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COMMENTS

The Definition of "Domestic Building and Loan Association"—Final Tax Regulations

Throughout the history of federal corporate income taxation, building and loan associations have enjoyed a privileged status vis-à-vis other financial institutions.¹ In 1962 substantial changes were made in the tax treatment of such associations, and for the first time the term "domestic building and loan association" was specifically defined in the code.² In July 1964, regulations were proposed³ to implement the new definition, and, after presentations by interested parties and an informal hearing, final regulations were promulgated on October 30, 1964.⁴ It will be the purpose of this discussion to examine the newly adopted regulations and to evaluate their effects in the light of congressional intent regarding the statutory definition. Special emphasis will be placed on the quantitative tests established in the regulations, with respect to which two changes will be proposed.

I. INTRODUCTION

The importance of qualifying as a domestic building and loan association should not be underestimated. From 1909 to 1951, building and loan associations were fully exempt from the federal corporate income tax.⁵ Although the exemption was repealed in 1951,⁶ qualifying associations were permitted under the predecessor of section 593 of the 1954 Code⁷ to consider any sum up to one hundred per cent of their taxable income as a reasonable addition to a bad-debt reserve, as provided under what is now section 166(c).⁸ The only limitation on the deduction was that it could not be such as to cause the sum of this institution's reserves, surplus, and undivided profits to exceed twelve per cent of its total deposits or withdrawable shares at the end of the year.⁹ In 1962, section 593 was amended so

1. Mutual savings banks not having capital stock represented by shares and cooperative banks operated for mutual purposes without profit are also accorded the favorable treatment. INT. REV. CODE OF 1954, §§ 593, 595.

2. See Revenue Act of 1962, §§ 6(a), (c), 76 Stat. 977, 982.

3. Proposed Treas. Reg. §§ 301.7701-13, -14, 29 Fed. Reg. 8422-28 (1964).

4. Treas. Reg. §§ 301.7701-13, -14 (1964). Although the effective date of the regulations is October 16, 1962, some of the provisions do not take effect for taxable years ending prior to November 1, 1964.

5. See, e.g., Act of August 5, 1909, § 38, 36 Stat. 112 (the corporate tax provisions were a rider on the Payne-Aldrich Tariff); Revenue Act of 1932, § 103(4), 47 Stat. 193; Revenue Act of 1934, § 101(4), 48 Stat. 700.

6. Revenue Act of 1951, § 313(a), 65 Stat. 490.

7. INT. REV. CODE OF 1954, § 593 (formerly Int. Rev. Code of 1939, § 23(k)(1)).

8. INT. REV. CODE OF 1954, § 166(c) (formerly Int. Rev. Code of 1939, § 23(k)).

9. INT. REV. CODE OF 1954, § 593(b)(1)(B)(ii) (formerly Int. Rev. Code of 1939, § 23(k)(1)).

as to make available to qualifying institutions a choice of three methods, only one of which is available to nonqualifying taxpayers,¹⁰ for the computation of the section 166(c) deduction. Under the experience method, which is available to all taxpayers, the reasonableness of the bad debt reserve deduction is determined by reference to the taxpayer's bad debt experience in prior years.¹¹ The percentage-of-real-property-loans method permits qualifying institutions to deduct a sum equal to the amount necessary to raise the reserve for losses on loans which come within section 593(e)(1)'s definition of "qualifying real property loans" to three per cent of such loans outstanding at the end of the taxable year;¹² the percentage-of-taxable-income method allows the deduction of a sum equal to sixty per cent of taxable income for the year, so long as the institution's reserve for bad debt losses on qualifying loans is not thereby caused to exceed six per cent of outstanding qualifying loans.¹³ However, neither the percentage-of-real-property-loans method nor the percentage-of-taxable-income method may be used to cause the total of reserves, surplus, and undivided profits of the institution to exceed twelve per cent of its total deposits or withdrawable shares as of the close of the taxable year.¹⁴ Since sixty per cent of taxable income will ordinarily greatly exceed the amount deductible under the experience method, permitting the use of the percentage-of-taxable-income method gives building and loan associations a substantial tax advantage. In addition, institutions qualifying as building and loan associations are afforded a further tax advantage under section 595, which provides that a foreclosure of property which was security for a loan is not a taxable event.¹⁵

Prior to 1962, institutions receiving the favorable tax treatment were not characterized with precision. Among institutions qualifying under the Act of August 5, 1909, were "domestic building and loan associations, organized and operated exclusively for the benefit of their members. . . ."¹⁶ The exclusivity requirement, which was strictly construed by the government,¹⁷ was discarded in 1918. In that year the revenue act exempted "domestic building and loan associations" without further limiting the term.¹⁸ To prevent use of the

10. See Revenue Act of 1962, § 6(a), 76 Stat. 978.

11. INT. REV. CODE OF 1954, § 593(b)(4).

12. INT. REV. CODE OF 1954, § 593(b)(3). "The term 'qualifying real property loan' means any loan secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan" INT. REV. CODE OF 1954, § 593(e)(1). Certain enumerated types of loans are excepted. See INT. REV. CODE OF 1954, § 593(e)(1)(A)-(D).

