SULLIVAN & CROMWELL LLP

October 29, 2014

IRS Issues Audit Directive on Worthless Debt Deductions for Banks and Bank Affiliates

LBI Directs Its Auditors Not to Challenge Certain Worthless Debt Deductions

SUMMARY

The Large Business and International Division ("LBI") at the IRS issued an audit directive (the "Directive") to its revenue agents relating to bad debt deductions claimed by banks and regulated bank affiliates.[1] The Directive clarifies the application of the presumption rules for these bad debt deductions which, the IRS admitted, were out of date. Pursuant to the Directive, LBI examiners are instructed not to challenge worthless debt deductions claimed by banks and regulated bank affiliates (including a partnership wholly owned by a bank and its affiliates) satisfying the parameters described below. Under the Directive, credit-related loan charge-offs (including estimates of certain selling costs) reported on financial statements filed with the SEC or bank regulator will generally be treated as sufficient evidence that a debt is worthless. Furthermore, LBI examiners are not to challenge worthless debt deductions taken by banks or regulated bank affiliates in excess of such credit-related loan charge-offs if the bank or bank affiliate applies the conclusive presumption rule in the regulations and certain other requirements are satisfied.

The Directive reflects an effort by LBI to make the audit process more efficient by liberalizing the requirements under the presumption rules and by extending their application to bank affiliates that are not corporations. The Directive is an internal instruction to IRS employees; it is not an official pronouncement of law and cannot be used, cited or relied on by a taxpayer. The Directive does not apply to small banks that use the reserve method of accounting for loan losses.

The Directive only applies to audits of taxable years beginning in 2010 through 2014.

THE DIRECTIVE

BACKGROUND

Taxpayers are allowed a deduction for debt owed to the taxpayer that becomes worthless. In general, the worthlessness of a debt obligation must be established through a facts and circumstances analysis. In addition to the general facts and circumstances test for deductibility available to all taxpayers, there are two conclusive presumption rules available to banks pursuant to which a determination by bank regulators that a debt should be charged off for regulatory purposes is deemed sufficient proof that a debt is worthless for tax purposes.

Under the first of the two conclusive presumption rules,[2] a bank that makes a "conformity election" will have any debt that the bank charges off for regulatory purposes conclusively presumed to have been worthless. Significantly, in order for a bank to make a conformity election, a bank regulator must have made a written determination in its most recent examination that the bank maintains and applies loan loss classification standards that are consistent with regulatory standards.

Under the second conclusive presumption rule, banks that do not make a conforming election and regulated bank affiliates can use the so-called "specific order method" to conclusively establish that the bank or regulated bank affiliate's charged-off debt has become worthless. Under the specific order method, debt that is charged off pursuant to specific orders from a regulatory authority (or that the regulatory authority subsequently confirms would have been ordered to be charged off) is presumed worthless.[3]

In 2013 the IRS and Treasury issued Notice 2013-35 in which they raised concerns that significant changes to the regulatory standards for loan charge-offs since the adoption of the conclusive presumption rules may have made it inappropriate to rely on the loan charge-off rules to establish worthlessness for purposes of the worthless debt deduction. Treasury and IRS requested public comments on whether the conclusive presumption rules should be modified.

AUDIT GUIDANCE IN THE DIRECTIVE

On October 24, 2014 Heather Maloy, LBI Commissioner, issued the Directive setting forth criteria for when an LBI examiner should not challenge a bank or regulated bank affiliate's worthless debt deduction. Noting the burden imposed on banks, bank affiliates and examiners required to independently determine the worthlessness of bad debt and also noting difficulties with the out-of-date conclusive presumption rules, the Directive addresses and modifies the three methods available to large and mid-sized banks for establishing that debt is worthless for tax purposes: **the facts and circumstances analysis, the specific order method and the conformity election**.

