Part III - Administrative, Procedural, and Miscellaneous

Conclusive Presumption of Worthlessness of Debts

Notice 2013-35

SECTION 1. PURPOSE

This notice requests public comments on Treas. Reg. § 1.166-2(d)(1) and (3) (the "Conclusive Presumption Regulations"). In particular, comments are sought on whether 1) changes that have occurred in bank regulatory standards and processes since adoption of the Conclusive Presumption Regulations require amendment of those regulations, and 2) application of the Conclusive Presumption Regulations continues to be consistent with the principles of section 166. Comments are also sought on the types of entities that are permitted, or should be permitted, to apply a conclusive presumption of worthlessness.

SECTION 2. LAW

Section 166(a)(1) permits a deduction for any debt that becomes worthless in the taxable year. Section 166(a)(2) authorizes the Secretary to issue guidance on deducting debt that becomes partially worthless within the taxable year, with the deduction not to exceed the amount charged off.

Generally, whether a debt has become worthless within the taxable year is determined by examining all pertinent evidence, including objective circumstances such as the value of the collateral and the financial condition of the debtor. Section 1.166-2(a). Additionally, worthlessness is generally associated with identifiable events demonstrating the worthlessness of the debt and justifying the abandonment of hope of

recovery. Cole v. Commissioner, 871 F.2d 64, 67 (7th Cir. 1989).

Section 1.166-2 includes two alternative rules that, if met, provide banks and other regulated corporations with a conclusive presumption that a debt is worthless. Section 1.166-2(d)(1) provides that

> [i]f a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or part, either-
>
> > (i) In obedience to the specific order of such authorities, or
> >
> > (ii) In accordance with established policies of such authorities, and, upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off,
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> then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year.

The conclusive presumption rule set forth in section 1.166-2(d)(1) is referred to herein as the "Specific Order Method."

Section 1.166-2(d)(3) provides an alternative method of accounting for banks that make a conformity election (the "Book Conformity Method"). If a bank regulator issues an express determination letter stating that a bank electing to use the Book Conformity Method maintains and applies loan loss classification standards that are consistent with the regulatory loan loss classification standards of the bank regulator, then loans classified by the bank as loss assets and charged off are conclusively presumed to have become worthless in whole or in part. The regulations define a loss asset as one that is classified as such under the standards set forth in

> the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" (See Attachment to Comptroller of the Currency Banking

> Circular No. 127, Rev. 4-26-91…) or similar guidance issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, or the Farm Credit Administration; or for institutions under the supervision of the Office of Thrift Supervision, 12 CFR 563.160(b)(3).

Section 1.166-2(d)(3)(ii)(C).

SECTION 3. DISCUSSION

A. Bank Regulatory Standards and Debt Asset Review Process

The Conclusive Presumption Regulations reflect a policy that when there is sufficient similarity 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, in whole or in part, the tax administrator should accept the determination of the regulator for purposes of section 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. In view of the "large volume of loans charged off annually for regulatory purposes," administrative convenience alone is not a sufficient reason for the Conclusive Presumption Regulations. See Treasury Department, Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions 19 (September 1991)("Treasury Report"). Rather, the standards and processes applied by a regulator must result in loan classifications that are "similar enough to the criteria for worthlessness under section 166 to make regulatory criteria and examination by regulatory authorities an acceptable surrogate for independent investigation by the Internal Revenue Service." Treasury Report, 19-22. Although the Treasury Department and the Internal Revenue Service believed that this similarity existed at the time of the

adoption of the Conclusive Presumption Regulations, subsequent changes in the standards or processes that bank regulators use to determine worthlessness of a debt may have undermined the assumptions underlying the Conclusive Presumption Regulations.

Since adoption of the Conclusive Presumption Regulations, there have been a number of significant changes to the regulatory standards for loan charge-offs. For example, bank regulators rarely order banks to charge off particular loans or provide written confirmation that a bank took an appropriate charge-off on a loan as required by the Specific Order Method. Bank regulators also have changed the standards that are used for charge-offs, and they no longer classify a loss asset using the April 26, 1991, version of the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks that is referenced in the Conclusive Presumption Regulations.

