

agency as of the last day of the calendar quarter. U does not choose under § 1.585-5(c)(2)(i)(B) a report date more frequent than quarterly. Thus, U's report dates under § 1.585-5(c)(2)(i)(A) are March 31, June 30, September 30, and December 31. For its taxable year beginning on February 1, 1987, U has total assets (within the meaning of § 1.585-5(c)(3)) of \$480 million on March 31, \$490 million on June 30, \$510 million on September 30, and \$540 million on December 31. Thus, pursuant to § 1.585-5(c)(1), U's average total assets for its taxable year beginning on February 1, 1987, are \$505 million.

Example 2. Bank W is a calendar year taxpayer, and its report date (within the meaning of § 1.585-5(c)(2)(i)(A)) is the last day of the calendar quarter. Pursuant to § 1.585-5(c)(4), W chooses to estimate the tax bases of its assets for 1990. Therefore, W must estimate the tax bases of all of its assets (other than cash) for its first three report dates in 1990. Since W's fourth report date (December 31) is the last day of its taxable year, the tax bases of its assets may not be estimated for this date. The adjusted tax bases of all of W's assets (other than cash) are \$450z on December 31, 1989, and \$480z on December 31, 1990. The book bases of those assets are \$500z on December 31, 1989; \$520z on March 31, 1990; \$540z on June 30, 1990; \$560z on September 30, 1990; and \$600z on December 31, 1990. Applying the formulas provided in § 1.585-5(c)(4)(ii), W's tax/book ratio as of the close of 1989 (R), is 0.9 (450z/500z). W's tax/book ratio as of the close of 1990 is 0.8 (480z/600z). Thus, Y is -0.1. The estimated adjusted tax bases of all of W's assets (other than cash) on the first three report dates of 1990 are as follows:

$$\begin{aligned} \text{1st} &= B \times (R + 1/4Y) \\ &= \$520z \times [0.9 + 1/4(-0.1)] \\ &= \$455z \\ \text{2nd} &= B \times (R + 1/2Y) \\ &= \$540z \times [0.9 + 1/2(-0.1)] \\ &= \$459z \\ \text{3rd} &= B \times (R + 3/4Y) \\ &= \$560z \times [0.9 + 3/4(-0.1)] \\ &= \$462z \end{aligned}$$

(d) *Definitions.* The following definitions apply for purposes of this section and §§ 1.585-6, 1.585-7 and 1.585-8:

(1) *Disqualification year.* A bank's disqualification year is its first taxable year beginning after December 31, 1986, for which the bank is a large bank within the meaning of paragraph (b) of this section.

(2) *Parent-subsidiary controlled group.* A parent-subsidiary controlled group includes all of the members of a con-

trolled group of corporations described in section 1563(a)(1). The members of such a group are determined without regard to whether any member is an *excluded member* described in section 1563(b)(2), a foreign entity, or a commercial bank.

(3) *Example.* The following example illustrates the principles of this paragraph (d):

Example. Bank X is a large bank within the meaning of § 1.585-5(b)(1)(i). Bank Y is not a large bank under § 1.585-5(b), and it maintains a bad debt reserve under section 585. In 1988, X purchases all of the stock of Y. If the acquisition causes Y to become a member of a parent-subsidiary controlled group described in § 1.585-5(b)(1)(ii), Y is a large bank beginning in its first taxable year that ends after the date of the acquisition. Pursuant to § 1.585-5(d)(1), this year is Y's disqualification year. Y must change in this year to the specific charge-off method of accounting for bad debts, in accordance with § 1.585-6 or § 1.585-7.

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§ 1.585-6 Recapture method of changing from the reserve method of section 585.