These modifications require examiners to apply more liberal presumption rules. These more liberal rules allow taxpayers to use loan charge-offs taken in compliance with accounting and regulatory rules as

evidence of worthlessness for bad debt deduction purposes, and these new rules verify a taxpayer's compliance through an examination of financial statements filed with the SEC or bank regulator and through self-certifications provided by the taxpayer rather than via the written statements from regulators that are required under the current conclusive presumption rules in the regulations. Further, the more liberal presumption rules in the Directive expand the application of presumptions to regulated non-corporate non-bank affiliates.

The Directive only applies for taxable years beginning in 2010 through 2014. It is unclear what rules will apply for taxable years beginning in 2015 or whether additional guidance will be issued before the tax returns for such years are due.

Facts and Circumstances Analysis

Pursuant to the Directive, in the case of banks and regulated bank affiliates (including partnerships wholly owned by a bank and its regulated affiliates) using the **facts and circumstances analysis** (i.e., not one of the conclusive presumption rules in the regulations), an LBI examiner should not challenge a worthless debt deduction for debt and debt securities if the deduction is the same amount as the credit-related impairment portion of the taxpayer's charge-off for debt and debt securities as reported on a financial statement filed with the SEC or required to be provided to a bank regulator. In no event, however, may the post deduction tax basis in the debt or debt securities be less than the post charge-off book basis of the debt or the carrying amount of the debt securities, respectively (ignoring, for this purpose, any portion of the charge-off not related to credit impairment). Information on the amount of the charge-off reported on the taxpayer's financial statement, the taxpayer's tax basis in the debt instruments, the book basis of debt and carrying value of debt securities as well as other relevant details must be included in the certified statement to be provided by the taxpayer to the examiner.

For purposes of audits of the 2010 through 2014 taxable years, all banks and regulated bank affiliates have been given a conclusive presumption of worthlessness with respect to credit-related charge-offs.

Specific Order Method.

In addition to the conclusive presumption for credit-related charge-offs provided by the Directive, the Directive liberalizes the specific order method available under the regulations, which allows banks and regulated corporations a presumption for charge-offs made pursuant to a specific order or written confirmation by a regulator. Under the Directive, LBI examiners are instructed not to challenge worthless debt deductions claimed during taxable years 2010-2014 by a bank or regulated bank affiliate (including a partnership wholly owned by a bank and its regulated affiliates) in excess of its credit-related charge-offs for a charge-off taken pursuant to a specific order or written confirmation by a bank regulator (and reported on a financial statement filed with the SEC or required to be provided to a bank regulator). In particular, an LBI examiner is not to challenge a deduction made pursuant to a specific order or written confirmation *even if the bank or regulated bank affiliate does not provide the examiner with a copy of the*

specific order or written confirmation. The tax basis test described above applies, ignoring any portion of the charge-off not related to credit impairment (but taking into account amounts charged off pursuant to the specific order or written confirmation).

Conformity Election

For banks that have made the conformity election, LBI examiners are instructed not to challenge worthless debt deductions if a bank has made a proper conformity election, even if the bank does not have the written determination from its regulator that the bank maintains and applies loan loss classification standards that are consistent with regulatory standards. There is no tax basis test. Unlike the other methods, this method is available only to banks and is not available to regulated bank affiliates.

For banks and regulated bank affiliates using any of these three methods, LBI examiners are instructed not to challenge deductions for estimated selling costs to the extent such selling costs are included in the charge-off reported by the bank or bank subsidiary in its financial statements filed with the SEC or the bank regulator.

Amended Returns and Adjustment Year

Banks and regulated bank affiliates that choose to follow the Directive may implement the applicable changes by filing an amended return or making the changes in its return for the current year. The first year that a taxpayer adopts the Directive is labeled as an Adjustment Year and special calculation and adjustment rules apply.

Certification

Upon examination, taxpayers that chose to follow the Directive must complete and sign a certification statement (a copy of which, as included in the Directive, is attached). The certification statement must be signed by the individual authorized to sign the taxpayer's tax returns for the year under audit and must certify under penalty of perjury as to certain of the applicable requirements for a worthless debt deduction under the Directive.

