Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **20123002F**
Release Date: 7/27/2012

CC:LB&I:RFPH:JAX:
POSTF-110186-12

UILC: 166.03-00

date: June 08, 2012

to: Revenue Agent

from:
Senior Attorney
Associate Area Counsel
(Large Business & International)

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subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Subsidiary =
Taxpayer =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
Date 1 =

Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Entity 1 =
Document 1 =
Abbreviation 1 =
Year 1 =
Year 2 =
City 1 =
City 2 =
State 1 =
Territory 1 =
OTS Finding 1 =
OTS requirement 1 =

OTS requirement 2 =

Order definition 1 =

Phone number 1 =
Page 1 =

ISSUE

Whether Subsidiary is entitled to bad debt deductions under I.R.C. § 166(a)(2) in the amount of $Amount 1, the amount moved from its general bad debt reserve to a specific valuation allowance account during the tax year ending Date 1?

CONCLUSION

Yes, Subsidiary is entitled to bad debt deductions under I.R.C. § 166(a)(2) in the amount of $Amount 1, the amount moved from its general bad debt reserve to a specific valuation allowance during the tax year ending Date 1.

FACTS

Taxpayer (hereafter, “Abbreviation 1” or the taxpayer), was a C corporation at all times during the years Year 2 through , and has approximately Amount 2 subsidiaries which together file consolidated income tax returns under the Abbreviation 1 name. The taxpayer and its wholly-owned subsidiary, Subsidiary (hereafter also called “the Bank”),

filed consolidated Federal income tax returns, Form 1120, for fiscal years ending Date 2 and Date 1. The Bank is a "large bank" that had total assets (cash plus the adjusted bases of all other assets) in excess of $Amount 3 at all times during the taxable year ending Date 1[1].

Subsidiary is a bank (as defined in I.R.C. § 581) and is subject to supervision by Federal authorities, including the Office of Thrift Supervision (OTS). It grants the majority of its loans to borrowers in City 1 and City 2, State 1, as well as in Territory 1. It filed Thrift Financial Reports with the OTS during the year at issue.

On Date 3, the Bank entered into a Stipulation and Consent to Issuance of Order to Cease and Desist with the Office of Thrift Supervision. An Order to Cease and Desist was issued by the OTS on Date 4. As recited in the Stipulation, the OTS found that OTS Finding 1. The Order required OTS requirement 1. It also required OTS requirement 2. Per the Order, Order definition 1.

The Bank's board of directors issued a Document1 on Date 5, . Under the Document 1, specific and/or general valuation allowances would be established on the Bank's books as needed. If a loan for which there was collateral "was found to have such severe problems that appear to impact its market value", its estimated fair value would be calculated in accordance with GAAP and Financial Accounting Standard 114. "Any portion of the loan in excess of this estimate would be classified as a loss, or charged off. . . . This quantifiable amount would require **a specific valuation allowance or charge off** of such amount." (Emphasis added.)

Valuation allowances are contra-asset accounts[2] that reduce recorded investment in an asset to its carrying amount. The "carrying amount," also referred to as book value or carrying value, is an accounting term for the value of an asset on the books of the business. In other words, the Bank, in placing assets in the valuation accounts, was reducing the value of its assets reported on its books. the Bank's consolidated financial statement for the year at issue stated that loan losses were charged against the specific valuation allowance when management believed the uncollectibility of a loan to be confirmed. The amounts placed into the specific valuation allowance account were not estimations; they were specific determinations made by the Bank, based on appraisals of the real property securing the delinquent loans.

During the taxable year ending Date 1, for book purposes and OTS regulatory purposes, Subsidiary moved portions of certain consumer and credit card debts that it determined to be unrecoverable from its general reserve for bad debts to a Special

[1] This information was taken as reported on Office of Thrift Supervision Thrift Financial Reports filed by the Bank for the year at issue.

[2] A contra-asset account is an account which is expected to have a credit balance (contrary to the normal debit balance of an asset account) that is related to another asset account having a debit balance. For example, the contra-asset account Accumulated Depreciation is related to a constructed asset(s) account.

Valuation account on its financial books. According to Page 1 of the Bank's Office of Thrift Supervision Thrift Financial Report for the year ending Date 1, the Bank transferred $Amount 4 of loans from general valuation allowances to the account for specific valuation allowances (the Special Valuation account) during the tax year at issue.

On its Federal income tax return for the taxable year ending Date 1, the Bank deducted $Amount 5 as a bad debt loss. Of this amount, $Amount 1 represented the amounts placed into the specific valuation allowance account during the tax year as partially worthless debts that had been charged off[3]. The deduction of the $Amount 1 that had been placed into the specific valuation allowance account as partially worthless debts is at issue in this opinion. The remaining $Amount 6, consisting of $Amount 7 in specific charge offs and $Amount 8 in other adjustments, is not at issue. The taxpayer did not attach any statement to its return for the tax year ending Date 1 making an election under Treas. Reg. § 1.166-2(d)(3) to use the conformity method of accounting to determine when debts owed to it become worthless.

