December 12, 2001

MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE

FROM: David B. Robison /s/David B. Robison
Industry Director, Financial Services

SUBJECT: Industry Directive on the Conformity Election for Bank Bad Debts

The purpose of this memorandum is to provide a directive to examiners in the audit of the bad debt conformity election for banking institutions, in light of and as a companion to the publication of Rev. Rul. 2001-59 in I.R.B. 2001-51. This Revenue Ruling resulted from the banking industry's and the Service's joint effort to clarify the conformity election as part of the Industry Issue Resolution Pilot Program.

The bad debt conformity election for banks was added to the Treasury Regulations in response to the September, 1991 Treasury White Paper, "Report to The Congress on The Tax Treatment of Bad Debts by Financial Institutions", which addressed industry requests for book/tax conformity in the bad debt area. The conformity election under Treas. Reg. § 1.166-2(d)(3) is an accounting method available to banks to establish a conclusive presumption of worthlessness, either in whole or in part, for its loans. If a bank has properly complied with the terms of the conformity election, the bank is entitled to a bad debt deduction for loans classified as "loss assets", which were charged off for regulatory purposes.

Proper election of the conformity method of accounting substantially reduces the time required for auditing bad debts, thus saving resources for both the bank and the Service. The attached guidelines are intended to assist examiners in determining whether a proper conformity election was made and to provide assistance to examiners on the efficient use of time and resources in the analysis of this issue. The commitment of staffing to examine conformity election bad debts is usually not an effective utilization of resources. Approaches to planning and conducting an examination of the conformity election are explained in the attachment.

This LMSB Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.

If you have any questions, please contact me at (212) 298-2130 or either Mary Grady, Commercial Banking/Savings & Loan Technical Advisor, at (212) 719-6270 or Jody Botsford, Savings & Loan/Commercial Banking Technical Advisor, at (626) 312-5101.

Attachment

INDUSTRY DIRECTOR GUIDELINES ON AUDITING
BANK BAD DEBT CONFORMITY ELECTION

In general, a deduction is allowed under IRC § 166 for any debt which becomes worthless within the taxable year. However, no precise test exists for determining whether a debt is worthless. In many situations, no single factor or identifiable event clearly demonstrates whether a debt has become worthless. Instead, a series of factors or events in the aggregate establishes whether the debt is worthless.

For tax years ending on or after December 31, 1991, a bank, within the meaning of IRC § 581,[1] may obtain a conclusive presumption of worthlessness for bad debts that it owns by making a conformity election under Treas. Reg. § 1.166-2(d)(3). Under this election, a debt charged off for regulatory purposes is conclusively presumed to be worthless, in whole or in part, if either (1) the charge-off results from a specific order from a regulatory authority or (2) the charge-off corresponds to the bank's classification of the debt as a "loss asset". Treas. Reg. § 1.166-2(d)(3)(ii)(C) defines the term "loss asset" as a debt that the bank has assigned to a class that corresponds to a loss asset classification under the standards set forth in the "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks" or similar guidance issued by the bank's supervisory authority.

Rev. Rul. 2001-59, published on December 17, 2001 in I.R.B. 2001-51, provides clarification of the classification of a loan as a "loss asset" in order to meet the bad debt conformity election. Following an analysis of the applicable legal authorities, the Revenue Ruling concludes that a bank's board of directors' resolution authorizing charge-offs of only "loss asset" loans is sufficient to demonstrate classification of the loans as loss assets for purposes of Treas. Reg. § 1.166-2(d)(3). The Revenue Ruling also provides examples of other procedures a bank can use to classify loans (or loan portions) as loss assets.

Furthermore, Rev. Rul. 2001-59 addresses the situation where a bank erroneously charged off loans for regulatory purposes, but the error was not substantial enough for the Commissioner to revoke the bank's conformity election under Treas. Reg. § 1.166-2(d)(3)(iv)(D). In such a situation, the revenue ruling concludes that even the erroneously charged off loans are entitled to the conclusive presumption of worthlessness and an adjustment is not warranted.