13. INT. REV. CODE OF 1954, § 593(b)(2).

14. INT. REV. CODE OF 1954, § 593(b)(1)(B)(ii).

15. INT. REV. CODE OF 1954, § 595(a).

16. Act of August 5, 1909, § 38, 36 Stat. 112.

17. See, e.g., Treas. Reg. 33, art. 87 (1914).

18. Revenue Act of 1918, § 231(4), 40 Stat. 1076.

exemption by mortgage and investment companies operating as building and loan associations in name only,¹⁹ the Revenue Act of 1921 exempted "domestic building and loan associations *substantially all* of the business of which is confined to making loans to members. . . ."²⁰ This language was retained until 1962 when a complicated tripartite definition of a qualifying building and loan association was enacted.²¹

Since 1962, in order to qualify as a domestic building and loan association, an institution must satisfy certain requirements set forth in section 7701(a)(19) of the 1954 Code as to supervision, types of assets held, and business operations.²² With respect to supervision, the association's accounts must be insured by the Federal Savings and Loan Insurance Corporation, or the association must be subject by law to supervision and examination by state or federal authority having supervision over domestic building and loan associations or state or federal savings and loan associations.²³ In addition, the institution must meet four assets requirements. Ninety per cent of the association's assets must consist of cash, governmental obligations, obligations of state-chartered deposit insurance companies, passbook loans,²⁴ loans secured by or for the improvement of real property, property acquired through foreclosure or liquidation of loans qualifying under the ninety per cent requirement, and property used by the association in the conduct of its savings and loan business.²⁵ Eighty-two per cent of its assets must fall within a more restricted sub-group of the above, emphasizing loans on residential real property;²⁶ sixty-four per cent must fall within an even more restricted sub-group emphasizing loans on residential property containing four or fewer family units;²⁷ and no more than three per cent of the institution's assets may consist of stock in any corporation other than governmental instrumentalities and state-chartered deposit insurance corporations.²⁸ With respect to business operations, substantially all of the institution's business must consist of acquir-

19. See H.R. REP. NO. 350, 67th Cong., 1st Sess. 13 (1921). The House bill would have returned to the exclusivity requirement, but the Senate introduced the "substantially all" language. H.R. Doc. No. 8245, 67th Cong., 1st Sess. § 234(4) (1921); S. Doc. No. 73, 67th Cong., 1st Sess. § 231(4) (1921).

20. Revenue Act of 1921, § 231(4), 42 Stat. 253. (Emphasis added.)

21. See Revenue Act of 1962, § 6(c), 76 Stat. 982.

22. INT. REV. CODE OF 1954, § 7701(a)(19).

23. INT. REV. CODE OF 1954, § 7701(a)(19)(A).

24. Passbook loans are loans secured by a deposit or share of a member.

25. INT. REV. CODE OF 1954, § 7701(a)(19)(C).

26. INT. REV. CODE OF 1954, § 7701(a)(19)(D).

27. INT. REV. CODE OF 1954, § 7701(a)(19)(E). An association may deviate up to five per cent from the sixty-four per cent of assets requirement; however, for each percentage point of deviation, the sixty per cent of taxable income ceiling is lowered five percentage points. INT. REV. CODE OF 1954, § 593(b)(5).

28. INT. REV. CODE OF 1954, § 7701(a)(19)(F).

ing the savings of the public and investing in loans for the improvement of real property, loans secured by an interest in real property, and passbook loans.²⁹

II. REGULATIONS

Although a number of provisions in the regulations implementing the new definition are complicated and controversial, others are straightforward and subject to little or no criticism. Among the latter are the subsections dealing with the supervision requirements³⁰ and the requirement that substantially all of an association's business other than investing in loans must consist of acquiring the savings of the public.³¹ The treatment of the supervision requirement is clearly not subject to question since the regulations do little more than restate the statutory language, which is amply unequivocal.³² With regard to the acquisition of savings, the regulations provide that the statutory requirement will ordinarily be considered satisfied if savings are acquired in conformity with Federal Home Loan Bank Board regulations or substantially equivalent regulations by state law or supervisory authority, or if eighty-five per cent of the association's total deposits are held by the general public rather than by "family or related business groups or persons who are officers or directors of the association."³³ The regulations pertaining to the assets requirements generally provide detailed descriptions of the statutory categories and give examples of qualifying and nonqualifying assets.³⁴ Although questions have arisen concerning some of these provisions,³⁵ most appear reasonable and seemingly will not be more restrictive than is justified by the statute.

