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INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL, SBSE, DENVER , GROUP 1
Attention: William P. Boulet, Jr., Attorney

FROM: Acting Associate Chief Counsel (Financial Institutions & Products) CC:FIP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 13, 2000. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corporation X =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Tax Year 4 =
Tax Year 5 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Agency A =
Agency B =
Letter 1 =

Letter 2 =
Letter 3 =
Memorandum A =
Memorandum B =
Memorandum C =
Memorandum D =

ISSUE

Whether Corporation X's treatment of bad debt losses for Tax Year 3 should be characterized as an unauthorized change in method of accounting? If not, does that automatically entitle Corporation X to the tax charge-offs claimed in that year.

CONCLUSION

Characterizing Corporation X's treatment of bad debt losses for Tax Year 3 as an unauthorized change in method of accounting should be reconsidered. However, this does not mean that Corporation X is automatically entitled to the tax charge-offs as claimed for Tax Year 3.

FACTS

Corporation X is an institution described in § 7701(a)(19) and uses the reserve method described in § 593 of the Internal Revenue Code to account for its bad debt losses. There does not appear to be any question that Corporation X was entitled to use the reserve method under § 593. For tax years prior to the effective date of section 801 of the Tax Reform Act of 1986, Pub. L. No. 99-514, Corporation X used the cash receipts-and-disbursements method of accounting. For tax years thereafter, Corporation used an accrual method of accounting.[1]

On Date 1, Corporation X filed an Application for Change in Accounting Method, Form 3115, seeking consent to change its treatment of charging off bad debts from the conclusive presumption method under § 1.166-2(d) to the conformity method under § 1.166-2(d)(3). However, this change was effective for Tax Year 4.

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[1] This overall change in method from cash to accrual would appear to have a number of ramifications with respect to Corporation X's loan treatment. For example, under a cash method, Corporation X would not include in income the unpaid interest on a loan whereas under an accrual method interest (including discount) would accrue in income and, if accrued and unpaid, be added to basis in the loan.

On Date 2, Corporation X filed an Application for Change in Accounting Method, Form 3115, seeking consent to change its treatment of delinquent interest. However, this change was effective for Tax Year 5.[2]

For financial and regulatory purposes, Corporation X apparently records mortgage loans under a single account ("Account 1") but separately records specific and general loan reserves on its books as contra assets to this account ("Contra-Account 1"). Upon foreclosure, Corporation X apparently transfers the related real estate loan from Account 1 to another account ("Account 2"). This second account is identified as REO.[3] Corporation X, for book purposes, also apparently records specific and general reserves with respect to its REO property in Account 2 and in some way "provisions" the reserve accounts in another account ("Account 3"), captioned "Loss on Real Estate."[4] For financial and regulatory purposes, Corporation X apparently also establishes general reserves against the inherent risk associated with making loans.

For federal income tax purposes, Corporation X charged-off as losses against its tax reserves in Tax Year 2 amounts for:

1. Specific write-offs related to loans sold to third parties and certain short payoff loans;
2. Write-offs on specific foreclosed property; and

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[2] We are not sure what this change encompassed. To the extent that this change reached Corporation X's accounting for accrued but unpaid interest, some understanding of its effect on Corporation X's accounting for gain on the sale of foreclosed property under § 595 may be necessary to fully resolve the issues raised herein. See Rev. Rul. 75-251, 1975-1 C.B. 175; First Charter Financial Corporation, 669 F.2d 1342 (9th Cir. 1982).

[3] We understand that REO signifies real estate owned and that it usually refers to real property obtained by a thrift institution through foreclosure. As more fully discussed later in this memorandum, foreclosure property has significant tax ramifications because of the application of § 595.

[4] Although "provision" may refer to a contra-asset account, it may also refer to an expense that must recognized currently when the exact amount of the expense is still uncertain or it may refer to an appropriation of retained earnings for a specified purpose. See Barron's Dictionary of Accounting Terms (2d Ed.) (1995). Because it is not clear exactly how Corporation X's books and records with respect to its bad debts were maintained and reconciled (either for financial or for tax purposes), we are unsure which possible meaning of "provision" is intended here.