(a) *General rule.* This section applies to any large bank (as defined in § 1.585-5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in § 1.585-5(d)(1)) and that does not elect the cut-off method set forth in § 1.585-7. Except as otherwise provided in paragraphs (c) and (d) of this section, any bank to which this section applies must include in income the amount of its net section 481(a) adjustment (as defined in paragraph (b)(3) of this section) over the four-year period beginning with the bank's disqualification year. If a bank follows the rules prescribed by this section, its change to the specific charge-off method of accounting for bad debts in its disqualification year will be treated as a change in accounting method that is made with the consent of the Commissioner. Paragraph (b) of this section specifies the portion of the net section 481(a) adjustment to be included in income in each year of the recapture period; paragraph (c) of this section provides rules on the effect of disposing of loans; and paragraph (d) of this section provides rules on the

suspension of recapture by financially troubled banks.

(b) *Four-year spread of net section 481(a) adjustment*—(1) *In general.* If a bank to which this section applies does not make the election allowed by paragraph (b)(2) of this section, the bank must include in income the following portions of its net section 481(a) adjustment in each year of the four-year recapture period: 10 percent in the bank's disqualification year; 20 percent in its first taxable year after its disqualification year; 30 percent in its second taxable year after its disqualification year; and 40 percent in its third taxable year after its disqualification year.

(2) *Election to include more than 10 percent in disqualification year.* A bank to which this section applies may elect to include in income, in its disqualification year, any percentage of its net section 481(a) adjustment that is larger than 10 percent. Any such election must be made at the time and in the manner prescribed by § 1.585-8. If a bank makes such an election, the bank must include in income the remainder, if any, of its net section 481(a) adjustment in the following portions: $\frac{2}{5}$ of the remainder in the bank's first taxable year after its disqualification year; $\frac{1}{3}$ of the remainder in its second taxable year after its disqualification year; and $\frac{1}{5}$ of the remainder in its third taxable year after its disqualification year. For this purpose, the remainder of a bank's net section 481(a) adjustment is any portion of the adjustment that the bank does not elect to include in income in its disqualification year.

(3) *Net section 481(a) adjustment.* For purposes of this section, the amount of a bank's net section 481(a) adjustment is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately preceding its disqualification year. Since the change from the reserve method of section 585 is initiated by the taxpayer, the amount of the bank's bad debt reserve for this purpose is not reduced by amounts attributable to taxable years beginning before 1954.

(4) *Examples.* The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M is a large bank within the meaning of § 1.585-5(b). M's disqualification year is its taxable year beginning on January 1, 1989, and M maintained a bad debt reserve under section 585 for the preceding taxable year. Pursuant to § 1.585-5(a), M must change from the reserve method of accounting for bad debts to the specific charge-off method in its disqualification year. M does not elect the cut-off method set forth in § 1.585-7. Thus, M must follow the recapture method set forth in this § 1.585-6. M's net section 481(a) adjustment, as defined in § 1.585-6(b)(3), is \$2 million. M does not make the election allowed by § 1.585-6(b)(2). Pursuant to § 1.585-6(b)(1), M must include the following amounts in income: \$200,000 in taxable year 1989; \$400,000 in 1990; \$600,000 in 1991; and \$800,000 in 1992.

Example 2. Assume the same facts as in Example 1, except that M elects under § 1.585-6(b)(2) to recapture 55 percent of its net section 481(a) adjustment in its disqualification year. Pursuant to § 1.585-6(b)(2), M must include the following amounts in income: \$1,100,000 in taxable year 1989; \$200,000 in 1990; \$300,000 in 1991; and \$400,000 in 1992.

(c) *Effect of disposing of loans*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, if a bank to which this section applies sells or otherwise disposes of any of its outstanding loans on or after the first day of its disqualification year, the disposition does not affect the bank's obligation under this section to include in income the amount of its net section 481(a) adjustment, and the disposition does not affect the amount of this adjustment.

(2) *Cessation of banking business*—(i) *In general.* If a bank to which this section applies ceases to engage in the business of banking before it is otherwise required to include in income the full amount of its net section 481(a) adjustment, the bank must include in income the remaining amount of the adjustment in the taxable year in which it ceases to engage in the business of banking. For this purpose, and except as provided in paragraph (c)(2)(ii) of this section, whether a bank ceases to engage in the business of banking is determined under the principles of § 1.446-1(e)(3)(ii) and its administrative procedures.