[1]See Treas. Reg. § 1.166-2(d)(4)(i)

I. GUIDELINES FOR AUDITING CONFORMITY ELECTION REQUIREMENTS

When auditing a bank under the conformity method of accounting, the examiner must confirm that four requirements have been met for the conclusive presumption of worthlessness to apply to loans owned by the bank. Those four requirements are: (1) a valid conformity election; (2) a valid Express Determination Letter; (3) the loan must be charged off for book purposes; and (4) the loan must be classified as a loss asset (unless charge-off was ordered by the bank's regulator). If a bank fails to meet either the conformity election or the Express Determination Letter requirements, the bank will not be entitled to utilize the conformity method.

The two remaining requirements of book charge-off and loss asset classification apply to each loan separately. A bank's failure to meet either of these two remaining requirements for a specific loan will not result in an adjustment, unless this failure or a pattern of failures is substantial enough to result in a determination to revoke the bank's conformity election under Treas. Reg. § 1.166-2(d)(3)(iv)(D).

For example, in the situation where a bank erroneously charged off loans for regulatory purposes, but the error was not substantial enough to revoke the conformity election, Rev. Rul. 2001-59 concludes that even the erroneously charged off loans are entitled to the conclusive presumption of worthlessness and an adjustment is not warranted. However, if a bank had a computer input error that inadvertently resulted in the addition of an extra 0 (e.g. $5,000,000 vs. $500,000), this would be considered the correction of a clerical error and the adjustment should be made. See, for example, IRC § 6213(b)(1) and Treas. Reg. § 1.446-1(e)(2)(ii)(b).

In order to determine whether a bank has met the above four requirements of the conformity election and is entitled to a conclusive presumption of worthlessness for its charged off loans, it is recommended that the examiner initially request the following information:

Form 3115 electing conformity
Express Determination Letter(s)
Reconciliation of book charge-offs to tax deductions Bank's policies and procedures on loan classification
Annual reports
Bank's Reports of Condition and Income (Call Reports)/ Savings and Loan's Thrift Financial Reports
Securities and Exchange Commission (SEC) filings, e.g. Forms 10-Q, 10-K, 8-K

A Valid Conformity Election

One of the initial documents an examiner must obtain is the bank's Form 3115 (Application for Change in Accounting Method) electing conformity. A Form 3115 must be filed by an existing bank to elect the conformity method of accounting. This election must be made on a bank by bank basis and could have been made for years as early as 1991. New banks adopt the conformity method by filing a statement with their initial tax return.

Express Determination Letter

In addition, the examiner must also obtain the bank's Express Determination Letter(s) (EDL) covering the years under audit. Pursuant to Treas. Reg. § 1.166-2(d)(3)(iii) (D), every bank under the conformity method must obtain an EDL from its Federal supervisory authority verifying that the bank maintains and applies loan loss classification standards that are consistent with the supervisory authority's regulatory standards. The necessary language for an EDL can be found in Rev. Proc. 92-84, 1992-2 C.B. 489.

At the end of each regulatory examination by its supervisory authority, the bank must request and receive a new EDL. Retroactive EDLs covering earlier regulatory examination periods are not acceptable. Banks are generally examined by their regulator every 18 months.

If a bank fails to obtain the required EDL, the conformity election is automatically revoked as of the beginning of the tax year that includes the date as of which the supervisory authority conducts its examination.

Book Charge-Off Required

It is also recommended that the examiner obtain from the bank a reconciliation of the bank's charge-offs to its bad debt deductions, since a loan must be charged off on the books and records of the bank for the conclusive presumption of worthlessness to apply.[2] Under the conformity election, the bad debt deduction is limited to the year of the book charge-off. Accordingly, the examiner should compare the book charge-offs and bad debt deductions to see if there are any obvious inconsistencies, which should be reconciled.

For book purposes, a savings & loan (S&L) may establish a specific allowance for loans classified as either substandard, doubtful, or loss. Pursuant to Treas. Reg. § 1.166-2(d)(4)(ii), for banks regulated by the Office of Thrift Supervision (OTS), 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. This section was added to clarify that the term "charge-off," as it pertains to S&Ls, includes the establishment of specific allowances for loan losses.