29. INT. REV. CODE OF 1954, § 7701(a)(19)(B); see INT. REV. CODE OF 1954, § 7701(a)(19)(C)(iii)-(iv).

Testimony of representatives of the building and loan industry indicated a desire for greater specificity. "The words 'substantially all' are a danger to the whole business because we are in the hands of the tax agents who themselves don't know what that means." Remarks of Mr. McKenna, Ass't General Counsel, United States Savings and Loan League, 2 *Hearings on H.R. 10650 Before the Senate Finance Committee*, 87th Cong., 2d Sess. 1386 (1962).

The assets requirements, standing alone, would contain a major loophole. An association would not be prevented from receiving a substantial portion of its revenue from a business based upon a service rather than upon an income-producing asset. Thus, an association could carry on a major sideline in insurance brokerage, real estate brokerage, or any service not prohibited by the statutes and regulations governing the association. Section 7701(a)(19)(B) prevents such a result.

30. INT. REV. CODE OF 1954, § 7701(a)(19)(A).

31. INT. REV. CODE OF 1954, § 7701(a)(19)(B).

32. See Treas. Reg. § 301.7701-13(b) (1964).

33. Treas. Reg. § 301.7701-13(c)(2) (1964).

34. Treas. Reg. § 301.7701-13(d)-(j) (1964).

35. Both the statute and the regulations include among qualifying assets "certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations." INT. REV. CODE OF 1954, § 7701(a)(19)(C)(ii); Treas. Reg. § 301.7701-13(d)(4) (1964). At the informal hearing on the proposed regulations,

The most complicated and controversial provisions in the new regulations are those which provide a degree of specificity to the statutory requirement that "substantially all" of the association's business, other than acquiring the savings of the public, must consist of investing in loans for the improvement of real property, loans secured by an interest in real property, and passbook loans.³⁶ According to the regulations, in order to satisfy the statutory investing-in-loans requirement, an association must meet both a gross income test³⁷ and a sales activity test³⁸ or must be able to "demonstrate that substantially all its business (other than acquiring the savings of the public) consisted of investing in the prescribed loans."³⁹ In general, the basic requirement of the gross income test is that more than eighty-five per cent of the association's gross income must be attributable to the types of assets described under the ninety-per-cent-of-assets requirement.⁴⁰ These income sources include interest and dividends on securities permitted under the ninety-per-cent requirement; gain or loss on the sale of governmental obligations; income from, and gain or loss on the sale of, property acquired through liquidation or foreclosure of any loan;⁴¹ and interest, premiums, commissions, penalties, and fees on loans permitted under the ninety-per-cent requirement. In order to meet

the question was raised whether this language includes certificates of deposit in the reserve fund of the Maryland Savings-Share Insurance Corporation and the Massachusetts Co-Operative Central Bank, the assets of which are by statute divided into two separate, distinct funds: a reserve fund for loans to member associations and a fund for the insurance of accounts of member associations. MD. ANN. CODE art. 23, §§ 161MM-NN (Supp. 1964); MASS. ANN. LAWS, app. to ch. 170, § 1 (1959). Arguably, under a very narrow interpretation of the Code only deposits in the insurance funds would qualify. However, since there is no apparent reason to exclude reserve-fund certificates, it is to be hoped that deposits in both funds will be considered qualifying assets.

The test applied in the regulations to determine whether a loan is on residential property is whether the loan is on property which is used on a non-transient basis. Treas. Reg. § 301.7701-13(j)(8) (1964). While the dichotomy between residential and transient appears sound, see *Swenson v. Thomas*, 164 F.2d 783 (5th Cir. 1947), the inclusion of dormitories, fraternity and sorority houses, and rest homes in the category of property not ordinarily considered residential, Treas. Reg. § 301.7701-13(j)(8) (1964), seems inconsistent with the transiency test. The typical period of occupancy for student accommodations, nine months, seems too long to be considered transient. Furthermore, Federal Home Loan Bank Board rules specifically recognize fraternities as "real estate designed or used primarily for residential purposes." 12 C.F.R. § 555.3(a) (1963). An even stronger argument can be made for rest homes, which in most cases constitute not a transient lodging but a last, permanent residence.

36. INT. REV. CODE OF 1954, § 7701(a)(19)(B).

37. Treas. Reg. § 301.7701-13(c)(3)(ii) (1964).

38. Treas. Reg. § 301.7701-13(c)(3)(iii) (1964).

39. Treas. Reg. § 301.7701-13(c)(3)(i) (1964). See text accompanying notes 86-87 *infra*.

40. Treas. Reg. § 301.7701-13(c)(3)(ii) (1964).

41. Gain or loss on foreclosed property is recognized only when the property is subsequently sold, not at the time of foreclosure. See INT. REV. CODE OF 1954, § 595(a).