3. Write-offs of delinquent interest.

In Tax Year 3, Corporation X charged-off as losses against its tax reserves amounts for:

1. Specific write-offs related to loans sold to third parties and certain short payoff loans;
2. Write-offs on specific foreclosed property; and
3. Write-offs of delinquent interest;
4. Write-downs to Net Realizable Value;
5. Losses recognized on the transfer of reserves from general to specific reserves for loans in Account 1;
6. Losses recognized on the transfer of reserves from general to specific reserves for foreclosed property in Account 2;
7. Losses attributable to PMI;
8. Write-offs in Account 2 (to establish reserves); and
9. Reverse Reserves Foreclosed.

In support of its bad debt write-off for tax for Tax Year 3, Corporation X provided Letter 1 dated Date 3 from Agency A and Letter 2 dated Date 4 from Agency B. Although Letter 1 detailed specific loans and charge-off amounts, Letter 2 merely confirmed that, after review by Agency B of schedules prepared by Corporation X, the charge-offs and specific reserves listed by Corporation X on those schedules would have been specifically required by Agency B had Corporation X not already recognized the deduction from income. For regulatory purposes, Agency B considered the establishment of a specific reserve to be the equivalent of a charge-off.

The examining agent's position is summarized in Memorandum A as supplemented by Memorandum B. The examining agent concludes that Corporation X made an unauthorized change in its method of accounting for bad debts when it first began to charge-off debts against its tax reserves based upon partial worthlessness upon the establishment of a specific reserve. Memorandum A, page 21; Memorandum B, page 1. The examining agent characterizes this difference in treatment of charge-offs attributable to partial worthlessness as a change with respect to a material item within the meaning of § 446. Id. Thus, the examining agent would deny Corporation X the ability to charge-off losses for partial worthlessness because Corporation X had not established, in prior years, a practice of charging-off against its tax reserves any losses attributable to partial worthlessness.

Corporation X's position is summarized in Memorandum C. Corporation X characterizes the focus on the accounting method issue as directed to its charge-

offs in Tax Year 3 against its tax reserves for (a) write downs to net realizable value on REO, (b) losses attributable to PMI, and (c) losses attributable to specific reserves on both mortgage loans and REO. Corporation X states that in prior tax years it may have charged these losses to its tax reserves when the losses were realized by sale (either of the REO or the loan). Memorandum C, at pages 50-51. Corporation X takes the position that its conduct in Tax Year 3 did not amount to a change in method of accounting as it is within its discretion whether to recognize losses attributable to partial worthlessness. Id. at page 56. Corporation X also takes the position that partial worthlessness, as reflected in its charge-offs in Tax Year 3, was properly established through Letter 2. See Memorandum C, at pages 56 and 57.

Corporation X states that the additions of the newly identified items in Tax Year 3 resulted from a change in underlying facts. First, Corporation X states that new technology apparently aided the gathering of additional information in a cost effective manner. This new technology included the "ticking" and "adding up" of different types of entries to the general ledger, introduction of the personal computer, and spreadsheet programs that assisted staff in making the required analysis of the general ledger possible. See Memorandum C, pages 64 and 65.

Corporation X also states that it experienced a change in economic conditions along with a change in financial accounting requirements in Tax Year 3. Additionally, for financial accounting purposes, Corporation X apparently began experiencing increased realizable losses in Tax Year 3.[5] See Memorandum C, at page 66. These changes in circumstances, coupled with increased projected financial losses, apparently required Corporation X to reconsider its assumptions about how loss reserves should be measured and recorded, and how the existing accounting system should be used and adjusted to deal with the developing economic situation.[6] Id., pages 66 and 67.

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[5] The audit history shows that, prior to Tax Year 3, Corporation X' s addition to the Qualified Loan Reserve ("QTL") was generally computed using the percentage of taxable income formula.

[6] Corporation X further states that it is the amount of the charge-off rather than the timing of its recognition that is at issue and that improving the accuracy of the factual determination of the amount of a debt that will not be recoverable is not a change in method of accounting. See Memorandum C, pages 67 and 68.

