FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 6975
July 21, 1972]

# REGULATION Q

## Changes in Deferred-Interest Deposit Arrangements for Income Tax Purposes

*To the Member Banks of the Second Federal Reserve District:*

Following is the text of a letter from the Board of Governors of the Federal Reserve System to the American Bankers Association:

This refers to your letter of March 9, 1972, asking the Board to give consideration to waiving any interest penalty that may apply if banks and customers wish to make changes in deferred interest deposit agreements in the light of certain amendments to the Federal income tax regulations.

Banks and customers have entered into deposit agreements with maturities exceeding one year that provide for the payment of interest only at the maturity of the obligation. By virtue of administrative rulings issued by the Internal Revenue Service prior to June 1970, the customer was not required to include any of the interest in his gross income until the year it was paid or made available at maturity, and banks were permitted to report the interest for Federal income tax purposes on an accrual basis. The advantage of these arrangements to the customer was the opportunity to defer interest income to minimize his overall tax liability.

On December 28, 1971, the Internal Revenue Service published in the *Federal Register* (36 Fed. Reg. 24995) amendments to the Federal income tax regulations under sections 1232 and 6049 of the Internal Revenue Code relating to bonds and other evidence of indebtedness with "original issue discount." These regulations apply to deferred interest CDs purchased and deferred interest deposits made in calendar years beginning January 1, 1971. Although no interest is paid or made available to the depositor until the maturity of the deposit obligation, the regulations require a depositor to include a portion of the deferred interest in his gross income each year over the term of the obligation. The calculation of the portion allocable to each year involves an apportioning of the total interest to be received on a pro-rata (straight-line) monthly basis. For Federal tax purposes, banks must report interest as paid to the depositor on the same basis.

You are concerned with the effect of Regulation Q on situations where: (1) banks amend deposit contracts or substitute current interest deposit arrangements for deferred interest deposit arrangements in order to permit depositors to receive interest on an annual or more frequent basis so as to avoid the complex original issue discount interest income computation and inclusion rules, and (2) a depositor makes an early withdrawal from his deposit in order to pay the tax on deferred interest required to be reported by the original issue discount regulations.

You ask whether the action taken by banks and depositors in these situations involves an "emergency" withdrawal under the provisions of section 217.4(d) of Regulation Q and, if so, whether the Board would be willing to waive the interest penalty specified in that section.

The short answer to these queries is that the situation does not provide a basis for an "emergency" withdrawal as contemplated by the Regulation. Section 217.4(d) of Regulation Q relates to payment of the *principal* of a time deposit prior to maturity; neither that section nor any other section of Regulation Q prevents a bank and its customer from renegotiating the terms of the contract relating to the frequency and dates of payment of interest on a deposit.

Conversion from a deferred interest deposit arrangement to a current interest deposit arrangement affects only interest payments on the obligation. The depositor would receive interest at an earlier date than had been agreed upon at the time he entered into the contract. As long as the principal of the deposit is left undisturbed and the maturity of the obligation is unchanged, conversion to current interest arrangements does not constitute a payment, in part or in full, of a deposit prior to maturity and is not governed by the provisions of section 217.4(d).

With respect to early withdrawal by the depositor in order to receive funds to pay the unanticipated tax liability, it is not necessary to disturb the *principal* of the deposit. It is evident that the additional tax liability resulting from the original issue discount regulations will be *less* than the interest earned (but

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not paid) on the deposit. In other words, the interest earned will be more than sufficient to cover the additional tax liability, and the bank and customer may agree that the depositor will be paid the interest earned in order to cover that liability. Since there is no necessity to reach the principal of the deposit, section 217.4(d) would not apply.

The Board is of the view that, in the circumstances of this case, equity requires an additional form of relief. Bank customers entered into these contracts on the assumption that favorable tax treatment would remain available. The Board believes that a significant purpose of such contracts has therefore been frustrated by the changes in the income tax regulations. Consequently, the Board has concluded, on the basis of the doctrine of frustration of the contract, that there would be no violation of Regulation Q if depositors or banks terminate their deposit agreements entered into prior to the effective date of the amended IRS regulations and affected thereby. Termination of the deposit agreements on this basis does not involve the provisions of section 217.4(d) of Regulation Q.

The Board wishes to make clear that its views are limited to this particular situation and are not intended to establish a general rule with respect to the termination of deposit contracts in the event of other changes in tax regulations that may affect them.

Please inform those of your depositors who may be affected of the Board of Governors' views on this matter.

Alfred Hayes,
*President.*