Section 166. – Deduction for Bad Debts
26 CFR 1.166-2: Evidence of worthlessness

Rev. Rul. 2001-59

ISSUES

1. What steps are necessary to record or memorialize the assignment of a loan (or loan portion) as a “loss asset” for purposes of the conformity method of accounting for worthless bad debts?

2. Does the conclusive presumption of worthlessness under the conformity method apply to loans erroneously classified as loss assets?

FACTS

ABC corporation is a “bank” (as defined in § 1.166-2(d)(4)(i) of the Income Tax Regulations) and is subject to supervision by Federal authorities. *ABC* has elected under § 1.166-2(d)(3) to use the conformity method of accounting to determine when debts owed to *ABC* become worthless bad debts.

Under a resolution adopted by *ABC’s* board of directors, *ABC’s* officers and employees are authorized to charge off loans (or portions of loans) only when the charge-off is required under the loan loss classification standards issued by the bank’s supervisory authority. Thus, when *ABC’s* officers and employees charge off a loan for regulatory purposes, they do not take any additional steps to record or memorialize whether, in their judgment, the charge-off is required by the loan loss standards that have been issued by *ABC’s* supervisory authority.

The loan loss standards require *ABC* to charge off “loss assets.” Loss assets are loans (or portions of loans) determined to be uncollectible and of such little value that their continuance as bankable assets is not warranted. In the case of a consumer loan or credit card debt, regardless whether there is specific adverse information about the borrower, *ABC* is required to charge off the asset when its delinquency exceeds certain established thresholds. Thus, *ABC* must charge off installment loans that are 120 days, or five payments, past due and credit card debts that are 180 days past due after seven zero billings. In addition, if *ABC* receives specific adverse borrower information (for example, the borrower’s death or bankruptcy) confirming a loss before the applicable 120 day or 180 day threshold date has passed, then an immediate charge-off is required. See Comptroller of the Currency, “Allowance for Loan and Lease Losses,” Comptroller’s Handbook 10, 19 (June 1996); “Uniform Agreement on

the Classification of Assets and Appraisal of Securities Held by Banks," Attachment to Comptroller of the Currency Banking Circular No. 127, Rev. 4-26-91.

ABC's supervisory authority, in connection with its most recent examination of the bank's loan review process, made an express determination that *ABC* maintains and applies loan loss standards that are consistent with the regulatory standards issued by the Comptroller of the Currency.

During the taxable year ending on December 31, 2000, *ABC* charged off for regulatory purposes certain credit card debts that were not required to be charged off under applicable regulatory loan loss standards. Except for the erroneously charged off credit card debts, *ABC* charged off only loans required to be charged off under the loan loss standards.

On its Federal income tax return for 2000, *ABC* deducted as wholly worthless debts all assets that it had charged off for regulatory purposes, including the debts that had been erroneously charged off despite the absence of an applicable regulatory requirement. Even so, the total amount of worthless bad debts claimed on the return was not substantially in excess of the amount that would be warranted by the exercise of reasonable business judgment in applying the loan loss standards of *ABC's* supervisory authority.

LAW AND ANALYSIS

Section 166(a)(1) of the Internal Revenue Code allows a deduction for a debt that becomes worthless during the taxable year. In addition, § 166(a)(2) permits a deduction for "partially worthless debts" if the taxpayer charges off an appropriate amount on the taxpayer's books and records and the Internal Revenue Service is satisfied that the debt is recoverable only in part.

No precise test exists for determining whether a debt is worthless. In many situations, no single factor or identifiable event clearly demonstrates whether a debt has become worthless. Instead, a series of factors or events in the aggregate establishes whether the debt is worthless. Among the factors indicating worthlessness are: a debtor's serious financial reverses, insolvency, lack of assets, continued refusal to respond to demands for payment, ill health, death, disappearance, abandonment of business, and bankruptcy. Additionally, a debt's unsecured or subordinated status and expiration of the statute of limitations can provide an indication that the debt is worthless. Conversely, availability of collateral or third party guarantees, a debtor's earning capacity, payment of interest, a creditor's failure to press for payment, and a creditor's willingness to make further advances are factors suggesting that the debt is not worthless. Accordingly, § 1.166-2 of the regulations requires consideration of all pertinent evidence and provides that a deduction is warranted if the surrounding circumstances indicate that the debt is uncollectible and that legal action to enforce

payment would in all probability not result in the satisfaction of execution on a judgment.

In the case of a "bank" (as defined in § 1.166-2(d)(4)(i) of the regulations) or other corporation subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, § 1.166-2(d)(1) provides administrative simplicity by creating a conclusive presumption of worthlessness for loans charged off in whole or in part in obedience to specific orders or in accordance with the established policies of those authorities.