The appeals officer summarized the matter in Memorandum D in a manner that is materially consistent with the above summations.[7] Corporation X apparently provided tax workpapers and three letters from regulatory agencies (Letters 1, 2 and 3) in response to the appeals officer's request for documentation to support specific bad debt deductions. Memorandum D, at pages 3 and 4.

Letter 1 was issued by Agency A near in time to Agency A's examination of Corporation X for the period of time described in Letter 1, including part of Tax Year 3. Further, Letter 1 detailed specific loan numbers and charge-off amounts. Letter 2 was issued by Agency B several years after the conclusion of the period covered in the letter (which included part of Tax Year 3). Apparently Letter 2 was issued by Agency B based on a review of schedules prepared by Corporation X and states in relevant part that Agency B was "able to confirm that the charge-offs and specific reserves listed on the enclosed schedules ... would have been specifically required by [Agency B] if [Corporation X] had not already recognized the deduction from income."[8] Memorandum D, at page 4. Letter 3, also issued by Agency B, concerns events and matters unrelated to Tax Year 3.

LAW AND ANALYSIS

Section 166 allows a taxpayer to claim a loss for a bad debt under certain circumstances. Generally, section 166(a) requires that the debt be worthless (in whole or in part). A taxpayer may, but is not required to, claim losses attributable to partial worthlessness. See § 166(a)(2); § 1.166-3(a)(ii). The regulations under § 166 provide general rules for determining worthlessness. Essentially, the determination of worthlessness is a facts and circumstances determination. See § 1.166-2(a).

The consequence of a taxpayer's charge-off of tax basis is reflected either as a direct deduction against income (the "specific charge-off method") or as an indirect deduction against income by means of an addition to a reserve for losses (the "reserve method"). See Treasury Report to the Congress on The Tax Treatment of Bad Debts by Financial Institutions (September 1991) ("Treasury Report"), page 1.

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[7] Although the terms used by the appeal officer to describe the accounts and contra-accounts differs somewhat from the labels used by the examining agent, we understand that both descriptions refer to the same accounts.

[8] We are unable to tell, however, whether Corporation X underwent any regulatory examinations between the issuance of Letter 1 and Letter 2, and if so, whether such examination was performed by Agency A or Agency B.

Charge-off generally refers to the write down or write-off of an asset for book purposes. For purposes of both § 166 and § 593, however, charge-off refers also to a charge-off of tax basis in a debt to reflect worthlessness. For a taxpayer (such as Corporation X) that uses a reserve method of accounting, charge-off refers as well to the act of recording or "charging" that worthlessness against its tax reserves, which has the result of reducing its reserve for bad debt losses. Thus, the term "charge-off" may refer to more than one step in the bad debt process and, as such, may have a different meaning and tax consequence depending on context.

A charge to a § 593 tax reserve is based on worthlessness. See § 593(c)(3) (which requires any debt becoming worthless or partially worthless to be charged to the appropriate reserve).[9] There is no separate definition of worthlessness applicable to taxpayers using the reserve method. The ability of a § 593 reserve method taxpayer to establish worthlessness for purposes of timing a charge-off of tax basis in a debt, and the consequential charge to its tax reserve for bad debt losses, is governed by the same rules that govern the ability of a taxpayer on the specific charge-off method to support the timing of a current tax deduction for a bad debt loss. Unlike a taxpayer who claims a corresponding tax deduction under the specific charge-off method under § 166, however, a taxpayer using the reserve method under § 593 gets no tax deduction directly attributable to the worthlessness of a debt, regardless of whether that debt is worthless in whole or in part. See § 593(a)(1).