the sales activity test an association must comply with its two parts—the sales-of-whole-loans test and the sales-of-whole-loans-and-participations test. The sales-of-whole-loans test⁴² requires that the total dollar value of whole loans⁴³ sold during the taxable year not exceed the greater of twenty per cent of the beginning-of-year portfolio and fifteen per cent of the amount of loans acquired for investment during the taxable year.⁴⁴ The twenty per cent figure, however, must be reduced by the sum of the whole loans sold as a percentage of the beginning-of-year portfolio for each of the preceding two years.⁴⁵ Thus, if an institution in both 1965 and 1966 sold whole loans amounting to seven per cent of its beginning-of-year portfolio for those years, its twenty per cent allowance for 1967 would be reduced to six per cent. The sales-of-whole-loans-and-participations test, which is the other part of the sales activity test, requires that the sum of the dollar amounts of whole loans and of participating interests sold during the taxable year not exceed one hundred per cent of the amount of loans acquired for investment during that year.⁴⁶

III. EVALUATION OF REGULATIONS IMPLEMENTING THE STATUTORY INVESTING-IN-LOANS REQUIREMENT

In enacting the statutory business operations requirement, Congress apparently was attempting to deny qualification to institutions which have a substantial part of their business outside the normal "savings and loan" sphere, while not restricting to any significant extent building and loan associations' activities falling properly within that area. Prior to 1962, an association qualified for favorable tax treatment if substantially all of its business consisted of making loans to members.⁴⁷ This definition was found unsatisfactory because the evolution of building and loan associations from cooperatives to

42. Treas. Reg. § 301.7701-13(c)(3)(iv) (1964).

43. A sale of a whole loan refers to the transfer of the entire obligation; a sale of a participation interest refers to the transfer of only a portion of the obligation.

44. "The term 'loans acquired for investment during the taxable year' means the amount of loans outstanding as of the close of the taxable year, reduced (but not below zero) by the amount of loans outstanding as of the beginning of such year, and increased by the lesser of (1) the amount of repayments made on loans during the taxable year or (2) an amount equal to 20 percent of the amount of loans outstanding as of the beginning of the taxable year. For this purpose, repayments do not include repayments on loans to the extent such loans are refinanced by the association." Treas. Reg. § 301.7701-13(c)(3)(iii)(c) (1964).

The fifteen per cent figure may be increased by the excess of fifteen per cent of the dollar value of loans acquired for investment during the preceding two years over the dollar amount of whole loans sold during that period. Treas. Reg. § 301.7701-13(c)(3)(vi)(a) (1964). This is a carryover of the unused sales allowance for the preceding two years.

45. Treas. Reg. § 301.7701-13(c)(3)(iv) (1964).

46. Treas. Reg. § 301.7701-13(c)(3)(v) (1964).

47. See note 20 *supra* and accompanying text.

public institutions had made "membership" a relatively meaningless concept.⁴⁸ After referring to this problem, the report of the Senate Finance Committee accompanying the 1962 bill⁴⁹ set out the intended effect of the definitional change:

"[Y]our committee has concluded that the definition of a domestic building and loan association . . . *should be brought more nearly into conformance with actual practice*. At the same time it was deemed desirable to restrict this tax treatment to those primarily engaged in making residential real estate loans . . . and [to omit] from the definition cases such as those where these institutions have been used for speculative purposes."⁵⁰

Referring specifically to the investing-in-loans requirement, the report stated: "This restriction will, of course, prevent such a savings institution from carrying on the business of brokering mortgage paper if this represents any substantial part of its business."⁵¹

The italicized language above would seem to indicate that Congress did not intend any substantial new restrictions on the business carried on by building and loan associations beyond those specifically mentioned that were designed generally to channel the associations' business into residential real property mortgage lending.

A. Gross Income Test

Although not specifically authorized by the language of the statutory definition, the gross income test is a defensible means of effectuating congressional intent not to restrict savings and loan activities of qualifying institutions. For example, it appears that the gross income test will have little if any effect upon the business operations of building and loan associations which are members of the Federal Home Loan Bank System.⁵² Statistical compilations of the Federal Home Loan Bank Board for the year 1962 indicate that 83.9 per cent of the aggregate gross income of member institutions was interest on

48. See S. REP. NO. 1881, 87th Cong., 2d Sess. 48 (1962). Some state statutes provide that all borrowers from a building and loan association shall be considered members. *E.g.*, MINN. STAT. ANN. § 51.01(16) (1945); KAN. GEN. STAT. ANN. § 17-5301 (1961). The same provision appears in the charters of federal savings and loan associations. See 12 C.F.R. § 544.1 (1963).

49. H.R. 10650, 87th Cong., 2d Sess. (1962).

50. S. REP. NO. 1881, 87th Cong., 2d Sess. 48 (1962). (Emphasis added.) Language identical to that quoted appears in the House report. See H.R. REP. NO. 1447, 87th Cong., 2d Sess. 37 (1962).

