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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 Projects)
CC:FIP

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

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

ISSUES

1. Does the conclusive presumption of worthlessness standard set forth in Treas. Reg. § 1.166-2(d)(3)(ii) include consumer loans such as credit card loans and installment loans that are classified as a regulatory loss asset after a certain time period passes?

2. Does the Internal Revenue Service have the authority to question a bank's loan loss classification standards?

3. Under Treas. Reg. § 1.166-2(d)(3)(ii)(C), which defines a loss asset, does the phrase "or similar guidance" include manuals, handbooks and guidebooks of a bank's supervisory authority?

CONCLUSIONS

1. 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 cards loans and installment loans that are classified as a regulatory loss asset after the applicable period passes.

2. The Internal Revenue 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.

3. The phrase "or similar guidance" may include the supervisory authority's manuals, handbooks and guidebooks as they relate to the loan loss classification standards of high volume consumer installment loans and credit card plans when those documents include a standard similar to the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" and the documents require the standard applied in a uniform manner.

FACTS

In general, under I.R.C. § 166 a deduction is allowed for any debt that 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 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). We also assume the bank owns the debt instrument or credit account for regulatory purposes, as well as for federal tax purposes.

LAW AND ANALYSIS

Issue 1

Treas. Reg. § 1.166-2(d)(3)(ii)(A)(1) provides that debts charged off, in whole or in part, for regulatory purposes during a taxable year are conclusively presumed to have become worthless, in whole or in part, during that year, but only if the charge-off results from a specific order of the bank's supervisory authority or 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 debt the bank has assigned to a class that corresponds to a loss classification under the

standards in the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" or similar guidance issued by the bank's supervisory authority.

The "Uniform Agreement on the Classification of Assets and Securities Held by Banks" states,

> Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Attachment to Comptroller of the Currency Banking Circular No. 127, Rev. 4-26-91, Comptroller of the Currency, Communications Department, Washington, DC 20219.

The preamble to Treas. Reg. § 1.166-2(d)(3) states,

> The Treasury Department's study on the appropriate criteria to be used in determining whether a debt is worthless for Federal income tax purposes concludes that the regulatory criteria governing the charge-off of debts by banks are sufficiently similar to the criteria for worthlessness under section 166 to make regulatory criteria and examination by the regulatory authorities an acceptable surrogate for an independent investigation by the Internal Revenue Service. See Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions at 19-24 (Treasury Department, September 1991).

T.D. 8396, 1992-1 C.B. 95.

Specifically, the Treasury Department's study states,

> The breadth of circumstances taken into account in classifying commercial and real estate loans for regulatory purposes is comparable to the inquiry that would be appropriate for a finding of worthlessness for purposes of section 166. Although the classification of consumer installment loans and credit card plans depends on a single fact, length of delinquency, the unsecured (or as may be the case with consumer loans secured by household items, undersecured) nature of these loans may cause that single fact to be an adequate measure of worthlessness for tax purposes. In any event, the high volume of such loans and their comparatively low face value would make an in-depth inquiry into all relevant facts and circumstances a

> very burdensome task for the lending institution. In the absence of persuasive evidence, such as an unusually high recovery rate for such loans, that the automatic charge-off criteria for these types of high volume loans results in overstated losses, it is appropriate to permit the regulatory loss classification to determine the worthlessness of such debts for tax purposes.

Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions at 23 (Treasury Department, September 1991).

The Comptroller of the Currency Handbook for National Bank Examiners provides specific regulatory criteria for determining whether a loan should be classified as a loss asset. High-volume loans, such as consumer installment loans, credit card plans, and check credit plans, are subject to automatic charge-off procedures. Consumer installment paper that is delinquent 120 days or more and credit card debt that is delinquent 180 days or more are considered loss assets for regulatory purposes.[1]

Based on the preamble that accompanied the final regulations, the conclusive presumption of worthlessness 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 after the applicable time period passes.

Issue 2

Treas. Reg. § 1.166-2(d)(3)(iii)(D) imposes a condition precedent to the use of the conformity election. In connection with its most recent examination involving the bank's loan review process, the bank's supervisory authority must have made an express determination that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority. The supervisory authority of a bank is the appropriate federal banking agency for the bank. See Rev. Proc. 92-84, 1992-2 C. B. 489, which provides for a uniform express determination letter that is required to be used for such an express determination.

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[1]Comptroller of the Currency, Handbook for National Examiners – Commercial, International §§ 209.1, 211.1 and 212.1 (1990). These provisions provide for exceptions to the automatic charge-off procedure when significant amounts are involved and the bank can demonstrate that repayment will be made irrespective of delinquency status. Alternatively, these procedures do not preclude the classification of assets delinquent for a lesser period when classification is warranted. Although citations are to the OCC Handbook, comparable standards apply to institutions supervised by the FRB, the FDIC, and the OTS.

Only a bank's supervisory authority may issue or revoke an express determination letter. Notwithstanding an express determination letter, a charge-off is entitled to the conclusive presumption only if the bank assigns the loan to a class that corresponds to a loss classification under the standards set forth by the bank's supervisory authority. Treas. Reg. § 1.166-2(d)(3)(ii)(C). In addition, the Service may revoke a 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. Treas. Reg. § 1.166-2(d)(3)(iv)(D). As this office previously advised you, evidence of excessive charge-offs may be reflected in an unusually high recovery rate for such loans either from collections or sales.[2]

Issue 3

Treas. Reg. § 1.166-2(d)(3)(ii)(C) defines the term "loss asset" for purposes of the conformity election as debt that the bank has assigned to a class that corresponds to a loss classification under the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" or similar guidance issued by the bank's supervisory authority. As noted above, the Treasury Department's study as it relates to the conformity election acknowledges the criteria in the supervisory authorities' handbooks. The phrase "or similar guidance" may include the supervisory authority's manuals, handbooks and guidebooks as they relate to the loan loss classification standards of high volume consumer installment loans and credit card plans when those documents include a standard similar to the "Uniform Agreement on the Classification of Assets and Securities Held by Banks" and the documents require the standard apply in a uniform manner. The loss standards in the handbook for examiners employed by the Comptroller of the Currency, as well as the handbooks for examiners employed by the Office of Thrift Supervision, Federal Reserve Board, and Federal Deposit Insurance Corporation currently satisfy the requirements in Treas. Reg. § 1.166-2(d)(3)(ii)(C). If these handbooks change in the future, further consideration of these issues may be warranted.

If you have any further questions, please contact CC:FIP:B01 at (202) 622-3920.

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[2]See Denholm & McKay Company v. Commissioner, 5 T.C.M. (CCH) 476 (1946).