

## PART XIII: FINANCIAL INSTITUTIONS

### 7843. What forms of deposits or other services are available in banks and other financial institutions?

Although the varieties of savings vehicles and services available through banks and other financial institutions seem endless, they may generally be grouped into one of four categories, as follows: (1) demand deposits; (2) time deposits; (3) savings deposits; or (4) life insurance and annuities.

A *demand deposit* is a deposit of funds that is payable on demand and generally includes all deposits that are not “time deposits” or “savings deposits.” With some exceptions, demand deposits do not pay interest.

A *time deposit* is a deposit of funds that the depositor does not have a right to withdraw for a specified period following the date of the deposit. Time deposits include deposits payable on a specified future date, after the expiration of a specified period of time, on written notice given a specified number of days prior to payment, or, as in the case of Christmas clubs and similar clubs, after a certain number of periodic deposits have been made during a specified minimum period of time. Time deposits may be evidenced by certificates of deposit (CDs), passbooks, statements, or otherwise. Time deposits evidenced by certificates of deposit are usually payable only on presentation of the certificate.

A *savings deposit* is generally any deposit of funds that is not payable on a specified date or at the expiration of a specified period of time. Money in a savings deposit may usually be withdrawn at any time; however, a financial institution may require that an advance written notice be given prior to a withdrawal. A savings deposit may be subject to “negotiable orders of withdrawal” (i.e., a NOW account).

In addition, banks and other financial institutions may make *life insurance* and *annuities* available to individual investors, subject to certain restrictions.<sup>1</sup>

### 7844. How is interest earned on a time or savings deposit taxed? In what year should the interest be reported?

Generally, any interest earned on time or savings deposits is ordinary income that must be included in the account owner’s gross income.<sup>2</sup> Because “interest” in this sense includes any compensation paid by the financial institution for the use of its depositors’ money, many distributions commonly referred to as “dividends” are actually payments of interest and will be taxed as such.<sup>3</sup> These include “dividends” on deposits or share accounts in cooperative banks, credit unions, domestic building and loan associations, federal savings and loan associations, and mutual savings banks. On the other hand, dividends on the capital stock of such organizations should

1. *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995).

2. Treas. Reg. §1.61-7(a).

3. See *Deputy v. duPont*, 308 U.S. 488 (1940).

be reported as dividends and not as interest.<sup>1</sup> Although “interest” and “dividends” are taxed in the same manner, except for the special treatment of “qualified dividends,” the distinction is still made for reporting purposes.

“Dividends” received from a mutual savings bank that received a deduction under IRC Section 591 are *not* eligible for the 20/15/0 percent rates applicable to “qualified dividend income” (See Q 608).<sup>2</sup>

Generally, interest must be included in gross income for the year in which (1) it is actually received by the taxpayer or, if earlier, (2) it is constructively received by the taxpayer.<sup>3</sup> Interest is constructively received by a taxpayer in the year during which it is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available so that the taxpayer might draw upon it at any time, or so that he or she could have drawn upon it during the year if notice of intention to withdraw had been given.<sup>4</sup> Interest may be constructively received even though the taxpayer was never notified that the interest was available.<sup>5</sup> On the other hand, interest is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions (see Q 579).<sup>6</sup>

If certificates of deposit (and certain other time deposits) with a term in excess of one year are issued at a price less than the “stated redemption price” that will be paid on maturity (i.e., the certificate is issued at a discount), the depositor must treat the “original issue discount” as interest received over the term of the certificate. Thus, the amount of original issue discount deemed to have been received during the calendar year must be included in the depositor’s ordinary income on his or her tax return for that year (see Q 7635).<sup>7</sup> Addressing the proper year for reporting interest on an 18-month certificate, the Service stated that the OID rules in IRC Section 1272 may require taxpayers to include interest as it accrues on certificates that have a stated maturity date of more than one year.<sup>8</sup>

Original issue discount on certificates of deposit with a term of one year or less does not have to be reported until the year of disposition.<sup>9</sup> However, for short-term obligations a taxpayer may elect to include original issue discount (or “acquisition discount” under an alternative election) as it accrues.<sup>10</sup> Such an election applies to all short-term taxable corporate obligations (and Treasury bills with respect to acquisition discount) acquired on or after the first day of the first taxable year for which the election is made, and it continues to apply until the Service consents to revocation of the election. Thus, an election with respect to a certificate of deposit will apply to such other taxable short-term obligations (including Treasury bills), and vice versa. See Q 7614 regarding these elections.