51. S. REP. NO. 1881, 87th Cong., 2d Sess. 48 (1962).

52. The Federal Home Loan Bank System includes 78% of all building and loan associations in the United States, representing 98.3% of the assets held by all associations. UNITED STATES SAVINGS AND LOAN LEAGUE, SAVINGS AND LOAN FACT BOOK 112 (1964).

mortgage loans, 4.9 per cent was interest on other investments, and 7.7 per cent was in the form of premiums, commissions, and fees.⁵³ Since most building and loan association loans are secured by an interest in real property, all but a relatively insignificant percentage of the income on mortgage loans would qualify for purposes of the gross income test. Furthermore, a large proportion of the income from other investments presumably represents qualifying income from United States Government obligations, since six per cent of the member associations' aggregate assets consist of such investments.⁵⁴ In addition, nearly all of the premiums, commissions, and fees are qualifying income because they are derived from loans permissible under the ninety per cent of assets requirement.⁵⁵ Therefore, even a conservative estimate would place the aggregate of qualifying income above ninety per cent. Since the above percentage distribution of gross income has remained fairly constant throughout the past decade,⁵⁶ the five per cent margin would indicate that an overwhelming majority of member savings institutions qualifying under the assets requirements will be unaffected by the gross income test. Of course, it is conceivable that individual institutions would be affected due to an abnormal distribution of assets. It is probable, however, that such exceptions will be uncommon. As noted earlier, qualifying income under the gross income test is basically that attributable to all assets includable within the ninety-per-cent-of-assets requirement.⁵⁷ Since the allowance for nonqualifying income is fifteen per cent, it is apparent that, in order to meet the ninety-per-cent-of-assets requirement and yet fail to meet the gross income test, an institution would have to have its nonqualifying assets invested at a much higher rate of return than its qualifying assets. This could come about only by realizing a high rate of return on nonqualifying assets while retaining an unusually high percentage of qualifying assets in the form of cash on hand, cash on deposit with other institutions, and low-yield government securities. It would seem that such deviations from the norm for the industry would be rare, since principles of good business management would militate against such an emphasis on low-yield investments.

53. FEDERAL HOME LOAN BANK BOARD, COMBINED FINANCIAL STATEMENTS OF MEMBERS OF THE FEDERAL HOME BANK SYSTEM, pt. 1, at 13 (1963). Unfortunately, a statistical summary is not available for the 1,365 associations which are not members of the Federal Home Loan Bank System.

54. UNITED STATES SAVINGS AND LOAN LEAGUE, *op. cit. supra* note 52, at 91.

55. See Treas. Reg. § 301.7701-13(c)(3)(ii)(d) (1964).

56. UNITED STATES SAVINGS AND LOAN LEAGUE, *op. cit. supra* note 52, at 104; FEDERAL HOME LOAN BANK BOARD, *op. cit. supra* note 53, at 11.

57. See text accompanying note 40 *supra*. Compare Treas. Reg. § 301.7701-13(c)(3)(ii) (1964), with INT. REV. CODE OF 1954, § 7701(a)(19)(C).

B. *Sales Activity Test*1. *Sales-of-Whole-Loans Test*

Although it is difficult to determine with certainty whether the statutory language requires or justifies the particular sales-of-whole-loans test contained in the regulations, it would appear that some test based on such activity is justified under the statutory language and the intent of Congress. The Senate Finance Committee's report accompanying the Revenue Act of 1962 indicates that the statutory investing-in-loans requirement was designed to deny the preferential tax treatment to institutions carrying on a substantial business in brokerage of mortgage paper.⁵⁸ It is arguable that the phrase, "brokering mortgage paper," does not include the sale of loans originally made by the selling institution, since a broker is generally thought of as a middleman who, having no direct interest in the property involved, brings together two other parties to a transaction.⁵⁹ If this technical view of brokerage were accepted, the typical sale of a loan by a building and loan association would not be considered as brokering mortgage paper because in most instances the seller is the institution that originated the loan. Therefore, it would be arguable that any sales-of-whole-loans test would be too restrictive in that it would prohibit activities which Congress may not have intended to restrict. However, three considerations make it appear that the Committee did intend the investing-in-loans requirement of the statute to inhibit sales of whole loans regardless of whether the loans were originated by the selling institution. Admittedly, a three-branched distinction is commonly made in the mortgage business.⁶⁰ "Mortgage lenders" originate mortgages for retention in their own portfolios; "mortgage companies" originate mortgages for sale to other institutions; and "mortgage brokers" bring borrowers and lenders together without ever having a direct financial interest in the mortgage paper. However, since mortgage companies are also often included within the term, "mortgage brokers,"⁶¹ it is likely that the Senate Finance Committee's reference to brokerage of mortgage paper was meant to refer to sales of loans originated by the selling association as well as those originated by an institution other than the seller. Furthermore, the statute requires investment in loans, and the term "investment" is generally thought of as connoting a degree of permanence as opposed to a rapid turnover for profit.⁶² An association

58. S. REP. NO. 1881, 87th Cong., 2d Sess. 48 (1962).

59. See, e.g., *Lawrence Gas Co. v. Hawkeye Oil Co.*, 182 Iowa 179, 165 N.W. 445 (1917); *Richmond Mortgage & Loan Corp. v. Rose*, 142 Va. 342, 128 S.E. 604 (1925).