(ii) *Transition rule.* A bank that ceases to engage in the business of banking as the result of a transaction to which section 381(a) applies is not treated as ceasing to engage in the

business of banking if, on or before March 29, 1994, either the transaction occurs or the bank enters into a binding written agreement to carry out the transaction.

(3) *Certain section 381 transactions.* This paragraph (c)(3) applies if a bank to which this section applies transfers outstanding loans to another corporation on or after the first day of the bank's disqualification year (and before it has included in income the full amount of its net section 481(a) adjustment) in a transaction to which section 381(a) applies, and under paragraph (c)(2) (i) or (ii) of this section the transferor bank is not treated as ceasing to engage in the business of banking as a result of the transaction. If this paragraph (c)(3) applies, the acquiring corporation (the acquiror) steps into the shoes of the transferor with respect to using the recapture method prescribed by this section and assumes all of the transferor's rights and obligations under paragraph (b) of this section. The unrecaptured balance of the transferor's net section 481(a) adjustment carries over in the transaction to the acquiror, and the acquiror must complete the four-year recapture procedure begun by the transferor. In applying this procedure, the transferor's taxable year that ends on or includes the date of the acquisition and the acquiror's first taxable year ending after the date of the acquisition represent two consecutive taxable years within the four-year recapture period.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. Bank P is a bank to which this §1.585-6 applies. P's disqualification year is its taxable year beginning on January 1, 1989, and P recaptures 10 percent of its net section 481(a) adjustment in that year pursuant to §1.585-6(b)(1). In July 1990 P disposes of a portion of its loan portfolio in a transaction to which section 381(a) does not apply, and P continues to engage in the business of banking. Pursuant to §1.585-6(c)(1), the disposition does not affect P's obligation under §1.585-6(b)(1) to recapture the remainder of its net section 481(a) adjustment in 1990, 1991 and 1992. Nor does the disposition affect the amount of the adjustment.

Example 2. Assume the same facts as in Example 1, except that P ceases to engage in the business of banking in 1990, as determined under the principles of §1.446-

1(e)(3)(ii) and its administrative procedures. Pursuant to §1.585-6(c)(2)(i), in 1990 P must include in income the remaining 90 percent of its net section 481(a) adjustment.

Example 3. Assume the same facts as in Example 1, except that P's 1990 disposition of loans is a transaction to which section 381(a) applies, P ceases to engage in the business of banking as a result of the transaction, and P's taxable year ends on the date of the transaction. Thus, in the transaction, P transfers substantially all of its loans to an acquiring corporation (Q). Q is a calendar year taxpayer. Because the transaction occurred before March 29, 1994, the transition rule of §1.585-6(c)(2)(ii) applies, and P is not treated as ceasing to engage in the business of banking. Pursuant to §1.585-6(c)(3), Q steps into P's shoes with respect to using the recapture method prescribed by §1.585-6. The unrecaptured balance of P's net section 481(a) adjustment carries over to Q in the section 381(a) transaction, and Q must complete the four-year recapture procedure begun by P. Pursuant to §§1.585-6(b) and 1.585-6(c)(3), P includes 20 percent of its net section 481(a) adjustment in income in its taxable year ending on the date of the section 381(a) transaction, and Q includes 30 percent of the adjustment in income in 1990 and 40 percent in 1991.

Example 4. Assume the same facts as in Example 3. Assume also that Q becomes a large bank under §1.585-5(b) as a result of the transaction and maintained a bad debt reserve immediately before the transaction. Q must change to the specific charge-off method for all of its loans in the first taxable year that it is a large bank. Thus, Q not only completes the recapture procedure begun by P but also follows the rules prescribed by §1.585-6 or §1.585-7 with respect to its own reserve.

