



OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
December 11, 1998

CC:DOM:FS:FI&P

UILC: 166.00-00

Number: **199912005**

Release Date: 3/26/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: JOEL E. HELKE
CHIEF, CC:DOM:FS:FI&P

SUBJECT: Internal Revenue Service National Office Field Service
Advice

This Field Service Advice responds to your memorandum dated September 16, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Bank =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Date 3 =

ISSUE:

Whether under a valid conformity election, loans classified as "substandard" or "doubtful" for bank regulatory purposes and charged to a specific allowance qualify as deductible bad debts.

CONCLUSION:

No. Only loans that are classified as “loss” assets for regulatory purposes qualify as deductible bad debts under a valid conformity election. See Treas. Reg. § 1.166-2(d)(3)(ii)(A).

FACTS:

Bank is a thrift regulated by the Office of Thrift Supervision (“OTS”). Bank made a valid conformity election pursuant to Treas. Reg. § 1.166-2(d)(3) for Year 4.

On Date 2, the OTS issued to Bank an “Express Determination Letter” for purposes of satisfying Reg. §§ 1.166-2(d)(3)(ii) and 1.166-2(d)(3)(iii)(D). In that letter, the OTS concludes that, as of the date of the last regulatory examination on Date 1, Bank “maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.” For regulatory purposes, Bank classifies its loans as substandard, doubtful, or loss.

According to the examining agent, Bank has established a specific allowance for loans classified as either substandard, doubtful, or loss. For tax purposes for Year 4 and Year 5, Bank claimed bad debt deductions for all loans charged to this reserve. As a result, Bank claimed bad debt deductions not only with respect to loss loans, but also loans classified as either substandard or doubtful.

On Date 3, the OTS issued to Bank a confirmation letter concerning charge-offs taken for Year 1 through Year 3. The OTS confirmed that certain charge-offs and specific reserves would have been required by the OTS had Bank not already recognized the deduction from income. In the letter, the OTS added that it considers a specific reserve to be the equivalent of a charge-off. Bank received no such letter for Year 4 or Year 5.

LAW AND ANALYSIS:

In general, if a bank makes a valid conformity election, a debt is conclusively presumed to be worthless, in whole or in part, during that year if the debt is charged off, in whole or in part, for regulatory purposes pursuant to a specific order of the bank’s supervisory authority. See Treas. Reg. § 1.166-2(d)(3)(ii)(A)(1). Alternatively, a debt is conclusively presumed to be worthless, in whole or in part, during that year, if the charge-off corresponds to the bank’s classification of the debt, in whole or in part, as a loss asset. Id.

Here, there is no evidence that the OTS specifically ordered Bank to charge off loans for Year 4 or Year 5. Therefore, the first prong of the above test is not

satisfied. Accordingly, to qualify for the conclusive presumption, Bank must show that a loan was classified as a loss asset to the extent of the charge-off.

A “loss asset” is defined to mean a debt that is assigned to a class that corresponds to a loss asset classification under standards set forth by the appropriate regulatory authority. See Reg. § 1.166-2(d)(3)(ii)(C). In drafting the conformity election regulations, the drafters clearly rejected the request to extend the conclusive presumption to debts that were classified as either substandard or doubtful. See T.D. 8396, 1992-1 C.B. 95, 96; and T.D. 8492, 1993-2 C.B. 73, 74.

In the case of thrifts, the term “charge-off” includes the establishment of a specific allowance for loan losses in the amount of 100 percent of the portion of a debt classified as a loss. Reg. § 1.166-2(d)(4)(ii). This provision of the regulations was added to clarify that the term “charge off,” as it pertains to banks regulated by the OTS, includes the establishment of specific allowances for loan losses. Although the establishment of a specific allowance will satisfy the charge-off requirements of Reg. § 1.166-2(d)(3)(ii)(A)(1), the loans charged to a specific allowance must meet the standards of a loss asset under Reg. § 1.166-2(d)(3)(ii)(C) to qualify for a conclusive presumption of worthlessness. A loan classified as substandard or doubtful and charged to a specific allowance will not meet the standards of a loss asset, and thus is not deductible.

In the instant case, Bank claimed a bad debt deduction for all loans charged to a specific allowance. These included loans classified as substandard, doubtful or loss assets. The fact that Bank charged loans classified as substandard and doubtful to a specific allowance does not cause these loans to be reclassified as loss loans. Accordingly, to the extent that Bank claimed bad debt deductions for loans classified as substandard or doubtful, regardless of the fact that these loans were charged to a specific allowance, the deductions should be denied.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The examining agents should confirm that Bank established only a single reserve to which it charged substandard, doubtful and loss loans. It would be helpful to know whether Bank had ever established a practice of charging substandard loans to a substandard allowance, or doubtful loans to a doubtful allowance. In addition, the examining agents should verify that the OTS had not issued a specific order to Bank to charge off any portion of the loans classified as substandard or doubtful for the years in issue.

If you have any further questions, please call