In 2004, the bank regulators adopted the 2004 Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the "2004 Classification and Appraisal Agreement"), rescinding the prior 1991 agreement. The 2004 Classification and Appraisal Agreement classified applicable debt securities by relying on Financial Accounting Standards Board ("FASB") pronouncements. Under the 2004 Classification and Appraisal Agreement, a debt security is considered impaired if its fair value is less than its amortized cost, and the standards mandate recognizing a loss equal to the full difference between the debt's fair value and its amortized cost if the reduction in value (impairment) is other than temporary.

Additional changes to bank regulatory standards were made in 2009, when FASB issued additional guidance. See O.C.C. Bulletin 2009-11, Other-Than-Temporary

Impairment Accounting (April 17, 2009). That guidance changed how the impairment should be reported on financial statements for held-to-maturity debt securities. For a held-to-maturity debt security, the portion of loss related to credit loss is to be recognized in earnings (on the income statement), while the portion of loss related to all other factors is to be reported directly on the balance sheet as other comprehensive income (thereby bypassing the income statement). Financial Accounting Standards Board Staff Positions, FSP FAS 115-2 and 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (later codified as part of Accounting Standards Codification 320). Thus, beginning in 2009, the portion of the loss on held-to-maturity debt securities associated with credit impairment, as defined in regulatory standards, could be separately identified. These standards continue to be subject to future change, and they are currently under active review by FASB with a view, in part, to creating a uniform impairment model. See Exposure Draft, Financial Instruments—Credit Losses (Subtopic 825-15) (December 20, 2012).

In light of these changes to the regulatory standards relevant to loan charge-offs, the Treasury Department and the Internal Revenue Service are evaluating the Conclusive Presumption Regulations.

B. Entities Subject to the Conclusive Presumption Regulations

The Book Conformity Method under the Conclusive Presumption Regulations is expressly available only to banks. The Specific Order Method, in contrast, 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 Department and the Internal Revenue Service have received questions about which

taxpayers may qualify as “other corporations” for this purpose, particularly with respect to insurance companies and government-sponsored enterprises.

SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and Internal Revenue Service request public comments on the matters described in Section 3 of this Notice. While comments on any aspect of these matters are welcome, we request comments on the following questions in particular:

1. Which corporations are regulated by a Federal or State entity that reviews and makes determinations about worthlessness of debt assets in a manner consistent with the tax standards for worthlessness under section 166, and which of these entities should be covered by revised conclusive presumption rules?
2. Should the Conclusive Presumption Regulations be modified to reflect the changes in bank regulatory standards and processes since adoption of the regulations, and if so, how?
3. Are the current bank regulatory standards incorporating generally accepted accounting principles (“GAAP”) sufficiently similar to the standard of worthlessness under section 166 that they may appropriately be used in formulating revised conclusive presumption rules?
4. Should § 1.166-2(d)(1) and (3) be replaced with a single rule or should the regulations retain more than one conclusive presumption of worthlessness?

5. What process should be required by any new conclusive presumption regulations to verify that the regulated entity applied appropriate regulatory standards in taking a charge-off?

6. Are there limits that should be placed on the extent to which the timing of a deduction under section 166 may vary from the time when the regulatory standards mandate a charge-off?

7. Are there impediments to the uniform application of a loss standard across different GAAP debt classifications?

Comments must be submitted by October 8, 2013. All materials submitted will be available for public inspection and copying. Comments may be submitted to Internal Revenue Service, CC:PA:LPD:PR (Notice 2013-35), Room 5203, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to the Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2013-35), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.Comments@irscounsel.treas.gov. Include the notice number (Notice 2013-35) in the subject line.

SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Matthew P. Howard and John W. Rogers III of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Mr. Howard or Mr. Rogers at (202) 622-4695 (not a toll-free call).