* * *

ENDNOTES

1 LBI oversees corporations and partnerships with assets in excess of $10 million, as well as certain high-net-worth individuals.

2 Treas. Regs. § 1.166-2(d)(3).

3 Treas. Regs. § 1.166-2(d)(1).

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Attachment

LB&I DIRECTIVE RELATED TO § 166 DEDUCTIONS FOR ELIGIBLE DEBT AND ELIGIBLE DEBT SECURITIES CERTIFICATION STATEMENT

Taxpayer Name: _____

Taxpayer EIN: _____

Tax Year: _____

Relevant Period of Applicable Financial Statement: _____

Status of Taxpayer (Bank or Bank Subsidiary): _____

Taxpayer's Bank Regulator: _____

(For a Bank Subsidiary, list the Owning Bank's Regulator)

Specify whether the Taxpayer is described in the Directive under: C.1, C.2, or C.3:_____

_____

Please provide the following information for:

Taxpayers described in the Directive under C.1, C.2, and C.3:

A. Amount of the Charge-off reported on the Applicable Financial Statement for:

1) Eligible Debt: _____

2) Eligible Debt Securities: _____

B. Amount of the § 166 bad debt deduction reported on Federal income return for:

1) Eligible Debt: _____

2) Eligible Debt Securities:_____

C. Post-Charge-off:

1) Book basis for Eligible Debt: _____

2) Carrying value for Eligible Debt Securities:_____

D. Post-deduction tax basis for:

1) Eligible Debt:_____

2) Eligible Debt Securities:_____

Taxpayers described in the Directive under C.1 and C.2:

E. The portion of the Charge-off not related to credit impairment, if any:

1) Eligible Debt:_____

2) Eligible Debt Securities:_____

F. The First Year Adjustment determined on December 31 of the Adjustment Year (or the last day of the Adjustment Year, if different):

1) For Eligible Debt: _____

2) For Eligible Debt Securities: _____

Taxpayers described in the Directive under C.2:

G. The portion of the Charge-off charged-off pursuant to a specific order or written confirmation by a Bank Regulator:

1) Eligible Debt: _____

2) Eligible Debt Securities: _____

CERTIFICATION

By signing this certification statement, the taxpayer agrees to readily provide (upon request of the IRS) all relevant data and records to establish to the satisfaction of the IRS that the statements made in this certification statement are true, correct and complete.

I certify, under penalties of perjury, that for the taxable year under audit, for:

1) Taxpayers described in C.1 and C.2, A) the bad debt deduction claimed on the Taxpayer's Federal income tax return for Eligible Debt and Eligible Debt Securities is the same amount as the amount of the credit-related impairment portion its Charge-off of Eligible Debt and the same amount of the credit-related impairment portion of its Charge-off of Eligible Debt Securities as reported on the Taxpayer's Applicable Financial Statement for the same accounting period, subject to 2) below for Taxpayers described in C.2, and B) the post-deduction tax basis of Eligible Debt or Eligible Debt Securities is not less than the post Charge-off book basis of the same Eligible Debt or the carrying value of the same Eligible Debt Securities, as applicable under C.1 or C.2 above.

2) Taxpayers described in C.2, if the bad debt deduction claimed in the Taxpayer's Federal income tax return is in excess of the credit-related impairment portion of the Charge-offs reported on the Taxpayer's Applicable Financial Statement, then such excess amount was charged-off pursuant to a

specific order or written confirmation (as described in Treas. Reg. § 1.166-2(d)(1)) by a Bank Regulator as reported on its Applicable Financial Statement.

Signature: _____

Title: _____

Date: _____

For corporations, the certification must be signed by an individual authorized under I.R.C. section 6062.

Page Last Reviewed or Updated: 27-Oct-2014