

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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from: Associate Area Counsel (Miami)  
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subject:

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**DISCLOSURE STATEMENT**

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**ISSUES:**

1. Whether \_\_\_\_\_ (“\_\_\_\_\_” or the “Taxpayer”) is entitled to partial bad debt deductions in the amounts of \_\_\_\_\_ and \_\_\_\_\_ for the taxable years ending \_\_\_\_\_ and \_\_\_\_\_, respectively.
2. If \_\_\_\_\_ is entitled to partial bad debt deductions for the taxable years ending \_\_\_\_\_ and \_\_\_\_\_, whether \_\_\_\_\_ properly computed the amount of its claimed partial bad debt deductions.

**CONCLUSIONS:**

1.            is not entitled to partial bad debt deductions in the amounts of            and            for the taxable years ending            and            , respectively, because such amounts were not charged off during the respective taxable years in accordance with I.R.C. § 166(a)(2) and Treas. Reg. § 1.166-3(a)(2).
  
2.    If            is entitled to partial bad debt deductions for the taxable years ending            and            , the amount of the partial bad debt deductions are less than the amounts claimed by            .

**FACTS:**

The following facts have been provided by the Taxpayer:

1. On or about            ,            began operating its business.
  
2. From approximately            through            ,            was licensed as a            in the State of            .
  
3.            is taxable as a            .
  
4.            is engaged in the business of            .
  
5.            participated in, directly originated, or otherwise extended credit under the following loans that were outstanding during the years at issue:

Borrower Name

Loan Amount

6. The debt instruments underlying the loans identified in the preceding paragraph were secured by real estate located in \_\_\_\_\_, and in certain circumstances with rent rolls and/or other financial collateral related to those real properties.

7. During \_\_\_\_\_ through \_\_\_\_\_, the downturn in the \_\_\_\_\_ real estate market reduced the fair market value of the real estate and collateral that secured the obligations identified in Paragraph 5 above. Consequently, some borrowers defaulted on their loans.

8. During the years \_\_\_\_\_, some properties that were subject to the mortgages that \_\_\_\_\_ had participated in, directly or indirectly, were foreclosed.

9. During the years \_\_\_\_\_, some of the loan obligations were subject to modifications, forbearance agreements, short sale agreements and/or other changes that affected \_\_\_\_\_ ability to recover principal and interest owed under the loan agreements.

10. During \_\_\_\_\_ and \_\_\_\_\_, \_\_\_\_\_ determined that the value of the obligations identified in Paragraph 5 above were impaired. \_\_\_\_\_ allegedly recorded the amounts of the claimed impairment on a loan-by-loan basis on \_\_\_\_\_ general ledger in \_\_\_\_\_ and \_\_\_\_\_

11. For the \_\_\_\_\_ and \_\_\_\_\_ tax years, \_\_\_\_\_ balance sheet was prepared in a manner that included an \_\_\_\_\_ as a contra-asset account. \_\_\_\_\_ claims that this reduced the total amount of its loan portfolio by the amount of the partially worthless loans.

12. As of \_\_\_\_\_ and \_\_\_\_\_, the balance of \_\_\_\_\_ was \_\_\_\_\_ and \_\_\_\_\_, respectively.

13. \_\_\_\_\_ income tax return includes partial bad debt deductions with respect to its obligations in the amount of \_\_\_\_\_

14. \_\_\_\_\_ income tax return includes partial bad debt deductions with respect to its obligations in the amount of \_\_\_\_\_

15. \_\_\_\_\_ income tax return reports a \_\_\_\_\_ net operating loss, which was carried back to its \_\_\_\_\_ through \_\_\_\_\_ tax years as follows:

Tax Year

NOL Carryback Amount

Reduction in Taxes

Total

16. Financial Statements for \_\_\_\_\_ includes a Balance Sheet and a Statement of Income. Balance Sheet reflects in relevant part:

Statement of Income reflects an expense for \_\_\_\_\_ of \_\_\_\_\_, which reduced net income for that year.

17. Financial Statements include a note entitled \_\_\_\_\_ which provides in relevant part:

(Emphasis added).

18. Financial Statements for \_\_\_\_\_ includes a Balance Sheet and a Statement of Income. Balance Sheet reflects in relevant part:

Statement of Income reflects an expense for \_\_\_\_\_ of \_\_\_\_\_ which reduced net income for that year.

19. Financial Statements include a note entitled \_\_\_\_\_ which provides in relevant part:

(Emphasis added).

20. recorded the principal amount of the loans it participated in, directly originated, or otherwise extended credit in

did not reduce the balance of when it claimed the partial bad debt deductions at issue.