Additional simplification is provided by § 1.166-2(d)(3) of the regulations for tax years ending on or after December 31, 1991. Under the regulation, a bank subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, may elect to use the conformity method of accounting to determine when a debt becomes worthless. Under the conformity method, a conclusive presumption of worthlessness applies to loans charged off, in whole or in part, for regulatory purposes if the charge-offs correspond to the bank's classification of the loans, in whole or in part, as loss assets under applicable regulatory standards. Section 1.166-2(d)(3)(ii)(A)(2) provides that a bad debt deduction is allowed for the taxable year in which a debt is conclusively presumed to have become worthless.

For the conclusive presumption of worthlessness to arise, a bank must satisfy the express determination requirement of § 1.166-2(d)(3)(iii)(D) of the regulations and must classify the loan, in whole or in part, as a loss asset as described in § 1.166-2(d)(3)(ii)(C). The express determination requirement is satisfied if the bank's supervisory authority, in connection with its most recent examination of the bank's loan review process, has made an express determination that the bank maintains and applies loan loss classification standards that are consistent with the authority's regulatory standards. See Rev. Proc. 92-84, 1992-2 C.B. 489 (providing the form for the determination letter). Section 1.166-2(d)(3)(ii)(C) defines the term "loss asset" as a debt that the bank has assigned to a class that corresponds to a loss asset classification under the standards set forth in the "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks" or similar guidance issued by the bank's supervisory authority.

Various procedures can be used by a bank to classify loans (or loan portions) as loss assets. For example, an officer or employee may record or memorialize on a form the determination that a loan (or loan portion) is a loss asset. Loan or credit committee reports or internal credit rating reports also can demonstrate that a loan has been classified as a loss asset. Additionally, if officers and employees are authorized to charge off loans (or loan portions) only if the loans (or loan portions) are loss assets, then the charge-offs of the loans (or loan portions) demonstrate that the loans (or loan portions) have been classified as loss assets.

ABC has made the conformity election under § 1.166-2(d)(3) of the regulations and has satisfied the express determination requirement described in § 1.166-2(d)(3)(iii)(D). Additionally, under the resolution adopted by *ABC's* board of directors, *ABC's* officers and employees are authorized to charge off loans (or portions of thereof) only if the charge-offs are required under applicable loan loss standards issued by *ABC's* supervisory authority. Under these circumstances, *ABC's* charge-offs of certain loans (or loan portions) are sufficient to demonstrate classification of those loans (or loan portions) as loss assets under standards issued by *ABC's* supervisory authority.

Under § 1.166-2(d)(3)(ii) of the regulations, the conclusive presumption of worthlessness applies to loans charged off, in whole or in part, for regulatory purposes if the charge-off corresponds to the bank's classification of the loans, in whole or in part, as loss assets under applicable regulatory standards. Although the applicable loan loss regulatory standards did not require *ABC* to charge off certain credit card debts, the conclusive presumption of worthlessness attached to those debts when *ABC* erroneously charged off the debts for regulatory purposes.

Under § 1.166-2(d)(3)(iv)(D) of the regulations, if an electing bank fails to follow the conformity method of accounting to determine when debts become worthless, or if the bank's charge-offs are substantially in excess of those warranted by reasonable business judgment in applying the regulatory standards of the bank's supervisory authority, then the Commissioner may revoke the bank's election to use the conformity method. Under the facts described above, however, except for the erroneously charged off credit card debts, *ABC* properly used regulatory loan loss standards to determine its worthless bad debts and did not claim a deduction on its return for bad debts substantially in excess of the amount warranted by reasonable business judgment under the applicable regulatory standards. If the deduction claimed had been substantially in excess of that amount, the Commissioner could have revoked the conformity election.

HOLDINGS

1. *ABC's* charge-offs of certain loans (or portions thereof), pursuant to a board of directors' resolution authorizing the charge-off of a loan (or portion thereof) only if the charge-off is required under applicable regulatory standards issued by the bank's supervisory authority, are sufficient to demonstrate classification of the loans (or loan portions) as loss assets for purposes of § 1.166-2(d)(3) of the regulations.

2. The conclusive presumption of worthlessness applies to the credit card debts that *ABC* erroneously charged off for regulatory purposes during the taxable year ending on December 31, 2000. *ABC*, on its 2000 income tax return, properly deducted the credit card debts as worthless bad debts.

DRAFTING INFORMATION

The principal author of this revenue ruling is Craig Wojay of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Wojay at (202) 622-3920 (not a toll-free call).