[2] Discussions of books in this context refer to the bank's Regulatory Accounting Principles (RAP) books.

Although the establishment of a specific allowance will satisfy the charge-off requirements of the conformity election, the loans charged to a specific allowance must also meet the standards of a loss asset to qualify for a conclusive presumption of worthlessness. A loan classified as substandard or doubtful and charged to a specific allowance by an S&L will not meet the standards of a loss asset.

Loan Must Be Classified as a Loss Asset

A loan must also be classified as a "loss asset" by the bank for the conclusive presumption of worthlessness to apply, unless the loan was charged off pursuant to a regulator's specific order. Treas. Reg. § 1.166-2(d)(3)(ii)(C) defines the term "loss asset" as a debt that the bank has assigned to a class that corresponds to a loss asset classification under the standards set forth by the bank's supervisory authority. Therefore, it is recommended that the examiner obtain the bank's policies and procedures on loan classification.

Rev. Rul. 2001-59 provides that various procedures can be used by a bank to classify loans, in whole or in part, as loss assets. This evidence could include the board of directors' resolution referred to in the Revenue Ruling, credit committee reports or notations on loan files.

For example, an officer or employee may record that a loan has been classified as a loss asset on the internal form used by the bank at the time of charge-off. Copies of these internal forms could then be centrally filed by the bank making it easier for the examiner to verify that the classification requirement has been met. Additionally, if under a board of directors' resolution, the officers and employees are authorized to charge off loans only if the loans are "loss asset" loans, then the charge-offs of these loans demonstrates that the loans have been classified as loss assets.

Bank's Reports and Filings

Finally, it is recommended that the examiner obtain the bank's annual reports, call reports to its regulator and SEC filings. The examiner should analyze these filings to determine whether the bank's charge-offs and recovery rates warrant further review. For SEC registrants, the quarterly and annual Management Discussion and Analysis (MD&A) reports should provide information about the bank's loan loss methodologies, policies and procedures.[3]

[3]See the Securities and Exchange Commission Staff Accounting Bulletin: No. 102 - Selected Loan Loss Allowance Methodology and Documentation Issues (July 6, 2001) and the Board of Governors on the Federal Reserve System, Division of Banking Supervision and Regulation: SR 01-17 (SUP) - Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions

The examiner should use professional judgement to determine whether the bank's charge-off and recovery rates warrant further review. Some of the factors to be considered include the rate of charge-offs and recoveries in prior years and the change to charge-offs in comparison to prior year(s). The regulatory and SEC filings may help to determine the bank's historical recovery rates for applicable loan categories.

If the bank has met the conformity election requirements and its charge-off and recovery rates appear reasonable, no further audit steps are warranted.

However, if the bank's charge-off and recovery rates do not initially appear reasonable, the examiner should then consider the charge-off and recovery rates experienced by the bank in relation to its peers. Peer groups are often determined with reference to the bank's asset size, lines of business and/or geographic location. Federal studies (such as the Federal Reserve Bank of New York's publication "Current Issues in Economics and Finance") that track current industry charge-off averages may be useful in this analysis.

For example, if the current industry charge-off average is six percent of outstanding loans for a particular loan category and the taxpayer is charging off 12 percent, a material deviation may exist. The bank should be given the opportunity to explain what economic or other circumstances caused the difference.

A bank's experience with recoveries, as compared to its peers, may also reflect a charge-off in excess of reasonable business judgement. For example, if a bank were recovering 25 percent or more of the charged-off loans for a particular loan category, while peer data would indicate that 12 percent recover rate was more common, a material deviation may exist. The examiner should then question the bank as to why its recovery rate appears to be out of line with the industry.

If the bank is unable to adequately explain the above deviations, it may be appropriate to sample the loan files to see if the data supports the bank's charge-offs. A bank's failure to meet the loan loss classification or charge-off requirements for a specific loan, generally will not result in an individual loan adjustment. If the pattern of failures is substantial enough, however, it may result in a determination to revoke the bank's conformity election.

If the review of the loan files leads to the determination that the charge-offs were substantially in excess of reasonable business judgement, revocation of the election may be warranted. It should be noted that revocation of the conformity election is an extraordinary step when the procedural requirements have been met.