1. See IRS Pub. 17; IRS Pub. 550.

2. See generally IRC Sec. 1(h)(11).

3. Treas. Reg. §1.451-1(a).

4. Treas. Reg. §1.451-2(a).

5. See *Gajewski v. Comm.*, 67 TC 181 (1976), *aff'd without opinion*, 578 F.2d 1383 (8th Cir. 1978).

6. Treas. Reg. §1.451-2(a). See Rev. Rul. 73-220, 1973-1 CB 297.

7. IRC Sec. 1272; Treas. Regs. §§1.1232-1(d), 1.1232-3A(e).

8. IRS Information Letter INFO 2009-0151 (9-25-2009), citing IRC Sec. 1272(a)(2)(C) and Treas. Reg. §1.1275-1(d).

9. IRC Sec. 1272(a)(2)(C); see Rev. Rul. 73-221, 1973-1 CB 298; Rev. Rul. 80-157, 1980-1 CB 186; Rev. Rul. 82-42, 1982-1 CB 77.

10. IRC Sec. 1283(c).

If the certificate has a stated interest feature, any interest actually or constructively received during the calendar year under that feature must also be included in ordinary income for that year.

It is unclear how “indexed” certificates of deposit will be treated for income tax purposes. A certificate of deposit is considered “indexed” if the payment of principal at maturity corresponds to increases or decreases in a market standard, such as the S&P 500 or the NASDAQ 100. In many cases, no stated interest is paid on the investment. Instead, the payment of principal at maturity is determined in proportion to any increase in the underlying index. It is possible that the owner of an indexed certificate of deposit may be required to report all or a portion of any accrued interest annually, even though no payments are received prior to maturity. Whether the interest expense on amounts borrowed to purchase an indexed certificate of deposit will be deductible only in the year of maturity is even more unclear (See Q 7847).

Banks and other financial institutions must supply their depositors who earn original issue discount with a statement (Form 1099-OID) setting forth the amount of original issue discount deemed to have been received during the year.<sup>1</sup>

### **7845. If deposits are made to a joint savings account, who should report the interest income?**

For federal income tax purposes, if two or more persons own a joint savings account, the interest earned is owned and must be reported by each person to the extent that each is entitled *under local law* to share in such income.<sup>2</sup>

### **7846. Are “gifts” received from a financial institution for opening a savings account or making a time deposit taxed?**

Generally, yes. The fair market value of any gift (or premium) received by a depositor from a financial institution as an incentive to open a savings account or to make a time deposit is interest income that must be reported for the year in which it is received. Typically such amounts will be shown on the individual’s Form 1099-INT from the institution, along with interest paid on the account.<sup>3</sup> This is true whether the “gift” is a household appliance, automobile, cash, or other merchandise.

However, certain non-cash inducements provided by a financial institution to a depositor to open, or add to, an account will be treated as *de minimis premiums*. A non-cash inducement that does not have a value in excess of (1) \$10 for a deposit of less than \$5,000; or (2) \$20 for a deposit of \$5,000 or more will be treated as a *de minimis* premium. The cost to the financial institution of the premium is used in determining whether the dollar limitations are met. For administrative convenience, the Service will not require a depositor who receives a *de minimis* premium to treat the value of the premium as includible in gross income. In addition, the Service

1. See Treas. Reg. §1.6049-4.

2. Rev. Rul. 76-97, 1976-1 CB 15. See e.g., *Royster v. Comm.*, TC Memo 1985-258, *aff’d*, 820 F.2d 1156 (11th Cir. 1987).

