Industry Issue Resolution  
Pilot Program under Notice 2000-65  

Financial Services issues

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Banking and Savings Institutions of the Section of Taxation. Principal responsibility was exercised by Henry Ruempler. Substantive contributions were made by Ron Blasi, Hayden Brown, James Dahlberg, David Grant, and Charles Wheeler. The Comments were reviewed by C. Ellen MacNeil of the Section’s Committee on Government Submissions and by Steven D. Conlon, Council Director for the Committee on Banking and Savings Institutions.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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This report is in response to Notice 2000-65\textsuperscript{1} inviting interested parties to suggest issues for the Industry Issue Resolution Pilot Program. As indicated in the Notice, the Industry Issue Resolution Pilot Program is intended to provide guidance to resolve frequently disputed tax issues that are common to a significant number of large or mid-sized businesses. The members of the Committee on Banking and Savings Institutions who have contributed to this letter are experienced tax practitioners with substantial background in working with financial services industry clients on tax controversies.

We welcome the opportunity afforded by the Notice and more especially the initiative with respect to industry issue resolution. It is clear to us that IRS audits of banks and other financial institutions are burdened by disputes over several timing issues that consume too many resources of both Service and taxpayers. Banks face examination disputes over the tax treatment of problem loans, whether in the form of a deduction for worthlessness of bad debts under IRC section 166 or for the accrual of interest income on non-performing loans. The treatment of problem loans is an issue that is common to all large and mid-sized banks and frequently the subject of dispute between the Service and bank taxpayers. The tax treatment of bad debts and non-accruals is highly dependent on facts, and the range of fact situations is endless. Moreover, the issues relate simply to the timing of deductions, so the cost of the many tax controversies should be weighed against just the interest on the disputed amount, not the tax amount at issue in any given year. Finally, it should be observed that Congress and Treasury have recognized in the past that the tax issues related to problem loans need a more efficient method of resolution for bank taxpayers, because of the sheer volume of bank lending and the prospect for unnecessary factual disputes between bank taxpayers and the Service.\textsuperscript{2}

**Problem Loans - Bad Debt Charge-offs**

Disputes between lenders and the IRS on the deductibility of bad debts often focus on whether the debt was worthless in the year in which the deduction was claimed. As noted in the Treasury study, “an inherent difficulty in identifying the year of deduction is that worthlessness often results from a gradual deterioration in the debtor’s financial condition rather than an easily identifiable event.” A taxpayer may claim a deduction for financial, regulatory and/or tax purposes without discharging the borrower’s obligation under the debt, thereby creating an additional complication of possible recovery of the loss after the year in which the tax deduction is claimed. While the taxpayer must evaluate these factors when the tax return is filed, the IRS examination of that return often occurs several years later, with the benefit of hindsight.

\textsuperscript{1} 2000-52 I.R.B. 1.
\textsuperscript{2} See General Explanation of the Tax Reform Act of 1986 (JCT Bluebook) p 532, where the Congress directed the Secretary of the Treasury to study and issue a report concerning “under what circumstances a rule providing for a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate.” See also the Treasury Department response, Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions, (Treasury study) dated September 1991 which addressed both bad debts and non-accruals.
Over many years the regulations under IRC section 166 have provided several different mechanisms for banks or other regulated corporations to establish the evidence necessary to support a bad debt deduction. In 1921, language was promulgated that is today contained in regulation section 1.166-2(d)(i) that worthlessness was presumed where the charge-off occurred “in obedience to the specific orders of [Federal or state supervisory] authorities.” In 1973, that language was expanded in regulation section 1.166-2(d)(ii) to include cases where the charge off was made in accordance with established policies of such authorities and confirmed in writing upon the next examination. In 1992, the bad debt conformity election was provided in regulation section 1.166-2(d)(3), under certain circumstances, for a conclusive presumption for banks to claim deductions based on their regulatory charge-offs.

Each of these provisions was rooted in the need for banks to have a practical method for claiming deductions for bad debts without having factual disputes about the deductions on the basis of hindsight. More importantly, however, the 1991 Treasury study states, “[i]t is unlikely that banks and other regulated institutions would exploit the conservatism of the regulators to the serious detriment of the tax system.” Based on our experience working with bank clients, the proposition can be stated more directly - the requirement that banks claim a charge-off for financial statement and regulatory purposes serves as an effective discipline against inappropriate acceleration of tax deductions for bad debts. In many cases, however, the IRS examination of bank bad debt charge-offs starts with an apparent assumption that the banks are accelerating deductions under section 166. The conclusive presumption of worthlessness under the conformity election, which was intended to ease disputes over bad debts, is not working as well as it should.

First, many bank taxpayers have not adopted the conformity election because of one particular requirement in the regulations. Regulation section 1.166-2(d)(3)(ii)(A)(1) provides that the conclusive presumption applies only if the debt was categorized as a “loss asset” at the time of charge-off. As noted above, loans frequently deteriorate over time and a loan can decline in classification standards between the evaluation periods from a level above “loss asset” directly down to the level of “charge-off” for regulatory purposes, without technically stopping at the loss asset classification. Many banks have regulatory classification systems that do not accommodate this artificial IRS requirement that a deteriorating loan stop at the loss asset classification before being charged-off. This requirement effectively prevents many banks from adopting a needed practical mechanism for establishing that their bad debts are worthless for tax purposes. Banks that have adopted the conformity election, but claim deductions for charge-offs that were not classified as loss assets, run the risk of having the IRS revoke the election.