21. provided the following narrative explaining how it determined the amount of its claimed partial bad debt deductions and the journal entries it recorded:

#### Letter from Taxpayer to Examination.

To determine the “discounted fair market value,” estimates the date it expects to receive cash from the sale of the note or sale of the asset underlying the note after foreclosure, and then discounts from the expected date of recovery the current appraised value to the present using as the discount rate the rate of interest on the loan.<sup>1</sup>

#### **LAW and ANALYSIS:**

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<sup>1</sup> See Exhibit A for an example of how the Taxpayer calculated the amount by which a debt was impaired and the journal entries it recorded to reflect the impairment.

Issue #1

I.R.C. § 166(a)(2) provides that the Internal Revenue Service ("IRS") may allow a taxpayer to claim a partial bad debt deduction for a debt recoverable only in part, **in an amount not in excess of the part charged off within the taxable year.**" (Emphasis added). Treas. Reg. § 1.166-3(a)(2) provides --

**Charge-off required.** (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) **but only to the extent charged off during the taxable year.** (Emphasis added).

The purpose of the charge-off requirement is to perpetuate evidence of a taxpayer's election **to abandon** part of the debt as an asset. Findley v. Commissioner, 25 T.C. 311, 319 (1955), aff'd per curiam, 236 F.2d 959 (3d Cir. 1956) (emphasis added). An increase in a general reserve account does not constitute the required charge off. International Proprietaries, Inc. v. Commissioner, 18 T.C. 133 (1952). The taxpayer's intent to abandon the charged-off portion of the debt must be reflected in its books and records. Id.

In International Proprietaries, the taxpayer claimed a partial bad debt deduction of \$7,500 with respect to amounts due from two subsidiaries. Id. at 137. The taxpayer's board of directors had voted in favor of the charge-off and ordered that \$7,500 be charged against the surplus account (i.e., against net income). The taxpayer made a corresponding credit of \$7,500 to a reserve account entitled "Reserve for Inter-Company Advances." The taxpayer did not reduce the two accounts receivable which recorded the indebtedness due from each subsidiary. Id. at 136. The IRS determined that this \$7,500 in debt was not charged-off as required by the Code and disallowed the partial bad debt deduction.

The Tax Court in International Proprietaries held that the taxpayer's bookkeeping entries did not comply with the statutory requirement that there be a charge-off. The Court rejected the notion that an increase to a reserve account satisfies the charge-off requirement. Rather, "the taxpayer must eliminate the debt as an asset on its books in order to comply with the statutory requirements of charge-off." Id. at 139.

This case is not distinguishable from International Proprietaries. There, the taxpayer merely (1) increased its reserve account for bad debts, which decreased its balance sheet assets, and (2) credited surplus, which decreased its net income on its books. Similarly, (1) increased its

, a mere reserve account, which decreased its balance sheet assets and (2) credited , which decreased its net income per books.

By definition, an Allowance and a Provision is nothing more than a reserve.<sup>2</sup> Thus, did nothing more than create a reserve account for anticipated loan losses, calculated with reference to its loans. Under International Proprietaries, a court would disallow partial bad debt deductions.

In its recent submission to and , misleads when it alleges that it charged-off the claimed partial bad debt from its books. Rather, created an allowance and a provision for losses anticipated in the future (should the property go into foreclosure, be sold, etc.). An allowance and/or a provision is nothing more than a reserve.<sup>3</sup> International Proprietaries is quite clear that setting up a reserve for bad debts does not meet the charge-off requirements.

relies heavily on Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416 (1960). There, the taxpayer claimed partial bad debt deductions in the amounts of \$28,000 and \$12,000 on its 1954 and 1955 income tax returns, respectively. On its books, the taxpayer increased its account entitled "Reserve for Doubtful Notes and Accounts" (which reduced its assets) and debited "bad debts" (which reduced its net income). Id. at 430-31. The taxpayer did not charge-off the \$28,000 in its accounts receivable due from its subsidiary; however, it made an adjusting journal entry of \$28,000 in a new ledger account entitled "'Reserve for Loss on B & K Canada' [the subsidiary], the explanation being 'To charge bad debts with loss from Canadian operation.'" Id. at 431.

The Tax Court in Brandtjen held that the taxpayer was entitled to the partial bad debt deductions. First, the Court held that "the title of the new account [Reserve for Loss on B & K Canada] even though designated as a reserve, was in terms of a loss which had been incurred by reason of existing partial worthlessness, and not of an anticipated future loss." Id. at 443. The Court elaborated –

[W]e are disposed to accept what was done as an effective chargeoff for the purposes of the deductions claimed. The entries were definitely limited to the one account. They were intended to accomplish the purpose contended for, **and were described in words indicating a sustained loss, and not an anticipated future loss**, in the one specific account. In these respects, the situation here is distinguishable from that which existed in International Proprietaries, Inc. . . . .