As a general proposition, use of a reserve method results in a current tax deduction for statistically computed losses likely to occur in the future. See Treasury Report, page 7 (footnote 31 and surrounding text). That tax deduction is taken in the form of a reasonable addition to a reserve that is computed in accordance with the requirements of the taxpayer's reserve method of accounting.[10] Depending on how the reasonable addition is computed, a reserve method taxpayer may be entitled to a current tax deduction in an amount greater or lesser than the amount actually charged against its reserve in the same tax year. For a § 593 reserve method taxpayer to properly compute its deduction for a reasonable addition to its § 593 reserves, it must accurately compute its beginning and ending balance in those reserves. To that end, a § 593 reserve method taxpayer must properly charge to

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[9] See also § 1.166-4(c)(3) (which, in addressing tax reserves under former § 166(c), also refers to the amounts of "debts which have become wholly or partially worthless and have been charged against the reserve" in a tax year) (emphasis added).

[10] For Corporation X, this means in accordance with § 593.

those reserves losses based on the worthlessness of the debts covered by those reserves.[11]

(a) Determining Worthlessness

Special rules have been provided for regulated financial institutions which provide for the taxpayer's burden of proof with respect to factually establishing the worthlessness of an individual bad debt. See § 1.166-2(d). Generally, a conclusive presumption that a debt is worthless (in whole or in part) has been applied to those loans that have been classified as loss assets in response to the specific write-down order of the regulator, at least where the criteria used by the regulator in classifying the debt as loss were comparable to the criteria under § 166 for establishing worthlessness. See § 1.166-2(d)(1). These special rules generally apply to determinations of worthlessness regardless of whether the taxpayer is claiming that a debt is worthless in whole or in part.[12] Because these rules are generally directed at satisfying an evidentiary burden, taxpayers have been able to choose whether to rely on the conclusive presumption or on all of the surrounding facts and circumstances to determine in which tax year to recognize a bad debt for tax purposes. Compare § 1.166-2(d)(1) with § 1.166-2(d)(2).

As stated above, both a charge-off to a tax reserve and the specific charge-off of a debt directly against income are based on worthlessness. Thus, in accordance with § 1.166-2(d) of the regulations, a § 593 reserve method taxpayer should not be any more restricted with respect to a particular method of determining the worthlessness of a debt for purposes of charging its tax reserves than a specific charge-off method taxpayer is with respect to establishing the worthlessness of a particular debt for which a deduction is claimed. If a § 593 reserve method taxpayer does not make a charge-off against its tax reserves for a debt in reliance on the presumption of worthlessness under § 1.166-2(d)(1), then it may charge its tax reserves under § 1.166-2(d)(2) in a later taxable year upon a showing of sufficient evidence of worthlessness of the debt in that later taxable year. That is, §§ 1.166-2(d)(1) and 1.166-2(d)(2) of the regulations establish alternate means that are available to a taxpayer for satisfying its evidentiary burden with respect to establishing the worthlessness of a debt for tax purposes. As such, neither of these

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[11] Recoveries of bad debts previously charged against the § 593 reserves are credited, as a general matter, to those reserves and a § 593 reserve method taxpayer's computation of a reasonable addition to its tax reserves for the taxable year of such recovery is also affected because of this.

[12] For the reasons identified in the Treasury Report, at page 2, taxpayers may prefer not to take deductions based on partial worthlessness in every instance.

alternatives is a method of accounting. Rather, they are both part of the reserve method and the specific charge-off method of accounting for bad debts.

Section166 and the regulations thereunder do not preclude a taxpayer that is using the specific charge-off method from claiming a tax deduction attributable to the partial worthlessness of a loan merely because that taxpayer had not taken similar deductions previously. Thus, if the worthlessness of a debt would be considered to have been established by a taxpayer using the specific charge-off method in support of a current tax deduction based on partial worthlessness, then based on the same operative facts a § 593 reserve method taxpayer's charge against its tax reserve should be accepted. We would not foreclose a § 593 reserve method taxpayer from taking a charge-off to its reserve for an otherwise allowable loan loss based on partial worthlessness merely because it has not established such a practice in the past. The crucial determination in both situations is whether the taxpayer has established a currently recognizable loss based on partial worthlessness.[13]