Second, some of the banks that have adopted the conformity election have nonetheless experienced IRS challenges to their bad debt deductions. Some of these challenges are appropriate. Many, however, involve requests for information that are inconsistent with the existence of the conformity election (e.g. valuation of collateral) or propose to challenge the

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3 See e.g. FSA 20001817.
use of the conformity election on grounds not specified in the regulation. In far too many cases, taxpayers find themselves once again facing a loan by loan evaluation of charge-offs by the IRS.

We believe that the Service should revisit the issue of bank bad debt charge-offs generally. Regardless of whether a bank taxpayer claims deductions under the traditional standards of section 166 or whether it has adopted the conformity election, the IRS audit guidelines should instruct IRS examiners that a book charge-off is a strong factor to support the worthlessness of a bad debt for tax. IRS examinations of loan losses where no conformity election has been made should focus on a sampling of larger loans, and rely on the appropriate bank regulatory agency standard of delinquency time for charge-offs of small dollar loans. Finally the Service should revise the conformity election by eliminating the “loss account” requirement and redirecting the focus on the initial field examination to the three bases cited in Chief Counsel Advice 200027036 as grounds for IRS to revoke the conformity election. This would effectively expand the availability and the usefulness of the conformity election for both the IRS and bank taxpayers.

Problem Loans - Accrual of Interest Income

The courts have held that lenders may cease accruing interest on loans, where the loan has not been charged-off, where they can substantiate that there is no reasonable expectancy of payment. The IRS approach has been to apply an uncollectibility standard, on a loan by loan basis. The IRS has not accepted any given number days of delinquency constitutes substantiation for uncollectibility. In contrast, for bank regulatory and financial statement purposes, loans are put in non-accrual status based on delinquency for a stated number of days, unless the loan is well secured and in the process of collection. Thus, IRS examinations begin with amount of non-accrual income in the bank’s annual report and challenge the taxpayer to show on a loan by loan basis that the accrued but unpaid interest is uncollectible. Unlike bad debt charge-offs, the tax regulations do not contain any mechanism for avoiding the loan by loan factual analysis in the case of non-accruals.

The 1991 study the Treasury Department considered whether it would be appropriate to have a conclusive presumption for non-accrual loans based on bank regulatory standards. The Treasury concluded that the regulatory standard for non-accrual could not serve as a proxy for the tax standard. Nonetheless, the practical problems remain, imposing major costs on bank taxpayers and IRS agents. We believe the pilot program provides an opportunity for both the Service and the industry to revisit the topic and seek to fashion either a conformity rule or at least a safe harbor that can significantly reduce the factual disputes.

See e.g. Chief Counsel Advice 200027036, where the National Office spells out the three bases under which the conformity election can be revoked by the IRS, but specifically does not limit the inquiry of IRS agents to those three points.


See Treasury study pp. 24-28
By analogy, a recent IRS Chief Counsel memorandum for District Counsel on the bad debt conformity election may point the way to a possible conformity rule for non-accruals. The memorandum indicates that reliance by IRS on a bank regulatory rule based on the amount of time that a loan has been delinquent is appropriate in some cases. The memorandum cites affirmatively the 1991 Treasury study in part and states, “[h]igh volume loans are subject to automatic charge-off procedures” and therefore a deduction based on the conformity election is appropriate after the applicable time period passes. The memorandum notes, however, that the conformity election can be revoked by IRS based on excessive charge-offs, which may be evidenced by an unusually high recovery rate for such loans. We would suggest that if a fixed amount of time is, in some cases, adequate to justify a charge-off of the loan, then it is equally appropriate to use delinquency as a basis for non-accrual. In many cases, if a borrower were to make subsequent payments, the amounts are required by the note to be applied to the unpaid principal, before being applied to unpaid interest. A conformity rule for non-accruals could be conditioned on a maximum rate of recoveries as compared with industry averages, thereby protecting the Service from an unduly conservative lender.

Final Comment

We would be remiss if we did not include a comment on what we believe is the most significant tax controversy currently facing the banking industry - the treatment of loan origination costs. We view the recent decision in the case of PNC Bancorp, Inc. v. Commissioner, as the correct interpretation of the law. Based on our conversations with IRS officials, it appears that the Service may be close to issuing guidance on this issue, which we presume would be consistent with the Third Circuit decision. If so, then the treatment of loan origination may not be one that needs to be resolved under the industry issue resolution pilot program. If our assessment is incorrect, however, and if the Service decides to address loan origination costs under the pilot program, we would welcome that action.

7 ILM 200045030 (September 27, 2000).
8 212 F. 3d. 822 (3d Cir. 2000), rev’d 110 T.C. 349 (1998)