The Internal Revenue Service had placed the tax years ending Date 2 and Date 1 of the Bank under examination when, on Date 6, the Bank was closed by the Federal Deposit Insurance Corporation (hereafter, "FDIC") and the FDIC was appointed as a receiver. The assets and liabilities of the Bank were transferred to Entity 1, an unrelated third party, under terms negotiated by the FDIC.

The Internal Revenue Service determined that the taxpayer arranged its accounts for book and tax purposes in the manner that it did in order to comply with OTS regulations. 12 C.F.R. § 560.160, Asset Classification, provides:

> (a)(1) Each savings association must evaluate and classify its assets on a regular basis in a manner consistent with, or reconcilable to, the classification system used by OTS in its Thrift Activities Handbook;
>
> * * * * *
>
> (b) Based on the evaluation and classification of its assets, each savings association shall establish adequate valuation allowances **or** charge-offs, as appropriate, consistent with generally accepted accounting principles and the practices of federal banking agencies. (Emphasis added.)

During the Internal Revenue Service examination, the amounts moved into the Special Valuation account for the tax year ending Date 1 were audited on a sample basis for all entries relating to loans of more than $Amount 9. The Bank produced and the agent reviewed records reflecting the amounts of the loans at issue, payment histories of the

[3] This figure differs from Page 1 of the OTS Thrift Financial Report for the year ending Date 1 by $Amount 10; the Bank has not explained this discrepancy, which the Examination Division deemed immaterial.

loans, all correspondence between the Bank and the obligors on the loans, appraisals of the real properties securing the loans, and court filings with respect to any loan relating to which there had been litigation. The agent also verified the mathematical calculations performed by the Bank. The calculations were correct, with the exception of one loan for which there was a slight math error. The Service agreed that the amounts relating to loans of greater than $Amount 9 that were moved into the Special Valuation account were amounts that would never be collected by the Bank, and were required to be charged off or placed into a specific valuation allowance account under OTS loan loss standards. In light of the accuracy of the information relating to the loans reviewed, the agent deemed all of the portions of loans moved into the Special Valuation account worthless. The worthlessness of the bad debts and partial bad debts claimed as deductions is not at issue for purposes of this opinion.

LAW AND ANALYSIS

I.R.C. § 585 allows banks a deduction for a reasonable addition to a reserve for bad debts. Such a deduction is in lieu of any deduction under I.R.C. § 166(a). I.R.C. § 585(a). However, I.R.C. § 585(c)(1) provides that in the case of a large bank (defined by Treas. Reg. § 1.585-5(b)(1)(ii) for a bank that was a member of a parent-subsidiary controlled group as a bank whose parent-subsidiary controlled group's average total bases of assets exceeds $500,000,000 for the taxable year), I.R.C. § 585 shall not apply. Treas. Reg. § 1.585-5(c)(1) provides that the average total assets of a group for any taxable year are determined by—

> (i) computing, for each report date within the taxable year, the amount of total assets (as defined by section (c)(3) of Treas. Reg. § 1.585-5) held by the group as of the close of the report date;
>
> (ii) adding these amounts; and
>
> (iii) dividing the sum of these amounts by the number of report dates within the taxable year.

A report date is generally the last day of the regular period for which the taxpayer must report to its primary Federal regulatory agency. Treas. Reg. § 1.585-5(c)(2)(i). The same report date must be used for all members of the group for a taxable year. Treas. Reg. § 1.585-5(c)(2)(ii).

The amount of total assets held by an institution or group is the amount of cash, plus the sum of the adjusted bases of all other assets, held by the institution or group. Treas. Reg. § 1.585-5(c)(3). For this purpose, the adjusted basis of an asset is generally its basis for federal income tax purposes. Id.

In the present case, the Bank reports to the OTS and files reports

. On each of these reports, the sum of the Bank's cash and adjusted bases in all other assets was more than $Amount 3. Though the value of assets of the entire group are unknown, the Service has assumed, and we will assume for purposes of this opinion, that the value of the assets of the remainder of the group at no time during the tax year at issue were less than (-$Amount 11).

Because the value of the average total assets of the Bank's parent-subsidiary group for the tax year ending Date 1 exceeded $500 million, the Bank is ineligible for a deduction under section 585 for that tax year. Further, I.R.C. § 585(c)(1) provides that no deduction for any addition to a reserve for bad debts shall be allowed under any other provision of Subtitle A, Income Taxes.

I.R.C. § 166(a)(1) allows a deduction for a debt that becomes worthless within the taxable year. In addition, when a debt is recoverable only in part, I.R.C. § 166(a)(2) permits a deduction for a partially worthless debt not to exceed the portion of the debt charged off within the taxable year. See Treas. Reg. § 1.166-3(a)(1). The deduction for partially worthless debts is limited to specific debts. Treas. Reg. § 1.166-3(b).