For tax years ending on or after December 31, 1991, taxpayers may elect the conformity method. The adoption of the conformity method under § 1.166-2(d)(3) constitutes a change in a taxpayer's method of accounting for bad debts. When that method change is made, however, a taxpayer does so by means of a cut-off and there is no § 481 adjustment. Further, a taxpayer that changes to the conformity method is not required to adjust its tax basis for any debt as a result of that change. If the taxpayer has not previously claimed a partial charge-off for tax that has been recognized for book, the taxpayer must take such charge-off for tax in the first post-change tax year in which there is a further charge-off for book.[14] See

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[13] It has been argued to us that § 1.166-3(a)(1) precludes a § 593 reserve method taxpayer from taking any charge against its § 593 tax reserves for a properly established loss based on partial worthlessness. We decline to adopt this interpretation of § 1.166-3(a)(1) which, on its face, speaks only to deductions (presumably against gross income as that is the generally understood meaning) and does not purport to limit the proper accounting of charges against, and credits to, a § 593 reserve. Our position is also supported by § 593(c)(3) and § 1.166-4(c)(c)(3) both of which authorize charging partially worthless debts against a tax reserve.

[14] For example, assume that at the time a taxpayer elects the conformity method it has a debt of $100 with a book basis of $75 and a tax basis of $80. No adjustment to tax basis is made as a result of the taxpayer's election of the conformity method. However, in a later year the taxpayer classifies an additional 25% of the original debt as loss and takes a further charge-off for book of $25, resulting in a basis for book of

(continued...)

§ 1.166-2(d)(3)(iii)(B)(4). If, prior to electing the conformity method, a taxpayer has previously written-off a debt for book purposes but not for tax (that is, the taxpayer has a debt of $100 with a book basis of $0 but a tax basis in excess of $0), no tax loss on that debt will be recognized by the taxpayer as a result of adopting the conformity election. Rather, any tax loss to be recognized with respect to that debt will be recognized under the general rules for claiming a bad debt loss (i.e., upon establishment of worthlessness). See § 1.166-2(d)(3)(iii)(B)(3).

The use of the conformity method under § 1.166-2(d)(3), although constituting a method of accounting, is not limited in availability only to taxpayers using the specific charge-off method of accounting for bad debts. To the contrary, the conformity method can apply equally to taxpayers using the reserve method of accounting for bad debts. The only difference is in how the conformity method is incorporated in the taxpayer's reserve method of accounting for bad debts. Corporation X made the conformity election on Date 1 effective for Tax Year 4. The conformity election's advantages are not available to Corporation X in prior years and, consequently, Corporation X must establish that it properly took charge-offs to its reserve in Tax Year 3 based on worthlessness under the general rules of § 166, including §§ 1.166-2(d)(1) and 1.166-2(d)(2).

(b) Interplay of §§ 166, 593, and 595

As discussed above, in lieu of a tax deduction for bad debts under § 166, certain taxpayers, including Corporation X, may take a deduction for a reasonable addition to a reserve under § 593 in computing taxable income.[15] One issue in dispute is whether, and to what extent, Corporation X may charge partially worthless debts against its tax reserves. Based on the foregoing analysis, we conclude that Corporation X is not precluded from charging partially worthless debts to its § 593 tax reserves. The extent to which Corporation X is entitled to charge such losses in Tax Year 3 is not as certain, however. Another unresolved issue is whether

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[14](...continued)
$50. For federal income tax purposes, however, the amount of the taxpayer's charge-off for tax for the same tax year should be $30.

[15] In accordance with § 593, Corporation X was required to establish and maintain (1) a reserve for losses on qualifying real property loans, (2) a reserve for losses on nonqualifying loans, and (3) a supplemental reserve for losses on loans.

Corporation X's handling of foreclosure property (hereafter referred to as § 595 property) is correct.[16]

As with any method of accounting, consistency in a taxpayer's application of a reserve method is required and the reserve method under § 593 is not exempt from this requirement of consistency. However, before it can be ascertained whether Corporation X made an unauthorized change in method with respect to its § 593 reserve, it is necessary to establish a common understanding of how the § 593 reserve method is supposed to work.