Example 5. Assume the same facts as in Example 3. Assume also that Q is not a large bank after the transaction and properly establishes a bad debt reserve for the loans it receives in the transaction. This establishment of the reserve results in a new negative section 481(a) adjustment. Thus, Q not only completes the recapture procedure begun by P but also takes into account the new negative adjustment as required under section 381.

(d) *Suspension of recapture by financially troubled banks—(1) In general.* Except as provided in paragraph (d)(2) of this section, a bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for any taxable year must not include any amount in income under paragraphs (a) and (b) of this section for that taxable year and must disregard that taxable year in applying paragraphs (a) and (b) of

this section to other taxable years. See paragraph (d)(4) of this section for rules on determining estimated tax payments of financially troubled banks, and see paragraph (d)(5) of this section for examples illustrating this paragraph (d).

(2) *Election to recapture.* A bank that is financially troubled (within the meaning of paragraph (d)(3) of this section) for its disqualification year may elect to include in income, in one taxable year, any percentage of its net section 481(a) adjustment that is greater than 10 percent. This election may be made for the bank's disqualification year, for the first taxable year after the disqualification year in which the bank is not financially troubled (within the meaning of paragraph (d)(3) of this section), or for any intervening taxable year. Any such election must be made at the time and in the manner prescribed by § 1.585-8. A bank that makes this election must include an amount in income under paragraphs (a) and (b) of this section in the year for which the election is made (election year) and must not disregard this year in applying paragraphs (a) and (b) of this section to other taxable years. Such a bank must follow the rules of paragraph (b)(2) of this section in applying paragraph (b) of this section to later taxable years, treating the election year as the disqualification year for purposes of applying paragraph (b)(2) of this section. However, if the bank is financially troubled for any year after its election year, the bank must not include any amount in income under paragraphs (a) and (b) of this section for the later year and must disregard the later year in applying paragraphs (a) and (b) of this section to other taxable years.

(3) *Definition of financially troubled—*

(i) *In general.* For purposes of this section, a bank is considered financially troubled for any taxable year if the bank's nonperforming loan percentage for that year exceeds 75 percent. For this purpose, a bank's nonperforming loan percentage is the percentage determined by dividing the sum of the outstanding balances of the bank's nonperforming loans (as defined in paragraph (d)(3)(iii) of this section) as of the close of each quarter of the tax-

able year, by the sum of the amounts of the bank's equity (as defined in paragraph (d)(3)(iv) of this section) as of the close of each such quarter. The quarters for a short taxable year of at least 3 months are the same as those of the bank's annual accounting period, except that quarters ending before or after the short year are disregarded. If a taxable year consists of less than 3 months, the first or last day of the taxable year is treated as the last day of its only quarter. In lieu of determining its nonperforming loan percentage on the basis of loans and equity as of the close of each quarter of the taxable year, a bank may, for all years, determine this percentage on the basis of loans and equity as of the close of each report date (as defined in § 1.585-5(c)(2), without regard to § 1.585-5(c)(2)(i)(B)). In the case of a bank that is a foreign corporation, all nonperforming loans and equity of the bank are taken into account, including loans and equity that are not effectively connected with the conduct of a banking business within the United States.

(ii) *Parent-subsidiary controlled groups—(A) In general.* If a bank is a member of a parent-subsidiary controlled group (as defined in § 1.585-5(d)(2)) for the taxable year, the nonperforming loans and the equity of all members of the bank's financial group (as determined under paragraph (d)(3)(ii)(B) of this section) are treated as the nonperforming loans and the equity of the bank for purposes of paragraph (d)(3)(i) of this section. However, any equity interest that a member of a bank's financial group holds in another member of this group is not to be counted in determining equity. Similarly, any loan that a member of a bank's financial group makes to another member of the group is not to be counted in determining nonperforming loans. All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their nonperforming loan percentage on the basis of the close of each quarter of the taxable year, or all must (for all such taxable years) determine this percentage on the basis of

the close of each report date (as determined under § 1.585-5(c)(2)(ii), applied without regard to § 1.585-5(c)(2)(i)(B)).