The issue in the present case is whether the placements of debts into the Bank's specific valuation allowance account qualify as charge-offs of partially worthless debts under I.R.C. § 166(a)(2).

Section 166 and the regulations thereunder do not define the term "charge-off." Case law has held that the term is not limited to a taxpayer's act of physically charging off a debt. Rather, a taxpayer must take some action to remove the worthless portion of the asset from its books as an indication that the debt is worthless. Fairless v. Commissioner, 67 F.2d 475, 478 (6th Cir. 1933); Rubinkam v. Commissioner, 118 F.2d 148 (7th Cir. 1941) (anything which manifests the intent to eliminate an item from assets is sufficient). The Sixth Circuit has stated, "It was clearly the purpose of Congress to condition allowance for deduction of bad debts upon the perpetuation of evidence that they were ascertained to be worthless within the taxable year, and upon some specific act of the taxpayer clearly indicating their abandonment as assets." Fairless, 67 F.2d at 477. The Sixth Circuit further noted that "the charge-off of debts may take other forms than entries on the books of the taxpayer, may be effected in a variety of ways, and yet be sufficient for substantial compliance with the statute." Fairless, 67 F.2d at 477-478.

The Tax Court has held that in order to have made a charge-off, a taxpayer must take some affirmative action to show that a debt was no longer considered an asset. Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497 (1980). In the case of Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416 (1960), acq., 1960-2 C.B. 4, the Tax Court noted that neither section 166 nor the regulations prescribe a particular method for making a charge-off of a bad debt or a partially worthless debt from books of account. "But, generally speaking, an effective charge-off has been made if the entries relied upon have effectually eliminated the amount of the debt, or that part which is

worthless, from the book assets of the taxpayer." Brandtjen & Kluge, Inc., 34 T.C. at 441-442. In the Brandtjen case, the Tax Court allowed a claimed bad debt deduction despite the fact the taxpayer had recorded its claimed loss in a special reserve account, rather than eliminating any amount from its asset account. The Tax Court noted that the entries were limited to one specific reserve account, and were described in words indicating a loss already sustained, not an anticipated future loss, in the one specific account.

The Commissioner has followed the reasoning of these cases. In PLR 9338044 (June 30, 1993), 1993 WL 375620 (IRS PLR), a taxpayer's bad debt deduction was allowed where the taxpayer had not physically charged off the two loans at issue by the end of the tax year. However, under the strictures of the foreign country wherein the loans were made, the taxpayer had received permission to create, and had created, specific reserve accounts to hold the loans. In the foreign country involved, the charge-off process was a two-step process, and a specific reserve account had to be created prior to any charge-off of a loan.

In summary, for a charge-off, the courts and the Service appear to require a physical notation in a taxpayer's books reflecting that the portion of a debt determined to be worthless is no longer counted as an asset. Even where there is a failure to remove the debt from the asset column, a charge-off might be found where the books reflect the specific loss charged off in a specific debt reserve notation.

In the present case, the Bank's allocation of portions of specific loans that it deemed partially worthless to the specific valuation allowance account is similar to actions taken by the taxpayers in the Brandtjen case and in PLR 9338044 (June 30, 1993), described above. None of the taxpayers had made a physical charge-off of the amounts at issue, but all of them had placed the amounts into a specific reserve account. Like the taxpayer in PLR 9338044, the reason for the lack of a physical charge-off may have been an adherence to government regulations—in the case of the taxpayer in PLR 9338044, the regulations were those of the Ministry of Finance of another country; in our case, the regulations were those of the OTS. We conclude that the removals of the worthless portions of the general reserve account and placing them into the specific valuation allowance account were affirmative acts indicating a desire to remove the portions of the loans at issue from the Bank's assets, qualifying as charge-offs for purposes of I.R.C. § 166(a)(2). Thus, these portions of the debts at issue were charged off within the tax year as required by I.R.C. § 166(a)(2), and the Bank is entitled to the deduction.

Further support for our conclusion may be found in Treas. Reg. § 1.166-2(d)(4)(ii), which states: "*Charge-off*. —For banks regulated by the Office of Thrift Supervision, the term "charge-off" includes the establishment of specific allowances for loan losses in the amount of 100 percent of the portion of the debt classified as loss." While this definition applies only to Treas. Reg. § 1.166-2(d), it does lend support to a claim that actions other than a physical charge-off on the taxpayer's books may constitute a charge-off,

and specifically that the establishment of specific valuation allowance accounts for loan losses may, under the proper circumstances, constitute a charge-off. Subsidiary is regulated by the OTS.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This opinion was coordinated with Vincent Guiliano, (Lead Counsel for the) Commercial Banking and Savings & Loan Industry Counsel, and with Branch 6 of the Financial Institutions and Products Division of the Office of Chief Counsel.

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If you have any questions about this memorandum, please contact Senior Attorney at .

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