60. KLAMAN, *THE POSTWAR RESIDENTIAL MORTGAGE MARKET* 240-42 (1961).

61. Klamann, *The Postwar Rise of Mortgage Companies*, in NATIONAL BUREAU OF ECONOMIC RESEARCH, OCCASIONAL PAPER NO. 60, at 68 (1959).

62. See, e.g., *United States v. Chinook Inv. Co.*, 136 F.2d 984 (9th Cir. 1943); *Rice v. Halsey*, 156 App. Div. 802, 142 N.Y.S. 58 (1913); *Matter of Loose*, 167 Misc.

which acts as a broker for a loan made by another association never owns the loan and clearly has no investment in it. An association which makes a loan and sells it to another institution does hold the loan for a period of time but its sale of the loan within the taxable year is inconsistent with "investment" in the loan. In addition, policy considerations favor this interpretation of the statement in the Senate report. A generous bad debt reserve deduction may be necessary for an institution which regularly holds a large portfolio of mortgages, but it is far less necessary for an institution which holds a smaller portfolio due to the sale of a large percentage of the mortgage paper it originates. Thus viewed in the light of its legislative history, the statutory language does seem to justify a sales-of-whole-loans test.

Although such a test is justified, it is possible that the specific test found in the regulations is overly restrictive. Building and loan associations that are members of the Federal Home Loan Bank System are permitted by the Federal Home Loan Bank Board to sell whole loans, but only so long as the total dollar value of the loans sold in any year does not exceed twenty per cent of the institution's beginning-of-year portfolio;⁶³ the sales-of-whole-loans test represents a substantial tightening of these restrictions. Furthermore, many state-chartered building and loan associations that are not members of the Federal Home Loan Bank System will become subject to greater restrictions under the sales-of-whole-loans test. Twenty-one states currently have statutory provisions regarding sales of whole loans. In nine states it is explicitly provided that associations may sell loans up to one hundred per cent of their beginning-of-year portfolio.⁶⁴ In one state the upper limit is thirty per cent;⁶⁵ in another it is twenty-five per cent;⁶⁶ in four others it is twenty per cent.⁶⁷ Six states, while placing no statutory limit on sales of whole loans, provide that there shall be no limit on sales of certain types of loans insured or guaranteed by the Federal Housing Administration or the Veterans' Administration.⁶⁸

764, 4 N.Y.S.2d 611 (Surr. Ct. 1938); BLACK, LAW DICTIONARY 960 (4th ed. 1951) (invest).

63. 12 C.F.R. § 545.11 (1963).

64. CONN. GEN. STAT. ANN. § 36-178(t) (1958); IND. STAT. ANN. § 18-2102(h) (1964); IOWA CODE § 534.19(7)(c) (1962); KAN. GEN. STAT. ANN. § 17-5501(r) (Supp. 1961); MINN. STAT. ANN. § 51.35 (1945); MO. STAT. ANN. § 369.345 (1949); N.H. REV. STAT. ANN. § 393:23 (1955); TEX. CIV. STAT. ANN., art. 852a, § 5.03 (1964); WIS. STAT. ANN. § 215.20(17) (1957).

65. HAWAII REV. LAWS § 180-52 (1955) (Supp. 1963).

66. ALASKA STAT. § 06.30.535 (1962).

67. ARIZ. REV. STAT. ANN. § 6-451 (Supp. 1956); FLA. STAT. § 665.21(7)(b) (1963); NEB. REV. STAT. § 8-321 (1943); OHIO REV. CODE ANN. § 1151.42 (Page 1953).

68. ALA. CODE tit. 5, § 256 (1958); COLO. REV. STAT. ANN. § 122-2-18 (1953); MASS. ANN. LAWS ch. 170, § 27 (1961); MICH. COMP. LAWS § 489.33 (1948); ORE. REV. STAT. § 722.490 (1963); PA. STAT. ANN. tit. 15, § 1074-811 (1958).

