First National Bank in Little Rock v. Commissioner, 83 T. C. 202 (1984)

Bad debt deductions for intercompany loans must be deferred when filing consolidated returns until specific triggering events occur.

Summary

First National Bank in Little Rock created a wholly owned subsidiary to handle mortgage loans and filed consolidated returns with it. The bank sought to deduct additions to its bad debt reserve based on loans to the subsidiary. The court held that under the consolidated return regulations, these deductions must be deferred until the loans are sold outside the group or another triggering event occurs. This decision emphasizes the principle that consolidated returns treat the group as a single entity, necessitating the deferral of intercompany bad debt deductions.

Facts

First National Bank in Little Rock formed First National Mortgage Co. to provide home purchase financing and generate federally insured mortgages. The bank loaned funds to the mortgage company, which used them to make loans to home buyers and developers. These intercompany loans were treated as short-term loans for accounting purposes, with interest charged at an arm's-length rate. The bank and mortgage company filed consolidated federal income tax returns for 1974 and 1975, where the bank elected to use the reserve method for bad debt deductions under section 166(c) and the percentage method under section 585(b)(2) to compute additions to its reserve, including the intercompany loans in its base.

Procedural History

The Commissioner of Internal Revenue disallowed the bank's additions to its bad debt reserve to the extent they were based on loans to the mortgage company. The bank petitioned the United States Tax Court for a redetermination of the deficiencies determined by the Commissioner for the tax years 1974 and 1975.

Issue(s)

1. Whether the bank may include loans to its wholly owned subsidiary in its loan base for computing additions to its bad debt reserve when filing consolidated returns.

Holding

1. No, because under section 1. 1502-14(d)(1) of the Income Tax Regulations, bad debt deductions for intercompany loans must be deferred until one of the events described in sections 1. 1502-14(d)(2) and (3) occurs.

Court's Reasoning

The court applied section 1. 1502-14(d)(1) of the consolidated return regulations, which explicitly defers bad debt deductions for intercompany transactions until certain triggering events occur, such as the sale of the obligation to a nonmember. The court rejected the bank's arguments that the regulation was invalid or contrary to congressional intent, emphasizing that the regulation is consistent with the purpose of consolidated returns to treat the group as a single entity. The court also dismissed concerns about the interaction with the minimum tax provisions, stating that the minimum tax should be adjusted to prevent unfair results. The decision aligns with Revenue Ruling 76-430 and the case of Sooner Federal Savings & Loan Association v. United States, which reached similar conclusions about the deferral of intercompany bad debt deductions.

Practical Implications

This decision impacts how banks and other financial institutions compute their bad debt deductions when filing consolidated returns. It necessitates careful consideration of intercompany loans and the timing of bad debt deductions, as they must be deferred until a triggering event occurs. Practitioners should advise clients filing consolidated returns to exclude intercompany loans from their bad debt reserve computations until they are sold outside the group. This ruling may affect the tax planning strategies of banks with subsidiaries, potentially influencing decisions about filing consolidated returns versus separate returns. Later cases, such as Sooner Federal Savings & Loan Association, have followed this precedent, affirming the need to defer intercompany bad debt deductions under consolidated return regulations.

