FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429

Division of Supervision

Federal Income Taxes

FIL-9-99
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TO: CHIEF EXECUTIVE OFFICER
SUBJECT: *Interest Accruals on Short-term Consumer Loans – "Rule of 78s" Method*

The FDIC would like to bring to banks' attention an Internal Revenue Service (IRS) requirement for recognizing interest income on "short-term consumer loans" for federal income tax purposes.

On August 17, 1997, the IRS published Revenue Procedure (Rev. Proc.) 97-37 (see IRS Bulletin No. 1997-33), which, among other things, made it clear that the "Rule of 78s" method of computing interest income on certain "short-term consumer loans" was no longer acceptable for federal income tax purposes. Previously, the IRS had permitted the use of the Rule of 78s on such loans as an administrative exception to the general rule that disallows the Rule of 78s method of accounting for interest on indebtedness. This exception was only permitted for amortizing consumer loans that required level payments to be made on a regular basis at least annually. The loan term could not exceed five years and a balloon payment could not be due at the end of the loan term.

Effective for tax years ending on or after August 17, 1997, Rev. Proc. 97-37 required interest income on all short-term consumer loans, both new loans and those currently outstanding, to be recognized using the constant yield method. For banks that had been using the Rule of 78s, this meant that they would have to make a mid-year change in the method of calculating interest income for federal income tax purposes.

During examinations conducted in 1998, FDIC examiners found that certain banks had not changed from the Rule of 78s to the constant yield method of accounting for interest income for federal income tax purposes. Furthermore, many lenders who had been using the Rule of 78s method of accounting for federal income tax purposes experienced difficulty in attempting to comply with Rev. Proc. 97-37.

To address these problems, the IRS modified its guidance on the Rule of 78s in Rev. Proc. 98-60, which was issued December 21, 1998 (see IRS Bulletin No. 1998-51). Rev. Proc. 98-60 states that, as a matter of administrative convenience, the IRS will permit a taxpayer such as a bank to use the Rule of 78s method for recognizing interest income on certain short-term consumer loans "if the loans were issued prior to the first day of the taxpayer's first taxable year that begins on or after January 1, 1999." As an example, banks with a calendar year fiscal year may continue to recognize revenue for federal income tax purposes using the Rule of 78s method on short-term consumer loans (as described in the second paragraph on the previous page) that were on the books on or before December 31, 1998. However, these banks must use the constant yield method of accounting for interest earned on all short-term consumer loans that are issued on or after January 1, 1999.

Although these provisions of Rev. Proc. 98-60 provide some relief to institutions that did not cease to use the Rule of 78s for federal income tax purposes in 1997, institutions are reminded that this method of recognizing income on loans is not acceptable under generally accepted accounting principles. Accordingly, the Rule of 78s normally should not be used to report interest income in the quarterly Reports of Condition and Income (Call Reports) even if it is used for federal income tax purposes in accordance with Rev. Proc. 98-60.

The FDIC encourages banks to consult with their tax advisor concerning the requirements of Rev. Procs. 98-60 and 97-37. Copies of these revenue procedures should be available from your tax advisor or may be obtained on the Internet at www.irs.ustreas.gov.

For further information on the provisions of the two revenue procedures concerning the Rule of 78s, please contact William Blanchard of the IRS' Office of Assistant Chief Counsel (Financial Institutions and Products) on 202-622-3950.

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Director

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