Under the § 593 reserve method, a distinction is drawn between the reserve for qualifying real property loans and the reserve for other loans. Separate computations of these reserves is required by statute and regulations. See § 593(b) and § 1.593-5. Further, losses must be charged to, and recoveries credited to, the proper reserve. Id; see also § 593(c)(3). Under § 593, the taxpayer's use of a particular computational formula (for example, the percentage of taxable income to compute its maximum addition to the reserve for qualifying real property loans) does not bind the taxpayer to use that same computational formula either for that tax year or for subsequent tax years. See § 1.593-6A(a)(1). Thus, for example, where a taxpayer carries back a net operating loss to an earlier tax year, the taxpayer may recompute the amount of its addition to its reserve in that carry back year.[17] See Rev. Rul. 79-123, 1979-1 C.B. 215.

Although, generally, a change in method of accounting will not include an adjustment with respect to the addition to a reserve for bad debts, not every change in circumstance will avoid the triggering of a change in method of accounting for a reserve method taxpayer. For example, a shift from one special reserve method to another special reserve method is one instance of a change in circumstances that will rise to the level of a method change. See Rev. Rul. 85-171, 1985-2 C.B.148 (a change in method occurs when a taxpayer switches from the § 593 reserve method

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[16] Foreclosure property refers to any pledged security on a loan which has been reduced by the lender to possession and control. See § 1.595-1(a). Such property may be identified on the taxpayer's books as REO or it may carry some other designation depending on applicable regulatory guidelines. Because § 595 is not limited to real property, we will refer to such property as § 595 property.

[17] The recomputation is not without restrictions but the particulars are not relevant here.

to the § 585 reserve method even though the experience formula used under § 593 is calculated by reference to § 585).[18]

One fundamental difference between the § 593 and § 585 reserve methods is in what constitutes a reservable loan under the § 593 reserve method. For taxpayers eligible to use the § 593 reserve method, § 595 operates to extend debt treatment to § 595 property. There is, apparently, no question that Corporation X was eligible to use the reserve method under § 593 in Tax Year 3. However, it is not clear whether the examining agent believes that Corporation X failed to properly account for § 595 property or whether the book treatment of such property has led to some confusion over the proper tax treatment to be accorded such items. In either event, the proper tax treatment of § 595 property by a § 593 reserve method taxpayer is governed by § 595 regardless of the taxpayer's financial and regulatory book accounting for such property.

Debt treatment for § 595 property is mandated by statute for taxpayers such as Corporation X. See § 595(b); see also § 1.595-1(e)(1). Therefore, Corporation X should not recognize any gain or loss on the loan as a result of the foreclosure event and its tax basis in the property acquired is its tax basis in the loan determined as of the acquisition, and properly increased for costs of acquisition.[19] See §§ 595(a) and (c). As a consequence of such debt treatment, the evidentiary rules with respect to the determination of worthlessness under § 166 also apply to the determination of worthlessness on § 595 property subsequent to foreclosure. Thus, if Corporation X's adjusted tax basis in § 595 property exceeds the fair market value of such property (as established by proper appraisal), and Corporation X can establish (in the same manner as worthlessness in whole or in part is established for purposes of § 166) that an amount equal to any portion of the excess is uncollectible with respect to the loan for which the § 595 property stood as security, then Corporation X generally is entitled to treat such portion as a worthless debt under § 166. See § 1.595-1(e)(1). That is, Corporation X may charge its § 593 reserve for that loss.

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[18] As recognized in Rev. Rul. 85-171, the allowable amounts permitted to be deducted under the §§ 593 and 585 reserve methods can be very different despite the similarity in computational formulae.

[19] If a § 593 reserve method taxpayer accounts for § 595 property other than as debt, that taxpayer would not be on a good § 593 method of accounting for those loans to which the § 595 property stood as security and a method change may be needed to effectuate the correct tax treatment. However, if a § 593 reserve method taxpayer properly accounts for § 595 property as debt in accordance with the regulations under § 595, an examining agent may not disregard that treatment in favor of another.