(B) *Financial group—(1) In general.* All banks that are members of the same parent-subsidiary controlled group must (for all taxable years that they are members of this group) determine their financial group under paragraph (d)(3)(ii)(B)(2) of this section, or all must (for all such taxable years) determine their financial group under paragraph (d)(3)(ii)(B)(3) of this section.

(2) *Financial institution members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(2), consists of all financial institutions within the meaning of section 265(b)(5) (and comparable foreign financial institutions) that are members of the parent-subsidiary controlled group of which the bank is a member.

(3) *All members of parent-subsidiary controlled group.* A bank's financial group, determined under this paragraph (d)(3)(ii)(B)(3), consists of all members of the parent-subsidiary controlled group of which the bank is a member.

(iii) *Nonperforming loan—(A) In general.* For purposes of this section, a nonperforming loan is any loan (as defined in paragraph (d)(3)(iii)(B) of this section) that is considered to be nonperforming by the holder's primary Federal regulatory agency. Nonperforming loans include the following types of loans as defined by the Federal Financial Institutions Examination Council: Loans that are past due 90 days or more and still accruing; loans that are in nonaccrual status; and loans that are restructured troubled debt. A loan is not considered to be nonperforming merely because it is past due, if it is past due less than 90 days. The outstanding balances of nonperforming loans are determined on the basis of amounts that are required to be reported to the holder's primary Federal regulatory agency. For purposes of this paragraph (d)(3)(iii)(A), a holder that does not have a Federal regulatory agency is treated as Federally regulated under the standards prescribed by the Federal Financial Institutions Examination Council.

(B) *Loan.* For purposes of paragraph (d)(3)(iii)(A) of this section, a loan is any extension of credit that is defined and treated as a loan under the standards prescribed by the Federal Financial Institutions Examination Council. (Accordingly, a troubled debt restructuring that is in substance a foreclosure or repossession is not considered a loan.) In addition, a debt evidenced by a security issued by a foreign government is treated as a loan if the security is issued as an integral part of a restructuring of one or more troubled loans to the foreign government (or an agency or instrumentality thereof). Similarly, a deposit with the central bank of a foreign country is treated as a loan if the deposit is made under a deposit facility agreement that is entered into as an integral part of a restructuring of one or more troubled loans to the foreign country's government (or an agency or instrumentality thereof).

(iv) *Equity.* For purposes of this section, the equity of a bank or other financial institution is its equity (i.e., assets minus liabilities) as required to be reported to the institution's primary Federal regulatory agency (or, if the institution does not have a Federal regulatory agency, as required under the standards prescribed by the Federal Financial Institutions Examination Council). The balance in a reserve for bad debts is not treated as equity.

(4) *Estimated tax payments of financially troubled banks.* For purposes of applying section 6655(e)(2)(A)(i) with respect to any installment of estimated tax, a bank that is financially troubled as of the due date of the installment is treated as if no amount will be included in income under paragraphs (a) and (b) of this section for the taxable year. For this purpose, a bank is considered financially troubled as of the due date of an installment of estimated tax only if its nonperforming loan percentage (computed under paragraph (d)(3) of this section) would exceed 75 percent for a short taxable year ending on that date. For purposes of computing this nonperforming loan percentage, the ending of such a short taxable year would not cause the last day of that year to be treated as the last day of a quarter of the taxable year.