II. REVOCATION OF CONFORMITY ELECTION

As stated previously, if a bank fails to meet either the conformity election or the Express Determination Letter requirements, the bank will not be entitled to utilize the conformity method. However, a bank's failure to meet either the book charge-off and loss asset classification requirements for a specific loan will not result in an adjustment, unless this failure or a pattern of failures is substantial enough to result in a determination to revoke the bank's conformity election under Treas. Reg. § 1.166-2(d)(3)(iv)(D).

Pursuant to Treas. Reg. § 1.166-2(d)(3)(iv)(D), the Commissioner may revoke a bank's election to use the conformity method, if an electing bank fails to follow the conformity method of accounting to determine when debts become worthless, or if the bank's charge-offs are substantially in excess of those warranted by reasonable business judgement in applying the regulatory standards of the bank's supervisory authority. Accordingly, if an examination of a bank's books and records reveals that there is a pattern of charge-offs in the wrong year or under all the facts and circumstances the charge-offs were substantially in excess of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority, the conformity election may be revoked.

For example, the conformity bad debt deduction should match book charge-offs. The examiner should determine, based upon a review of the reconciliation schedules provided, whether the bank has engaged in a practice of charging off loans in the wrong year, either early or late. A pattern of charge offs in the wrong year could lead to a revocation of the conformity election.

In addition, as stated above, a bank's failure to meet the loan loss classification or charge-off requirements for a specific loan, generally will not result in an individual loan adjustment. If the pattern of failures is substantial enough, however, it may result in a determination to revoke the bank's conformity election.

Finally, in the case of an S&L where the creation of a specific reserve for loan losses results in a tax deduction for 100 percent of the portion of the debt classified as loss assets, electing conformity is not intended to allow a double deduction. Such a double deduction could result from the fluctuation in the specific reserve from one reporting period to the next. The examiner should compare the prior specific reserves per the Thrift Financial Reports to ensure that the same specific reserve for a particular loan does not result in a duplication of the tax deduction. If this duplication becomes a pattern, the examiner should consider revocation.

The examiner should use professional judgement in determining whether to pursue the extraordinary step of revoking a bank's conformity election. Based on the data collected, the Team Manager and Team Coordinator should determine

the extent of resources to devote to this issue. Conversations with the taxpayer and the Banking Technical Advisors may assist the examiner in setting the scope and depth for examining this issue and help minimize the audit burden on both the taxpayer and the examination team.

III. EXAMPLES OF LOANS NOT SUBJECT TO CONFORMITY ELECTION[4]

It should also be remembered that not all loans of a bank are entitled to the conclusive presumption of worthlessness under the conformity election. For example, the examiner should confirm the bank owns the worthless loans for both book and tax purposes. Loans not owned for book purposes are not subject to regulatory loan loss classification standards and thus are outside the scope of the conformity election. In addition, the examiner should be aware that the bank's bad debt tax basis might be affected by the mark to market provisions under IRC § 475.

The following are examples of some loans or portions of loans not subject to the conformity election because they are not subject to regulatory loan loss classification standards:

Securitized Loans - Many securitizations are treated as sales for book purposes[5], but are treated as financing arrangements for tax purposes. In these circumstances, if the bank does not own the loans for book/regulatory purposes, the loans cannot be charged off on the bank's books under the loss classification standards and, therefore, the conformity election cannot apply to the securitized loans. For example, credit card, installment and auto loan securitizations have generally been treated as sales for book purposes, but financing transactions for tax purposes. The determination of sale versus financing is highly fact intensive and requires a case by case analysis of the benefits and burdens of ownership.

Restructured Loans – A loan may be significantly modified for tax purposes. This significant modification requires the tax recognition of gain or loss, which may not exist for book purposes. See Treas. Reg. § 1.1001-3.

Interest on Nonperforming Loans - A bank may cease to accrue interest income for book purposes, even though it continues to accrue the interest for tax purposes. Thus, there is no loan on the books for this unpaid interest.

