Federal Home Loan Mortgage Corp. v. Commissioner, 121 T. C. 129 (U. S. Tax Court 2003)

In Federal Home Loan Mortgage Corp. v. Commissioner, the U. S. Tax Court ruled that the Federal Home Loan Mortgage Corporation could not increase its adjusted cost basis in mortgages for accrued interest that occurred during its tax-exempt period before 1985. The court held that for interest to be included in the basis for a bad debt deduction, it must have been previously reported as taxable income. This decision clarifies the requirements for bad debt deductions for entities transitioning from tax-exempt to taxable status, emphasizing the necessity of prior tax reporting for accrued interest.

Parties

The petitioner is the Federal Home Loan Mortgage Corporation (FHLMC), also known as Freddie Mac. The respondent is the Commissioner of Internal Revenue.

Facts

FHLMC was chartered by Congress on July 24, 1970, and was originally exempt from federal income taxation. This exemption was repealed by the Deficit Reduction Act of 1984 (DEFRA), effective January 1, 1985. FHLMC held mortgages in its portfolio and acquired others through foreclosure or as collateral. For the years 1985 through 1990, FHLMC accrued interest on these mortgages into income, including interest that accrued before January 1, 1985, when it was still tax exempt. FHLMC claimed overpayments and sought to increase its regular adjusted cost basis in these mortgages for the accrued interest to calculate gain or loss on foreclosures.

Procedural History

The Commissioner determined deficiencies in FHLMC’s federal income taxes for the years 1985 through 1990. FHLMC filed petitions in the U. S. Tax Court, claiming overpayments and challenging the Commissioner’s determinations. Both parties filed cross-motions for partial summary judgment on the issue of whether FHLMC could include pre-1985 accrued interest in its adjusted cost basis for bad debt deductions under section 166 of the Internal Revenue Code.

Issue(s)

Whether, for purposes of claiming a bad debt deduction under section 166, FHLMC is entitled to increase its regular adjusted cost basis in certain mortgages acquired before January 1, 1985, for unpaid interest which accrued during the period that FHLMC was tax exempt?

Rule(s) of Law

Section 166 of the Internal Revenue Code allows a deduction for bad debts, and the

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basis for determining the amount of the deduction is the adjusted basis provided in section 1011. Section 1. 166-6(a)(2), Income Tax Regs. , specifies that accrued interest may be included as part of the deduction allowable under section 166(a) only if it has previously been returned as income.

Holding

The U. S. Tax Court held that FHLMC could not include in its adjusted cost basis the interest that accrued on its mortgages before January 1, 1985, during its tax-exempt period, because such interest was not reported as taxable income on a federal income tax return.

Reasoning

The court's reasoning was grounded in the interpretation of section 1. 166-6(a)(2), Income Tax Regs. , which requires that accrued interest must have been "returned as income" to be included in the adjusted cost basis for a bad debt deduction. The court emphasized that "returned as income" means the interest must have been reported as taxable income on a federal income tax return. Since FHLMC was tax exempt before January 1, 1985, and did not report the accrued interest as taxable income, it could not meet this requirement. The court distinguished prior cases and revenue rulings cited by FHLMC, noting that they did not support an increase in basis for interest accrued during a tax-exempt period. The court also rejected FHLMC's argument that consistency in accounting methods should allow for such an adjustment, as the substantive requirement of reporting interest as taxable income was not met.

Disposition

The U. S. Tax Court granted the Commissioner's motion for partial summary judgment and denied FHLMC's motion for partial summary judgment on the issue of increasing the adjusted cost basis for pre-1985 accrued interest.

Significance/Impact

This decision clarifies the criteria for bad debt deductions under section 166 for entities transitioning from tax-exempt to taxable status. It underscores the importance of reporting accrued interest as taxable income for it to be included in the adjusted cost basis for such deductions. The ruling has implications for financial institutions and other entities that may have accrued interest during periods of tax exemption and later seek to claim bad debt deductions. It also highlights the distinction between accounting methods for financial reporting and the substantive requirements for tax deductions, emphasizing the necessity of prior tax reporting for accrued interest to be deductible as a bad debt.

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