(5) *Examples.* The following examples illustrate the principles of this paragraph (d):

Example 1. Bank R is a bank to which this § 1.585-6 applies. R's disqualification year is its taxable year beginning on January 1, 1987. R is not financially troubled (within the meaning of § 1.585-6(d)(3)) for taxable year 1987 or for any taxable year after 1989, but it is financially troubled for taxable years 1988 and 1989. Since R is not financially troubled for its disqualification year, R must include an amount in income under § 1.585-6 (a) and (b) for that year (taxable year 1987). R may make the election allowed by § 1.585-6(b)(2) for that year. Since R is financially troubled for taxable years 1988 and 1989, pursuant to § 1.585-6(d)(1) R does not include any amount in income under § 1.585-6 (a) and (b) for these years, and it treats taxable years 1990, 1991 and 1992 as the first, second and third taxable years after its disqualification year for purposes of applying § 1.585-6 (a) and (b).

Example 2. Assume the same facts as in Example 1, except that R is financially troubled for taxable year 1987 (its disqualification year). R may make the election allowed by § 1.585-6(d)(2) for 1987 (the disqualification year), for 1990 (the first year after the disqualification year in which R is not financially troubled), or for 1988 or 1989 (the intervening years). R elects to include 60 percent of its net section 481(a) adjustment in income in 1987. Thus, the remainder of the adjustment, for purposes of applying the rules of § 1.585-6(b)(2), is 40 percent. R must include in income 2/9 of the remainder in 1990, 1/3 of the remainder in 1991, and 4/9 of the remainder in 1992.

Example 3. Bank S, which is not a member of a parent-subsidiary controlled group, is a bank to which this § 1.585-6 applies. S's disqualification year is its taxable year beginning on January 1, 1987. S determines its nonperforming loan percentage under § 1.585-6(d)(3) on a quarterly basis. S is not financially troubled for taxable year 1987 and includes 10 percent of its net section 481(a) adjustment in income in that year. S's outstanding balance of nonperforming loans (as defined in § 1.585-6(d)(3)(iii)) is \$80 million on March 31, 1988; \$68 million on June 30, 1988; and \$59 million on September 30, 1988. The amount of S's equity (as defined in § 1.585-6(d)(3)(iv)) is \$100 million on each of these threedates. Thus, S's nonperforming loan percentage, computed under § 1.585-6(d)(3), would be 80 percent (80/100) for a short taxable year ending on April 15 or June 15, 74 percent $[(80+68) \div 200]$ for a short taxable year ending on September 15, and 69 percent $[(80+68+59) \div 300]$ for a short taxable year ending on December 15. Since S's nonperforming loan percentage for a short taxable year ending on April 15 or June 15 would exceed 75 percent, pursuant to § 1.585-6(d)(4) S is con-

sidered financially troubled as of these dates. Thus, S is treated as if no amount will be included in income under § 1.585-6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on April 15, 1988, and June 15, 1988. However, since S's nonperforming loan percentage for a short taxable year ending on September 15 or December 15 would not exceed 75 percent, S is not considered financially troubled as of these dates. Thus, S is treated as if 20 percent of its net section 481(a) adjustment will be included in income under § 1.585-6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on September 15, 1988, and December 15, 1988.

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§ 1.585-7 Elective cut-off method of changing from the reserve method of section 585.

(a) *General rule.* Any large bank (as defined in § 1.585-5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in § 1.585-5(d)(1)) may elect to use the cut-off method set forth in this section. Any such election must be made at the time and in the manner prescribed by § 1.585-8. If a bank makes this election, the bank must maintain its bad debt reserve for its pre-disqualification loans, as prescribed in paragraph (b) of this section, and the bank must include in income any excess balance in this reserve, as required by paragraph (c) of this section. The bank may not deduct, for its disqualification year or any subsequent taxable year, any amount allowed under section 166(a) for pre-disqualification loans (as defined in paragraph (b)(2) of this section) that become worthless in whole or in part, except as allowed by paragraph (b)(1) of this section. However, except as provided in paragraph (d)(3) of this section, the bank may deduct, for its disqualification year or any subsequent taxable year, amounts allowed under section 166(a) for loans that the bank originates or acquires on or after the first day of its disqualification year and that become worthless in whole or in part. If a bank makes the election allowed by this paragraph (a), its change to the specific charge-off method of accounting for