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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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MEMORANDUM FOR DISTRICT COUNSEL, MANHATTAN

CC:NER:MAN

Attn: Roland Barral

FROM: Assistant Chief Counsel (Financial Institutions and Products)  
CC:DOM:FI&P

SUBJECT: Revocation of the Conformity Election under Treas. Reg.  
§ 1.166-2(d)(3)

This memorandum responds to your request for Technical Assistance concerning the revocation of the conformity election under Treas. Reg. § 1.166-2(d)(3). This document is not to be cited as precedent.

ISSUES

1. What circumstances warrant the revocation of the conformity election in Treas. Reg. § 1.166-2(d)(3)?

2. In what circumstances are charge-offs substantially in excess of those warranted by reasonable business judgment for purposes of Treas. Reg. § 1.166-2(d)(3)(iv)(D)?

3. Should an agent examine the underlying loans to determine a pattern of abuse or must the agent first compare book and tax bad debt deductions to see if there are obvious inconsistencies?

CONCLUSION

1. If an examination of a bank's books and records reveals that there is a pattern of charge-offs in the wrong year, or the bank fails to follow the method of accounting required by the conformity election, 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.

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2. There are various circumstances in which a bank may be considered to have deducted charge-offs that were substantially in excess of reasonable business judgement. Although we can provide some examples, they cannot be considered all inclusive or dispositive for a particular case because the standard in Treas. Reg. § 1.166-2(d)(3)(iv)(D) is based upon a facts and circumstances analysis.

3. Under Treas. Reg. § 1.166-2(d)(3) the Internal Revenue Service may audit a bank that has made the conformity election to determine whether a bank complies with the requirements for the accounting method in particular, as well as the requirements for a bad debt deduction in general. It is within an agent's discretion to determine the most appropriate audit procedure for the conformity method. This may include not only comparison of book and tax conformity, but also the examination of underlying loan files and accounts.

## FACTS

In general, under I.R.C. § 166 a deduction is allowed for any debt which becomes worthless within the taxable year. For tax years ending on or after December 31, 1991, a bank may obtain a conclusive presumption of worthlessness for its bad debts 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 the charge-off results from a specific order from a regulatory authority, or the charge-off corresponds to the bank's classification of the debt as a loss asset for regulatory purposes.

For purposes of this Technical Assistance memorandum, we assume a bank has made a valid conformity election. A valid election requires a bank, first, to make an election pursuant to Treas. Reg. § 1.166-2(d)(3)(iii)(C) and, second, in connection with its most recent examination by its supervisory authority, to receive an express determination letter verifying that the bank maintains and applies loan loss classification standards that are consistent with the supervisory authority's regulatory standards pursuant to Treas. Reg. § 1.166-2(d)(3)(iii)(D).

## LAW AND ANALYSIS

### Issue 1

Under the conformity election, a debt charged off for regulatory purposes is conclusively presumed to be worthless in whole or in part if the charge-off results from a specific order from a regulatory authority, or the charge-off corresponds to the bank's classification of the debt as a loss asset for regulatory purposes. Treas. Reg. § 1.166-2(c)(3)(ii). Bank examiners may classify a loan (or some portion of a loan) according to the degree of risk associated with a particular loan and its potential for future losses. Banks use similar criteria in their internal loan review

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process. The relevant loan classifications are as follows: loss loans; doubtful loans; and substandard loans.<sup>1</sup>

If bad debt deductions are regularly claimed for loans not charged off pursuant to a specific order or for charge-offs that don't correspond to a regulatory loss classification standard, then a bank is not correctly using the conformity method. The conformity election may be revoked when the bank, in fact, fails to follow the method of accounting provided by the regulation. Treas. Reg. § 1.166-2(d)(3)(iv)(D).

A fundamental inquiry to verify if a bank is correctly applying the conformity method is first to ensure that the worthless loans are owned by the bank for book and tax purposes. The ownership question may arise when a bank enters into securitized transactions in which it pledges its loans as security. The pledged loans may be considered owned by the bank for tax purposes, however, the bank may not own the loans for regulatory purposes.<sup>2</sup> 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.<sup>3</sup>

There are two other circumstances under which the conformity election may be revoked by the Commissioner. First, a bank is not entitled to use the election and the conclusive presumption when there is a pattern of charge-offs in the wrong year. Treas. Reg. § 1.166-2(d)(3)(ii)(B). Second, the Commissioner may revoke the election when 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. See Issue 2 below.

Treas. Reg. § 1.166-2(d)(3)(ii)(A)(2) provides that a bad debt deduction for a loan that is subject to regulatory loss classification standards is allowable for a taxable year only to the extent that the debt is conclusively presumed to have become worthless during that year. If an examination of the bank's books and

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<sup>1</sup>Uniform Agreement on the Classification of Assets and Appraisal Securities Held by Banks (See Attachment to Comptroller of the Currency Banking Circular No. 127, Rev. 4-26-91, Comptroller of the Currency, Communications Department, Washington, DC 20219)

<sup>2</sup>See Statement of Financial Accounting Standards No. 125

<sup>3</sup> With respect to loans not subject to regulatory loss classification standards, bad debt deductions are determined under the general rules of § 166. Treas. Reg. § 1.166-2(d)(3)(iii)(B)(3).