3. See IRS Pub. 17; IRS Pub. 550; IR-1032 (4-14-70).

will not require the depositor to reduce the basis in the account by the de minimis premium. Furthermore, the Service will not require a financial institution that provides a de minimis premium to treat it as interest for purposes of reporting interest income.<sup>1</sup>

If the financial institution gives merchandise to an individual, other than an employee, who induces another person to open a savings account or make a time deposit, the fair market value of the “gift” is includable in gross income of that individual rather than that of the depositor.<sup>2</sup> Presumably, such income is not “interest” since it is not paid as compensation for the use of the recipient’s money.

### **7847. If an individual borrows the minimum required deposit on a certificate of deposit, is his interest expense on the loan deductible?**

Generally yes (if the taxpayer itemizes deductions); however, the total amount of investment interest expense otherwise deductible by a taxpayer is subject to the limitation explained in Q 7941.

If the loan and certificates are from the same bank, the loan and deposit will, regardless of the structure of the transaction, be treated as two separate transactions for tax purposes: the interest earned on the full face value of the certificate will be reported by the bank on Form 1099-INT and must be included by the individual in gross income for the year in which the certificate matures.<sup>3</sup> The interest paid on the loan will be subject to the limitations explained in Q 7941 (as well as the general rules for interest deductions (See Q 7932 through Q 7945)) and may be deducted only if the individual itemizes deductions on the income tax return for the year.

*Example:* Dr. Gasik deposits \$5,000 and borrows \$5,000 from Last National Bank to purchase a \$10,000 6-month money market certificate. At maturity, the certificate will pay interest of \$793, but Dr. Gasik will receive only \$372 (the interest earned minus \$421 of interest due on the \$5,000 loan from Last National). Dr. Gasik must report \$793 as interest income on his income tax return for the year in which the certificate matures. If Dr. Gasik itemizes deductions, he may include the \$421 interest expense in the computation of his investment interest deduction. However, if he does not itemize, any deduction will be lost. Neither Dr. Gasik nor the bank may offset the interest expense against the interest income for purposes of income tax reporting requirements.

If a short-term (i.e., a term of one year or less) certificate of deposit is issued at a discount, any interest expense paid or incurred on amounts borrowed to purchase or carry such certificate is usually deductible only in the year the certificate matures (or is disposed of); however, if there is an election to include the original issue discount on the certificate in income as it accrues, the current deduction of the interest expense will be limited only by the investment interest limitation explained in Q 7941. (See also Q 7944).

1. Rev. Proc. 2000-30, 2000-1 CB 113.

2. See Rev. Rul. 80-61, 1980-1 CB 287.

3. See Rev. Rul. 81-148, 1981-1 CB 574; Let. Rul. 8051033.

**7848. May an individual deduct the fees charged by a bank with respect to an interest bearing account on which checks may be drawn?**

It depends. Fees charged by a bank for the privilege of writing personal checks rather than for maintaining the interest-bearing account are personal in nature and are not deductible.<sup>1</sup> However, fees charged by a bank for the management of a money market deposit account, which requires a minimum balance and limits check writing and pre-authorized transfers, are treated as a “miscellaneous itemized deduction” because they are paid or incurred by the individual for the management, conservation, or maintenance of investments held for the production of income.<sup>2</sup>

“Miscellaneous itemized deductions” are deductible only to the extent that the aggregate of all such deductions exceeds 2 percent of adjusted gross income (see Q 631).

**7849. Is the penalty paid for early withdrawal of funds in a time deposit tax deductible?**

Yes. Interest and principal forfeited to a bank or other financial institution as a penalty for premature withdrawal of funds from a certificate of deposit or other time deposit are deductible “above-the-line” (i.e., in calculating adjusted gross income and not as an itemized deduction) for income tax purposes.<sup>3</sup>

1. Rev. Rul. 82-59, 1982-1 CB 47.

2. Let. Ruls. 8345067, 8423008.

3. IRC Sec. 62(a)(9); Temp. Treas. Reg. §1.62-1T(c)(10); Rev. Rul. 82-27, 1982-1 CB 32; Rev. Rul. 75-20, 1975-1 CB 29; Rev. Rul. 75-21, 1975-1 CB 367.