Loans Accounted for on a Cost Recovery Basis - A bank with a loan that is considered delinquent or nonperforming may still receive cash payments from the borrower. The bank may apply these payments first to principal for book purposes. However, for tax purposes, these payments may be recognized as interest income, based upon the terms of the loan document.

[4] Bad debt deductions for loans not subject to regulatory loss classification standards are determined under the general rules of IRC §166.
[5] See Statement of Financial Accounting Standards (SFAS) 125 and 140

Interest Accrual Reversals - For book purposes, a bank may be required to reverse previously accrued interest income, when a loan is impaired or nonperforming. However, interest income cannot be reversed for tax purposes. Thus, there is no loan of this interest for tax purposes.

In-Substance Foreclosures – In-Substance Foreclosures (ISF) represent the physical possession of the collateral property by a bank. An ISF is recorded as Other Real Estate Owned (OREO) for book purposes, even though a technical foreclosure has not taken place. In an ISF circumstance, the loan no longer exits for book purposes, but it still exists for tax purposes.

IV. PREVIOUSLY PUBLISHED DETERMINATIONS CONCERNING THE CONFORMITY ELECTION

Prior published determinations by the Chief Counsel's office in the conformity election area are being provided for informational purposes only. Please note that pursuant to IRC § 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent. Such advice generally involves specific taxpayers based on specific facts and represents the thinking of Chief Counsel's office at the time of issuance.

FSA 199912005, Released March 26, 1999:

In response to a request for Field Service Advice, Counsel concluded that only loans classified as "loss" assets for regulatory purposes qualify as deductible bad debts under a valid conformity election, while loans classified as "substandard" or "doubtful" do not.

FSA 200018017, Released May 5, 2000:

On the facts presented, Counsel recommended in this Field Service Advice that Exam consider revoking the taxpayer's conformity election in the earliest open year under examination in accordance with Treas. Reg. § 1.166-(d)(3)(iv)(D). Also, any such revocation must be handled as a cut-off method with no attendant adjustment under IRC § 481(a) with respect to loan amounts previously charged off for book purposes.

ITA 200027036, Released July 7, 2000:

In response to a request for Technical Assistance concerning the revocation of the conformity election under Treas. Reg. § 1.166-2(d)(3), Counsel concluded that the Service may audit a bank that has made the conformity election. The audit determines whether the bank complied with the requirements of the accounting method in particular, as well as the requirements for a bad debt deduction in general.

This advice also discusses instances in which the conformity election may be revoked.

The case of United States v. U.S. Bancorp, 12 F.Supp. 2d 982 (D.Minn.1998) is cited in a footnote in this advice. In this summons enforcement case, the bank argued that under a valid conformity election, the information sought by the Service was irrelevant, since the election provides a conclusive presumption of worthlessness for bad debts. The court concluded that the conclusive presumption does not make information regarding those debts irrelevant to the legitimate determination of the bank's tax liabilities and the accuracy of the bank's tax return. Accordingly, the bank was required to comply with the summons.

CCA 200045030, Released November 9, 2000:

In response to a request for Technical Assistance concerning the conformity election under Treas. Reg. § 1.166-2(d)(3), Counsel concluded, in part, that:

The conclusive presumption of worthlessness standard set forth in Treas. Reg. § 1.166-2(d)(3)(ii) can apply to consumer loans such as credit card loans and installment loans that are classified as a regulatory loss asset after the applicable period passes, assuming the bank owns the debt instrument or credit account for both regulatory and tax purposes; and

The Service does not have the authority to question a bank's loan loss classification standards when a bank makes a conformity election and has received an Express Determination Letter. However, the Service may revoke the conformity election, if a bank fails to follow the method of accounting required by the conformity election, or the bank's charge-offs were substantially in excess of reasonable business judgement in applying the regulatory standards of the bank's supervisory authority.

FSA 200129003, Released July 20, 2001

In this Field Service Advice dealing with whether a building and loan association's treatment of bad debt losses was an accounting method change, Counsel stated that the conformity election under Treas. Reg. § 1.166-2(d)(3) can apply equally to banks using the reserve method of accounting for bad debts and to banks using the specific charge-off method.