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records reveals that the bank has engaged in a pattern of charging off loans in the wrong year, either early or late, the conformity election may be revoked pursuant to Treas. Reg. § 1.166-2(d)(3)(iv)(D).

## Issue 2

Treas. Reg. § 1.166-2(d)(3)(iv)(D) states that a conformity election may be revoked by the Commissioner if it is determined that a bank has taken charge-offs and deductions that, under all the facts and circumstances existing at the time, were substantially in excess of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority.

The determination of what constitutes charge-offs substantially in excess of those warranted by reasonable business judgment is based on the facts and circumstances of each case. In the preamble to the final regulations under IRC § 166 concerning the conclusive presumption of worthlessness, the Service acknowledges that a supervisory authority's express determination, as described in Rev. Proc. 92-84, 1992-2 C.B. 489, permits some flexibility in the application of a bank's loan loss classification standards. Immaterial deviations from regulatory standards in the case of individual loans do not preclude the issuance of an express determination letter.<sup>4</sup> A similar concept should apply for tax purposes. An immaterial deviation from the regulatory standards in the case of individual loans should not result in the revocation of the conformity election; however, an adjustment to correct errors may be considered.

If an examination of the bank's books and records reveals that the bank has claimed excessive charge-offs and deductions (material deviations), the conformity election may be revoked.<sup>5</sup> Although a bank's regulator may issue an express determination letter, the Commissioner, not the bank's regulator, determines whether a bank is in compliance with the tax laws.

Some general guidelines to check for material deviations may include 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. For example, if the current industry charge-off average is six percent of outstanding loans for the type being examined and the taxpayer is charging off 12 percent, a material deviation may exist when data in loan files do not support a bank's charge-offs.

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<sup>4</sup>Preamble to Treas. Reg. § 1.166-2(d)(3), T.D. 8396, 1992-1 C.B. 95, 97.

<sup>5</sup>IRC § 446(b) requires that a method of accounting clearly reflect income.

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If it is not possible to determine industry charge-off averages for similar types of loans and periods, a bank's experience with recoveries may reflect a material deviation. For example, if a bank were recovering 25 percent or more of the charged-off loans, a material deviation may exist when data in loan files do not support a bank's deductions at the time of the charge-offs. The analysis may be the same if a bank routinely sells charged-off loans for a price that materially exceeds its basis.

### Issue 3

As discussed above, Treas. Reg. § 1.166-2(d)(3) provides three circumstances under which the conformity election may be revoked by the Commissioner. To establish any one of the three circumstances may require an examination of a bank's books, records, and underlying loan files.<sup>6</sup> An audit can commence with a comparison of the book charge-offs and bad debt deductions to see if there are any obvious inconsistencies, which should be reconciled. However, it is within an agent's discretion to determine the most appropriate audit procedure.

Note that the consistency required by the regulations is specifically between the book charge-offs resulting from a specific order or charge-offs taken under the regulatory loss classification standards and the bad debt deductions claimed on a bank's return. A bank that fails to maintain this consistency is not correctly applying the method of accounting.

Not all inconsistencies between book charge-offs and tax deductions violate the requirements of the regulations. For example, loans not subject to regulatory loss classification standards are outside the scope of the conclusive presumption, but may be accounted for under the general rules of IRC § 166. Three examples of loans, or portions of loans, not subject to loss classification standards are loans accounted for on a cost recovery basis, interest accrual reversals, and in-substance-foreclosures. Another example of an acceptable inconsistency would be doubtful or substandard loans that may be charged off for book purposes, but do not meet the loss classification standards and, therefore, are not allowed as a tax bad debt deduction. In this case, tax bad debt deductions would be less than book charge-offs. If an examination of the bank's books and records reveals that bad debt deductions have been taken for loans that have been classified for regulatory purposes as doubtful or substandard, then consistency has not been maintained by the bank.

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<sup>6</sup> Banks that refuse to provide documentation, *i.e.*, books, records or loan files, may be issued a summons. See United States v. U.S. Bancorp, 12 F. Supp. 2d 982 (D. Minn. 1998).

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Ultimately, because you are unlikely to find perfect consistency on the face of a bank's tax return and its financial records for total charge-offs versus bad debt deductions for loans subject to the conformity election, examination of a bank's books and records (including loan files) may be necessary to determine whether the conformity election method of accounting was applied correctly, and to determine whether circumstances otherwise exist that warrant removing a bank from the method.

If you have any further questions, please contact CC:DOM:FI&P:1 at (202) 622-3920.

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