FSR Insights

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IRS Requests Comments on Conclusive Presumption Regulations ("Bad Debt for Financial Instruments")

Introduction

On May 20, 2013, the Internal Revenue Service (IRS) requested comments in Notice 2013-35 (the "Notice") on whether recent changes to the bank regulatory standards for loan charge-offs require changes to the Conclusive Presumption Regulations under Reg. Sec. 1.166-2(d)(1) and 1.166-2(d)(3). The IRS is concerned that the bank regulatory changes have created standards that are no longer consistent with the principles of Sec. 166. The IRS is seeking comments to determine whether the current Conclusive Presumption Regulations should be modified in their application and availability to certain taxpayers.

Background

Under Sec. 166, a deduction is allowable when a debt is recoverable only in part and the amount of the deduction is not in excess of that charged off within the tax year. Absent any identifiable event that conclusively establishes a debt's worthlessness, a taxpayer must be prepared to establish worthlessness through whatever factors or evidence may be available.

As banks are regulated entities, banking regulators have established guidelines for determining the impairment or worthlessness of debts. These guidelines are important in the evaluation of a bank's financial position and capital adequacy. However, the determination by a banking regulator that a debt is impaired or worthless for regulatory capital purposes has not always triggered the same treatment for tax purposes.

To provide clarity in the deductibility of bad debts for regulated corporations, such as banks, the Treasury issued the Conclusive Presumption Regulations. These regulations allow banks and other corporations to establish the worthlessness of debts giving rise to bad debt deductions by showing compliance with regulatory charge off requirements.

Conclusive Presumption Regulations

In general, the Conclusive Presumption Regulations include two alternative rules that provide banks and other regulated corporations with a conclusive presumption that a debt is worthless: the Specific Order Method and the Book Conformity Method.[1] Under the Specific Order Method, any charge off is presumed to be a valid bad debt deduction for Sec. 166 if a bank or other corporation subject to regulatory authority charges off a debt in obedience to a specific order by a regulator or in accordance with established policies of that regulatory authority, and the authority confirms in writing that the charge off would have been subject to a specific order.

Alternatively, under the Book Conformity Method, if a bank regulator issues an express determination letter stating that a bank applies loan loss classification standards that are consistent with the regulatory loan loss classification standards of the bank regulator, then loans charged off by the bank are presumed to be valid Sec. 166 deductions.

[1] Treas. Reg. § 1.166-2(d)(1), 166(d)(3)

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The Notice highlights the policy behind the Conclusive Presumption Regulations that when sufficient similarity exists between the standards a tax administrator uses to permit a deduction for a bad debt and the standards a regulator uses to identify a loan that should be charged off, the tax administrator should accept the determination of the regulator for purposes of Sec. 166. This policy provides administrative convenience in that a debt asset is treated consistently for regulatory and tax purposes and only one agency needs to analyze the debt assets in a regulated entity's loan portfolio.

However, the Treasury has indicated that administrative convenience alone is not a sufficient reason for the Conclusive Presumption Regulations. Rather, the standards and processes applied by a regulator must result in loan classifications that are "similar enough to the criteria for worthlessness under Sec. 166 to make *regulatory criteria* and *examination by regulatory authorities* an acceptable surrogate for independent investigation by the IRS."[2]

Changing regulatory criteria

In 2004, bank regulatory standards for debt were brought in line with the Financial Accounting Standards Board pronouncements.[3] Under these standards, a debt security is considered impaired if its fair value is less that its amortized cost. The standards mandated that if the reduction in value was determined to be other than temporary, a loss equal to the full difference between the debt's fair value and its amortized cost should be recognized.

The FASB issued additional guidance in 2009 that changed how impairment should be reported for held-to-maturity debt securities.[4] For a held-to-maturity security, the portion of loss related to credit is to be recognized in earnings (on the income statement), while the portion of the loss related to all other factors (i.e., interest rate fluctuations, other non-credit related components affecting market value) is to be reported directly on the balance sheet as other comprehensive income.

According to the Notice, the IRS is concerned that the new bank regulatory standards incorporating generally accepted accounting principles are not sufficiently similar to the standard of worthlessness under Sec. 166 to permit the use of the Conclusive Presumption Regulations. Therefore, the IRS is seeking comments on whether the two standards are consistent and whether an impediment exists to the uniform application of a loss standard across different GAAP classifications (i.e., available-for-sale, held-to-maturity). Furthermore, the IRS would like to evaluate whether the two separate rules under the Conclusive Presumption Regulations should be streamlined into one rule.

Examination by regulatory authorities

While the Book Conformity Method is expressly available only to banks, the Specific Order method applies to a bank or "other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards." The Treasury and IRS have received questions concerning which taxpayers may constitute "other corporations" for this purpose, particularly with respect to insurance companies.

Previously, the IRS's Large Business & International Division issued an industry directive (the "Directive") advising examiners not to challenge an insurance company's bad debt deductions on mortgage backed

[2] *See* Treasury Department, Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions, 19-22 (September 1991).

[3] *See* O.C.C. 2004-25, Attachment: Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (June 15, 2004).

[4] *See* O.C.C. Bulletin 2009-11, Other-Than-Temporary Impairment Accounting (April 17, 2009).

securities, provided the company met certain conditions.[5] The Directive provided that an insurance company's partial worthlessness deductions under Sec. 166 are the same amount as the company's SSAP 43R credit-related impairment charge offs for the same securities. The Directive, while only applicable to insurance companies and not an official pronouncement of law, was believed by some to be a possible aid to banks that had taken Sec. 166 deductions on mortgage backed securities.

The IRS appears concerned about whether Federal or State regulators make determinations about worthlessness in a manner consistent with Sec. 166. While insurance regulators (under the Directive) and bank regulators have previously been deemed to maintain substantially equivalent standards to Sec. 166, the IRS would like to evaluate the extension of the Conclusive Presumption Regulations to entities governed by other regulatory authorities.

***FSR Insight**: The Conclusive Presumption Regulations are important in alleviating the burden of meeting separate evidentiary standards for the establishment of book and tax debt worthlessness.*

Clarification of which standards and which regulatory examinations are consistent with the principles of Sec. 166 will aid taxpayers by removing uncertainty in the application of the Conclusive Presumption Regulations.

[5] *See* I.R.S. Large Business and International Division, LB&I Control No. LB&I-4-0712-009 (July 30, 2012).

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