The allowance for sales of whole loans under the new test is clearly far more restrictive than the restrictions in state laws and in the Federal Home Loan Bank Board regulations. As was previously noted, such sales made during the taxable year may not exceed the greater of fifteen per cent of the amount of loans acquired for investment during the taxable year and twenty per cent of the beginning-of-year portfolio. However, the twenty per cent figure must be reduced by the sum of the percentages of whole loans sold in the preceding two years.⁶⁹ Thus, an institution's average yearly sales allowance is the greater of fifteen per cent of loans acquired for investment during the year and six and two-thirds per cent of its beginning-of-year portfolio. Generally, the six and two-thirds per cent sum will be greater than the fifteen per cent figure.⁷⁰

Despite its effect on the loan sales allowance of building and loan associations, the sales-of-whole-loans test cannot be considered clearly overrestrictive in light of the Committee's express intention to restrict the brokerage of mortgage paper by such institutions. However, since the congressional language in both the Committee reports and the statute is quite indefinite, ample room exists for policy considerations to dictate a more liberal sales-of-whole-loans allowance than that embodied in the particular percentages of the present test. Many federal programs are designed to facilitate home mortgage lending⁷¹ and the continued liberalization of these programs in recent housing acts⁷² reflects substantial congressional interest in increased homeownership and housing construction. Indeed, one of the basic reasons for the favorable tax treatment of

69. Treas. Reg. § 301.7701-13(c)(3)(iv) (1964).

70. Federal Home Loan Bank Board statistics for the year 1962 indicate that member associations had an aggregate beginning-of-year portfolio of 69 billion dollars and an aggregate end-of-year portfolio of 79 billion dollars. Repayments during the year totalled 11 billion dollars. Thus, loans acquired for investment during the year were 21 billion dollars (growth in loan portfolio plus the lesser of repayments and 20% of beginning-of-year portfolio) and 15% of this figure was 3.2 billion dollars. Six and two-thirds per cent of the beginning-of-year portfolio was 4.6 billion dollars. See UNITED STATES SAVINGS AND LOAN LEAGUE, *op. cit. supra* note 52, at 64-65.

Even if the 15% figure were greater than the 6 2/3% sum, an association would be unwise to attempt to sell whole loans amounting to 15% of its estimated loans acquired for investment during the year. Since the total dollar value of loans acquired for investment cannot be known with certainty before the end of the year, an association could not predict its ultimate sales allowance accurately, and necessary caution would require that the association hold its sales of whole loans somewhat below the estimated allowance in order to avoid the risk of losing its favored tax status.

71. *E.g.*, residential housing mortgage insurance, 73 Stat. 654, as amended, 75 Stat. 177, 12 U.S.C. § 1709(b) (Supp. V, 1964); home improvement loan insurance, 75 Stat. 157, 12 U.S.C. § 1709(k) (Supp. V, 1964); relocation housing insurance, 68 Stat. 599, as amended, 75 Stat. 149, 12 U.S.C. § 1715(l) (1958).

72. *E.g.*, Housing Act of 1964, §§ 102, 110, 114, 33 U.S.L. WEEK 23 (Sept. 1, 1964); Housing Act of 1961, §§ 101-02, 75 Stat. 149, 12 U.S.C. § 1715(l) (Supp. V, 1964); Housing Act of 1959, §§ 102-04, 107-10, 73 Stat. 654, 12 U.S.C. §§ 1703, 1709 (Supp. V, 1964).

building and loan associations is the encouragement of residential mortgage lending.⁷³ The sales-of-whole-loans test, with its relatively stringent limitation on the sale of mortgage loans, will tend to have an adverse effect upon this public policy. In many rapidly growing communities the demand for home construction loans is likely to exceed the savings capital inflow of local building and loan associations.⁷⁴ Strict limitations on sales of loans to institutions in communities where the inflow of savings capital exceeds the demand for loans would limit the ability of a local building and loan association to assist in the residential development of its community.⁷⁵

It is submitted that a test which would allow an institution to sell whole loans in an amount greater than is permitted under the present tax regulations would further congressional policy with respect to home mortgage lending by lessening the adverse effect upon the flow of lending capital and would not be inconsistent with the congressional desire to limit mortgage brokerage by building and loan associations.

2. Sales-of-Whole-Loans-and-Participations Test

The participation sales program, initiated by the Federal Home Loan Bank Board in 1957⁷⁶ and substantially liberalized in the Housing Act of 1959,⁷⁷ allows an institution to sell a portion of a loan originated by it to another institution.⁷⁸ The program serves the vital function of facilitating the transfer of lending capital from regions where it is in excess to regions where the demand for mortgages exceeds the locally generated supply of savings capital.⁷⁹

It is abundantly clear from statements made on the floor of both houses that Congress intended the new definition of a building and loan association to have no restrictive effect whatever upon the participation program. Senator Kerr, the Senate floor manager for the Revenue Bill of 1962, stated in answer to a question by Senator Sparkman concerning the effect of the bill on the participation program that "the program of participation lending has been developed and encouraged by the Federal Home Loan Bank Board and this bill does nothing to impede it."⁸⁰ Congressman Mills, the chairman of

73. *Hearings on H.R. 10650 Before the Senate Finance Committee*, 87th Cong., 2d Sess. 1, 1197, 1372 (1962).