Id. at 444. (Emphasis added).

Brandtjen is not like the instant case. The reason that the Tax Court in Brandtjen held in favor of the taxpayer was that the entries in the taxpayer's books were described in words indicating a sustained loss, and not an anticipated future loss. In contrast, books indicate that the entries were in the nature of a reserve for an anticipated

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<sup>2</sup> See Exhibit B.

<sup>3</sup> See Exhibit B.

future loss, not a sustained loss –

- (1) The to and explicitly provide

(Emphasis added). Thus, books indicate that it has neither sustained a loss nor abandoned the amounts claimed as partial bad debts, as required by Findley, 25 T.C. at 319. Rather, simply set up a reserve anticipating a future loss.

- (2) The names of the accounts debited and credited for the amounts claimed as partial bad debts are and  
An “ ” and a “ ” are terms synonymous with a “reserve.”<sup>4</sup> While the taxpayer in Brandtjen credited “bad debts” to reduce its net income, credited  
While a bad debt on the books means that a loss has already been sustained, a provision is nothing more than a reserve for an anticipated future loss.

- (3) As explained above, it was of paramount importance to the Tax Court’s opinion in Brandtjen that there are sufficient indicia of a sustained loss. Even though the taxpayer in Brandtjen titled its account in the nature of a reserve, the taxpayer used sufficiently descriptive and contemporaneous language in its books, “to charge bad debts with loss from Canadian operations,” in describing the entries made to the account “reserve for loss on B & K Canada.” In the instant case, not only did title its accounts in the nature of a reserve, so too was the contemporaneous explanation accompanying its journal entries. For example, in  
and  
the memos to the journal entries include  
and Such language indicates the anticipation of future losses.

Thus, this case is controlled by International Proprietaries, not Brandtjen. It follows that claimed partial bad debt deductions are not allowable for failure to satisfy the charge-off requirement in I.R.C. § 166(a)(2) and Treas. Reg. § 1.166-3(a)(2).

### Issue #2

When performs its impairment testing for book purposes each month or quarter, it calculates the amount of the impairment by

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<sup>4</sup> See Exhibit B.



To do so,

then

Each time that there is an impairment,  
 If there is a subsequent implied recovery of an impaired amount,  
 The balance of  
 at December 31 is the amount of the partial bad debt deduction claimed.  
 Thus, impairment calculation for book purposes is used to calculate  
 partial bad debt deductions for tax purposes. The Taxpayer has not cited legal authority  
 supporting the calculation of its partial bad debt deductions.

Before a taxpayer may charge off and deduct a debt in part, it is the taxpayer's burden to introduce evidence which establishes that in the year the partial worthlessness was claimed, the amount of such worthlessness could be predicted with reasonable certainty. Idi Management, Inc. v. Commissioner, T.C. Memo. 1977-369 citing Sika Chemical Corp. v. Commissioner, 64 T.C. 856, 862-863 (1975), affd. without published opinion 538 F.2d 320 (3rd Cir. 1976). In Idi Management, the Tax Court sustained petitioner's partial bad debt deduction "to the extent that their face values exceeded their fair market values." While subsequent events may be relevant to support the taxpayer's initial determination of partial worthlessness, the ultimate proof of worthlessness depends upon the facts and circumstances as they existed at the time the debt was claimed to have become worthless. Thompson v. Commissioner, T.C. Memo. 1983-81 rev'd on other grounds (citations omitted).

If is entitled to partial bad debt deductions in taxable years and  
 the amounts of the partial bad debt deductions are less than that reported by  
 The amount of partial worthlessness, if any, as confirmed by the Tax Court's holding in Idi Management, is the difference between the book value of the indebtedness and the current fair market value of the collateral property as of the close of the tax year for which the deduction is claimed. calculation of partial worthlessness, by including a discount factor, lacks an economic basis for if it were to sell the collateral property underlying the indebtedness as of the close of the tax years in question, would receive the then current fair market value. would not receive a discounted amount. Accordingly, overstated the amount of its partial bad debt deductions.

**CONCLUSIONS:**

1. \_\_\_\_\_ is not entitled to partial bad debt deductions in the amounts of \_\_\_\_\_ and \_\_\_\_\_ for the taxable years ending \_\_\_\_\_ and \_\_\_\_\_, respectively, because such amounts were not charged-off during the respective taxable years in accordance with I.R.C. § 166(a)(2) and Treas. Reg. § 1.166-3(a)(2).
  
2. If \_\_\_\_\_ is entitled to partial bad debt deductions for the taxable years ending \_\_\_\_\_ and \_\_\_\_\_, the amount of the partial bad debt deductions are less than the amounts reported by \_\_\_\_\_.

If you wish to discuss this matter, please contact me at (305) 982-5266.

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