losses; section 165 is more powerful than such a position maintains. Rather, section 165 attacks both losses without economic substance and transactions without business purpose aside from possible tax advantage.

The proper questions to ask when judging whether mortgage swaps create deductible losses are whether the swaps are:

(1) *Realized.* This is shown in the mortgage swap area because: (a) the loans actually declined in value before the trades were made; (b) the exchanges were fixed transactions in which the thrifts gave up their rights in the traded properties; and (c) the mortgages received were materially different from the transferred mortgages because each loan had a distinct borrower and was secured by unique property;

(2) *Recognized.* Under section 1001(c) the trades are recognized

98. I.R.C. §§ 1001(a), 1001(c), 165 (1988).

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> because there is no Code section that prohibits recognition; and (3) *Allowed*. A loss is allowed when the taxpayer demonstrates that the transaction that purports to create the loss might have occurred in a tax free world, i.e., that it has some legitimate business purpose.

To date, each decision concerning the mortgage swaps has failed to apply all three criteria correctly.

Some courts have stopped their analysis at realization because they believed that the loans were not materially different, rendering the losses unrealized.[99] Yet, the loans were materially different because they each were made to distinct borrowers and were secured by unique properties.

Other courts have gone on to an allowance analysis but have misapplied section 165 by limiting its powers to a search and destroy mission for manufactured losses.[100] This position fails to acknowledge the broader mandate of the business purpose test.

Even the Sixth Circuit, which properly applied section 165, is wrong because it fails to accept the material difference standard for realization.

What then is the correct result? Are the trades as created by Memorandum R-49 appropriate paths to a loss deduction? The answer to this question rests on whether the mortgage swaps had any business purpose.

As noted above, the mortgage swaps pass the realization and recognition hurdles to loss deductions because the traded loans were materially different. What we need to know is whether these trades also meet the business purpose test of section 165. In all but *Federal National Mortgage Association*[101] and the Sixth Circuit opinion in *Cottage Savings Bank*[102] this question

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99. Centennial Sav. Bank, F.S.B. v. United States, 682 F. Supp. 1389, 1398 (N.D. Tex. 1988), *aff'd in part and rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

100. *See* Federal Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580 (D.C. Cir. 1990); San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577 (5th Cir. 1989); First Fed. Sav. & Loan Ass'n of Temple v. United States, 694 F. Supp. 230 (W.D. Tex. 1988), *aff'd*, 887 F.2d 593 (5th Cir. 1989); Cottage Sav. Ass'n v. Commissioner, 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

101. 90 T.C. 405 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990).

102. 890 F.2d 848 (6th Cir. 1989), *cert. granted*, 111 S. Ct. 40 (1990).

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was not addressed. In *Federal National Mortgage Association* the thrift was able to show a business purpose for its transactions (even though the court would have granted the deduction absent that showing) and the loss was allowed.[103] In *Cottage Savings Bank* the thrift did not show a business purpose, and the loss was denied.[104] Thus, the results in these two cases are correct even if the reasoning of both decisions is flawed: the Sixth Circuit's because it does not accept material difference and the D.C. Circuit's because it does not accept business purpose.

In the other litigations, the question of business purpose was never asked. Perhaps now as these cases travel to the Supreme Court, that question will be answered.

103. 896 F.2d at 589.
104. 890 F.2d at 854-55.

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