IT&S of Iowa, Inc. v. Commissioner, 97 T. C. 496 (1991)

A bank's core deposit intangible, separate from goodwill, can be amortized if it has an ascertainable value and limited useful life.

Summary

IT&S of Iowa, Inc. acquired the What Cheer bank, allocating part of the purchase price to a core deposit intangible based on cost savings. The court upheld the separability of this intangible from goodwill and its eligibility for amortization, but found flaws in the valuation method. The taxpayer included interest-sensitive deposits, failed to account for reserve requirements and float, and used an inappropriate alternative funding source. The court allowed accelerated amortization but required recalculation of the intangible's value using the correct methodology and alternative funding rate.

Facts

IT&S of Iowa, Inc. , an Iowa bank, acquired the First State Bank of What Cheer in 1983. The purchase price was allocated to various assets, including a core deposit intangible valued at $938,549 using the cost savings method. This method compared the cost of the acquired bank's stable, low-cost deposits to an alternative funding source. IT&S claimed amortization deductions on this intangible, but the IRS challenged the valuation and amortization method.

Procedural History

The IRS determined deficiencies in IT&S's federal income tax for several years due to the amortization deductions. IT&S petitioned the U. S. Tax Court, which upheld the concept of core deposit intangibles but found errors in IT&S's valuation. The court ordered a recalculation under Rule 155.

Issue(s)

1. Whether the core deposit intangible of the acquired bank has an ascertainable value separate and distinct from goodwill?
2. Whether the core deposit intangible has a limited useful life?
3. Are the values and amortization schedules utilized by IT&S in calculating depreciation deductions reasonable?
4. May IT&S amortize the core deposit intangible on an accelerated basis?

Holding

1. Yes, because the core deposit intangible is a distinct asset that can be valued separately from goodwill.
2. Yes, because the court found the core deposit intangible had a limited useful life based on the attrition rate of the deposit base.

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3. No, because IT&S's valuation method included interest-sensitive deposits, failed to account for reserve requirements and float, and used an inappropriate alternative funding source.
4. Yes, because the present value approach to calculating annual amortization produces a reasonable allowance for depreciation.

Court's Reasoning

The court followed its precedent in *Citizens & Southern Corp. v. Commissioner*, affirming that core deposit intangibles are separate from goodwill and can be amortized if they have an ascertainable value and limited life. The court accepted the cost savings method for valuation but rejected IT&S's inclusion of interest-sensitive deposits in the core, as these were not truly insensitive to interest rate changes. The court also criticized the failure to reduce the core for reserve requirements and float, and the use of an unsecured debt issue as an alternative funding source, which was not comparable to insured deposits. The court upheld the use of a 20% after-tax return on equity as the discount rate and allowed the inclusion of tax savings in the valuation. The accelerated amortization method was approved as it reasonably allocated the asset's basis to income-producing periods.

Practical Implications

This decision clarifies that banks acquiring other banks can amortize core deposit intangibles but must carefully define the deposit core, excluding interest-sensitive accounts and accounting for reserve requirements and float. The alternative funding source used in valuation must be comparable to the core deposits in terms of risk, such as insured certificates of deposit. Taxpayers must use reasonable methods to establish the intangible's value and useful life. This case has been influential in subsequent bank acquisition cases, shaping how core deposit intangibles are treated for tax purposes. It also underscores the importance of expert testimony and detailed studies in proving the value and life of intangibles for amortization purposes.

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