(c) Treatment of Specifically Disputed Items

The following discussion is addressed primarily to the issue of the extent to which Corporation X is entitled to charge such losses in Tax Year 3 based on a claim of worthlessness.

(1) Write-downs to net realizable value

We understand that Corporation X may be required for regulatory purposes to provision for certain estimated costs and carrying charges not yet incurred. These amounts are generally reflected in the net realizable value (NRV) of the asset for book purposes. Consequently, for book purposes, Corporation X may realize a loss in excess of that deemed worthless for federal income tax purposes.

Prior to promulgation of the conformity method of § 1.166-2(d)(3), we have found no authority under the Code or regulations for a taxpayer's write-down of § 595 property (or any other debt for that matter) to NRV. Corporation X is, therefore, required to establish worthlessness, whether in whole or in part, in accordance with the requirements of §§ 1.166-2(d)(1) or (2). Even if such a book loss can be properly recognized for tax purposes under the conformity method, Corporation X may not rely on the conformity election in Tax Year 3. To the extent that a charge-off against the tax reserves is denied in Tax Year 3 for an amount written off for book by Corporation X in Tax Year 3, Corporation X may be allowed a deduction under the conformity method in the first post-change tax year in which there is a further charge-off for book. See § 1.166-2(d)(3)(iii)(B)(4).

(2) Losses recognized on the transfer of reserves from general to specific reserves for loans in Account 1 and for foreclosed property in Account 2.

For book purposes, Corporation X apparently accounted for the loan pre-foreclosure in Account 1 and set up any special reserves as contra accounts to Account 1. Upon foreclosure, Corporation X would account for the property acquired as a separate asset in Account 2. If required to reserve against loss on the acquired property, presumably Corporation X would set up a contra account to Account 2. For purposes of § 595, however, the loan and its foreclosed property continue to be treated as a single asset.

Generally, the fact that a charge-off for partial loss was taken on a loan for book when a special reserve was established does not require that a taxpayer charge-off that same amount against its tax reserves. See § 1.166-2(d)(2) (discussion of involuntary charge-offs). The taxpayer, however, must establish that the debt

became recoverable only in part subsequent to the year in which the involuntary charge-off was made. Id. Following adoption of the conformity method, a taxpayer need only satisfy the requirements of § 1.166-2(d)(3) in order to establish its entitlement to a charge-off.

The proper resolution of these two categories, therefore, would appear to turn on whether Corporation X can establish its entitlement to the amounts charged-off against its tax reserves in Tax Year 3. For the reasons discussed above, we do not agree with the position taken by the examining agent that a failure to claim tax losses attributable to partial worthlessness in prior tax years precludes a § 593 reserve method taxpayer from properly claiming tax losses attributable to partial worthlessness in later tax years. For the conclusive presumption of worthlessness under § 1.166-2(d)(1) to apply, however, Corporation X must satisfy all of the requirements of that regulatory provision. Where these requirements are satisfied, Corporation X is entitled to the charge-off in Tax Year 3.[20]

(3) Losses attributable to PMI.

We understand that, within the lending community, "PMI" generally refers to private mortgage insurance and that PMI usually denotes borrower paid amounts whereas LPMI usually denotes lender paid amounts. We understand that references to PMI here, however, may be either to private mortgage insurance or to the amount of outstanding principal balance of the loan that is subject to PMI coverage. It is possible that, for book purposes, Corporation X may be required to make a current provision for such amounts.

If "losses attributable to PMI" refers to private mortgage insurance, it is not clear how or why Corporation X treats PMI as part of the debt. If Corporation X began accounting for PMI as an interest accrual in Tax Year 3, whether such a change in treatment amounts to a change in method of accounting will depend on the particular facts and circumstances. For example, if Corporation X treated PMI as service fee income in prior tax years, a change in tax treatment in Tax Year 3 to begin treating PMI as an interest accrual (such that its accrual would be reflected in the tax basis of the related loan) would require the prior consent of the Commissioner. Alternatively, if Corporation X has always characterized PMI as interest (and assuming that the examining agent does not challenge that