74. CONWAY, MORTGAGE LENDING 561 (1960).

75. An association which reaches the limit of permissible sales under the tax regulations and is still in need of additional lending capital could probably obtain an advance from a Federal Home Loan Bank but the interest paid on such an advance would probably be passed on to the individual borrower, thus discouraging home mortgage borrowing.

76. CONWAY, *op. cit. supra* note 74, at 584.

77. 73 Stat. 654 (1959).

78. See generally CONWAY, *op. cit. supra* note 74, at 582-93.

79. *Id.* at 582-83.

80. 108 CONG. REC. 18564 (1962) (remarks of Senator Kerr).

the House Ways and Means Committee, stated that "the operation of the new definition will not impede the participation loan program endorsed by the Congress in 1959."⁸¹ Clearly, the participation sales program and the investing-in-loans requirement of the statute are in no way inconsistent. Federal Savings and Loan Insurance Corporation regulations provide that the seller of a participation interest must retain at least a twenty-five per cent interest in the loan.⁸² As a result, the originator continues to have a substantial "investment" in the loan.⁸³

It is apparent, however, that the sales-of-whole-loans-and-participations test could have a restrictive effect on sales of participating interests. For example, assume that an association had thirty-five million dollars in loans outstanding at the beginning of the taxable year, that it originated nine million dollars in loans during the year, and that it sold eight million dollars in whole loans to other institutions. The test under consideration limits the sales of whole loans and participation interests to one hundred per cent of "loans acquired for investment during the taxable year," this being equal to the growth in the loan portfolio during the year plus the lesser of the amount of repayments made on loans during the year and twenty per cent of the amount of loans outstanding at the beginning of the year. Therefore, in the example the association would not be permitted to sell any participation interests.⁸⁴ For a variety of business reasons, the institution may wish to sell participation interests, and other institutions in areas where savings inflow greatly exceeds the demand for loans may wish to invest in those interests.⁸⁵ Thus, the restriction imposed by the sales-of-whole-loans-and-participations test could have a restrictive effect on the individual associations and on the flow of mortgage money.

In light of the clear statements of congressional intent that the participation sales program not be hindered by operation of the new definition, it is submitted that there is no justification for inclusion of a sales-of-whole-loans-and-participations test. This test should be

81. *Id.* at 21760 (remarks of Congressman Mills). This statement was made as part of Congressman Mills' explanation of the conference committee bill immediately prior to final passage by the House.

82. 12 C.F.R. 563.9-1(b) (1963).

83. The seller of the participation retains only the bad debt risk attendant upon the retained portion because Federal Home Loan Bank Board rules for institutions insured by the Federal Savings and Loan Insurance Corporation require participation sales to be without recourse. 12 C.F.R. § 563.9-1(d) (1963).

84. Assuming that repayments for the year amounted to more than 7 million dollars, the association's loans acquired for investment during the taxable year were 8 million dollars (1 million dollars growth in loan portfolio plus 20% of beginning-of-year portfolio). The entire sales of whole loans and participations allowance was thus exhausted by the sale of the 8 million dollars in whole loans.

85. CONWAY, *op. cit. supra* note 74, at 561-62.

deleted from the regulations to insure noninterference with the participation program.

C. *Escape Clause*

An association which fails to satisfy either the gross income or the sales activity test may still qualify as a domestic building and loan association under the following provision of the regulations:

"[I]f an association does not meet [both the gross income test and the sales activity test], it will nevertheless meet the investing in loans requirement if it is able to demonstrate that substantially all of its business (other than acquiring the savings of the public) consisted of investing in the prescribed loans."⁸⁶

This provision might be thought to render inconsequential the limitations imposed by the gross income test and the sales activity test, because an association failing to meet the quantitative tests could nevertheless retain its preferential tax status by relying on this vague escape clause. However, language in the regulations makes it clear that the escape clause is intended only to prevent disqualification of associations whose failure to meet the quantitative tests is due solely to exceptional circumstances.⁸⁷

IV. CONCLUSION

For the most part, the regulations implementing the "domestic building and loan association" definition are supportable both in reason and on the basis of congressional intent. However, it would appear desirable for the Internal Revenue Service to reconsider its interpretation of the statutory investing-in-loans requirement and to align the regulations with congressional intent by eliminating all restrictions on sales of participating interests. Furthermore, consideration should be given to the suggested liberalization of the sales-of-whole-loans test.

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86. Treas. Reg. § 1.7701-13(c)(3) (1964).

87. "Transactions which are necessitated by exceptional circumstances and which are not undertaken as recurring business activities for profit will not be considered a substantial part of an association's business. Thus, for example, an association would meet the investing in loans requirement if it can establish that it failed to meet the gross income test because of receipt of a nonrecurring item of income due to exceptional circumstances, or it failed to meet the sales activity test because of sales made to achieve necessary liquidity to meet abnormal withdrawals from savings accounts." *Ibid.*