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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Expensing of OREO Foreclosure Costs

The Internal Revenue Service ("IRS") has recently issued a favorable Chief Counsel Memorandum regarding the tax treatment of foreclosure expenses in connection the acquisition of *other real estate owned* either through actual proceedings or by deed-in-lieu of foreclosure. Banks will now be able to deduct the foreclosure expenses as ordinary business expenses.

In the fact pattern in the Memorandum, it was noted that in the ordinary course of its lending business, a bank lends money to enable borrowers to purchase real property from third parties. Each loan is secured by the property purchased by the borrower. Although the bank generally sells the resulting loan, it does not hold a substantial portfolio of the mortgage loans.

When a borrower defaults on a mortgage loan, the bank commences a foreclosure proceeding to take title to, and possession of, the real property as a means of mitigating any loss on the defaulted loan. In some cases, a borrower in default on the mortgage loan voluntarily transfers title to the real property to the bank in exchange for cancellation of the remaining debt obligation in a transaction know as deed-in-lieu of foreclosure. Property acquired by a bank through foreclosure proceedings or by deed-in-lieu of foreclosure is referred to by the bank as *other real estate owned* or OREO.

The bank immediately seeks to sell real property that was acquired through foreclosure proceedings or by deed-in-lieu of foreclosure. The bank generally seeks to sell the property in *as-is* condition upon acquisition, and does not make improvements to the property prior to sale. The bank's activities, including acquiring, holding and disposing of OREO, are regulated by governmental authorities. These authorities generally require a bank to sell the property within certain time frames. Banking regulations permit banks to hold OREO for up to five years and up to an additional five years if an extension request for the holding period is granted. A bank also may be required to return to a borrower any proceeds of a subsequent sale of the foreclosed property that exceed the outstanding balance due to the bank on a mortgage obligation. The bank is generally restricted from acquiring property to resell for profit. The bank treats OREO as property held primarily for sale to customers in the ordinary course of its trade or business for purposes of section 1221(a)(1) of the IRS Code.

Assuming that a bank holds OREO for sale to customers in the ordinary course of business within the meaning of section 1221(a)(1), the sole question is whether the bank acquired the OREO for resale. In determining whether property is acquired for resale, the regulations provide a special rule for banks and others that originate (and generally sell) loans. As provided in section 1.263A-1(b)(13), the origination of loans is not considered the acquisition of property for resale, notwithstanding the frequency with which the taxpayer sells the loans it originates or the percentage of its originated loans that its sells.

As a result of the special rule in section 1.263A-1(b)(13), the bank's activity of originating loans is not considered the acquisition of property for resale. Thus, the bank's acquisition and sale of the property securing the loan does not convert the bank into a reseller if the foreclosure or deed-in-lieu of foreclosure and subsequent sale of the OREO are viewed as an extension of a bank's loan origination activity.

Under the facts presented, the bank is acting in its capacity as a lender and not as a traditional reseller of property. The bank is economically compelled to acquire the property and takes title and possession only as a last resort to recover funds originally loaned to the borrower. The bank is not acquiring property for the purpose of reselling it at a profit. In fact, the bank is not necessarily entitled to keep all of the proceeds from the sale of the property as the bank typically returns to the borrower any proceeds from the sale of the property that exceed the amount due to the bank on the mortgage obligation. In this context, solely taking title to and possession of mortgaged property from borrowers in default in an effort to mitigate loss is an extension of the primary activity of originating loans. Accordingly, where the loan-originating bank acquires real property through foreclosure or deed-in-lieu of foreclosure and promptly attempts to sell the OREO without improvement, the Memorandum concludes that the property is not 'property acquired for resale'.

As a result of the Memorandum, OREO acquired in connection with a loan originated by a bank will not be subject to the capitalization provisions of IRS Code section 263A, and legal fees and other costs incurred to acquire the OREO through foreclosure, as well as the cost and expense incurred while carrying the OREO prior to sale, should be fully deductible either when paid or incurred depending on the method of accounting used by the bank. The Memorandum may provide an opportunity for a bank to obtain a refund in those situations where foreclosure costs and expenses have been previously capitalized.

Preemptive Rights

Preemptive rights are generally referred to as the rights of existing shareholders to maintain their percentage of ownership of a company by having the right to buy a pro rata number of shares of any future issuances of common stock. Preemptive rights are often bargained for by investors, but usually are not contained in the articles of a company. If preemptive rights are contained in the articles of incorporation, this provision can only be eliminated by a vote of the shareholders. If a company offers more of its stock, shareholders having preemptive rights are afforded the right to buy the shares to keep their percentage of ownership the same. By having preemptive rights, shareholders can maintain their voting control and share of earnings. However, preemptive rights complicate financing. By forcing a company to offer its shares to existing shareholders before it offers the shares to outside investors, these rights can postpone or effectively eliminate the sale of shares by a company to outsiders.

Preemptive rights can also delay funding by an investor by requiring the company of first offer the shares to existing shareholders, creating a barrier to obtain financing by a company. Companies needing adequate financing and having to raise additional capital should consider eliminating preemptive rights if such rights exist in the articles of the company.