[20] We do not mean to imply by this statement that we conclude Corporation X has satisfied its evidentiary burden with respect to the amount of any claimed charge-off in Tax Year 3.

characterization), it is unclear how Corporation X can establish worthlessness as to PMI, especially if that PMI has been prepaid by the borrower.[21]

Further, if "losses attributable to PMI" refers instead to the write-down of that portion of a loan in default that is subject to PMI, we still do not understand how Corporation X can establish partial worthlessness with respect to this piece for tax purposes. Because PMI is purchased to cover the risk that the borrower will default and that security will be inadequate to fully compensate the lender, it is unclear how a book provision currently for PMI equates to worthlessness for tax purposes.

Based on the limited information on "losses attributable to PMI" provided for our consideration, we are unable to say what the proper tax treatment of PMI would be in this case. However, if PMI is not properly included in Corporation X's tax basis in a loan, Corporation X may not properly charge PMI against its § 593 reserves regardless of how PMI is characterized for book. See § 1.166-1(e).

(4) Write-offs in Account 2 to establish reserves.

As discussed above, § 595 provides special rules for taxpayers such as Corporation X. Consequently, Corporation X's book and tax accounting for the loan and the related § 595 property may be different. Certain adjustments (including journal entries) may be needed to reconcile these differences.

Based on the limited information provided to us, it is unclear whether the charge-offs against the § 593 reserves for these items represent loan losses for which Corporation X established specific reserves prior to proceeding to foreclosure or whether they reflect the establishment of general or non-loss reserves (for example, where the loan has been classified as doubtful or substandard by the regulator for book). If the charge-off is for a current claim of loss, evidence of worthlessness (whether in whole or in part) should be furnished in accordance with § 1.166-2(d). However, neither the establishment of a general reserve for loan losses, nor the classification of a loan as doubtful or substandard, will suffice to support a charge-off against a tax reserve.

(5) Reverse reserves foreclosed.

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[21] In fact, the presence of PMI would appear to affect the determination of worthlessness of the debt itself. For some general background on PMI, see American International Group, Inc., et al v. United States, 38 Fed. Cl. 274 (1997) (opinion contains a discussion of how private mortgage insurance is generally handled by the insurance industry).

Whether Corporation X is entitled to a charge-off in Tax Year 3 for losses in this category may likely be resolved based on the proper application of bad debt criteria to § 595 property as discussed above.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With respect to Corporation X's write-down of loans (including § 595 property) to net realizable value, we recognize that Bank of Kirksville v. United States, 943 F.Supp. 1191 (WD Mo. 1996), presents some risk with respect to the position stated above. However, we continue to believe that Bank of Kirksville is not a correct application of the relevant tax law.

Of far more significant concern to us, though, is what appears to be confusion over the proper application of debt treatment to § 595 property. Debt treatment for § 595 property was mandatory for thrifts in the years at issue, whether they used the reserve method under § 593 or the specific charge-off method of § 166. See § 1.595-1(a)(1). Absent obtaining a bank charter, the most likely fact that could affect Corporation X's eligibility to use § 593 would be its failing the 60% percent asset test in § 7701(a)(19)(C). If Corporation X is entitled to use the § 593 reserve method, however, then it is entitled to determine worthlessness with respect to such § 595 property in accordance with the regulations under § 166 as discussed above. See, e.g., § 1.595-1(e)(6)(i).

We are also troubled by the consequences that would flow from denying reserve method taxpayers the same ability to establish worthlessness in accordance with the special rules in § 1.166-2(d). Section 593 and the regulations under both §§ 166 and 593 clearly speak to charging the reserve for losses on loans covered by the reserve based on the taxpayer's establishing worthlessness in whole or in part.[22] [redacted]

[redacted]

[22] We have coordinated this FSA with ITA and have taken their comments into consideration in drafting this response. We understand that the position urged in the original FSA was premised on a different understanding of the facts and that it was accepted as a factual premise that the § 593 reserve method used by Corporation X precluded partial worthlessness from being charged against the tax reserve.

[redacted]

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Please call if you have any further questions.

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