INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 27, 2001

Number: **200134005**
Release Date: 8/24/2001
Index (UIL) No.:166.03-00
CASE MIS No.: TAM-125014-00/CC:ITA:B6

District, Field Operations

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Tax Year X =

Tax Year Y =

Amount A = $

Amount B = $

Amount C = $

Amount D = $

Amount E = $

Amount F = $

Amount G = $

Amount H = $

ISSUES:

1. Should the Internal Revenue Code section 481(a) adjustment required as a result of

Taxpayer's change in its method of accounting for interest on nonperforming loans include interest that was uncollectible at the beginning of the year of change?

2. What is the proper method of valuing collateral for purposes of determining whether interest is uncollectible and the extent to which debt is worthless?

3. Is the amount of the Code section 481(a) adjustment deducted by Taxpayer in the year of change as partially worthless debt limited to the amount of the adjustment included in income in that year?

CONCLUSIONS:

1. The Code section 481(a) adjustment required as a result of Taxpayer's change in its method of accounting for interest on nonperforming loans should not include interest that was uncollectible at the beginning of the year of change.

2. For purposes of determining whether interest is uncollectible and the extent to which debt is worthless, collateral should be valued at fair market value, determined without regard to estimated sales costs or an estimated reduction in amount realized due to a possible distress sale.

3. Our resolution of the first two issues renders the third issue moot.

FACTS:

Taxpayer is a bank that uses an overall accrual method of accounting and holds nonperforming loans that are mostly commercial real estate loans. In early Tax Year Y, Taxpayer received a letter ruling granting it permission to change its method of accounting for interest on nonperforming loans. Taxpayer's prior method conformed to the method used for regulatory purposes. Under that method, if a loan payment was more than 90 days past due, Taxpayer ceased accruing interest on the loan and reversed previously accrued interest. Under the new method, Taxpayer was required to accrue interest "until either the particular loan is charged off or the interest is determined to be uncollectible." The letter ruling further provided that in determining whether interest on a loan was uncollectible, Taxpayer was required to "substantiate, taking into account all the facts and circumstances, that it has no reasonable expectation of payment of the interest." The new method of accounting became effective with Tax Year X.

Code section 481(a) provides that a Taxpayer making a change of accounting method must take into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. Taxpayer calculated its section 481(a) adjustment as Amount A. Taxpayer maintains that interest on nonperforming loans that had not been reported under its prior method was required to be included in the section 481(a) adjustment if neither a charge off nor a determination of uncollectibility of interest had been made prior to Tax Year X.

Of the entire Code section 481(a) adjustment, Taxpayer deducted Amount B in Tax Year X as partially worthless debt. Taxpayer based its deductions on a study that compared the amount of principal and interest owed on a loan with the value of the collateral securing the loan. The exam division takes the position that of the amount deducted Amount C was uncollectible prior to Tax Year X, should not have been part of the section 481(a) adjustment, and was therefore improperly deducted. The exam division further contends that another Amount D was improperly deducted because Taxpayer used a faulty methodology in valuing the collateral for loans. Essentially, the exam division contends that list prices or appraisal values should be used, whereas Taxpayer used an approach that takes into account a number of factors such as estimated sales costs and an estimated reduction in amount realized due to a possible distress sale.

Taxpayer was permitted to report its Code section 481(a) adjustment over a six-year spread period. As an alternative to its position stated above, the exam division contends that any partial bad debt deductions for Tax Year X attributable to the adjustment should be limited to Amount E, the portion of the adjustment that was reported in that year.

Finally, in Tax Year X, Taxpayer accrued Amount F of interest on nonperforming loans pursuant to its new method of accounting. It also deducted Amount G of this amount as partially worthless debt in the same year. The exam division has disallowed Amount H of this amount on the theory that Taxpayer improperly valued the collateral securing its loans.

LAW AND ANALYSIS:

Issue 1

The first issue is whether the Code section 481(a) adjustment required as a result of Taxpayer's change in its method of accounting for interest on nonperforming loans should include interest that was uncollectible at the beginning of the year of change.

Under Taxpayer's prior accounting method, Taxpayer stopped accruing interest on nonperforming loans when the particular loan was placed in nonaccrual status for regulatory purposes (i.e., 90 days after payments on the loan became overdue). Under its new accounting method, Taxpayer continues accruing interest on any nonperforming loan until either (1) the loan is worthless under Code section 166 and charged off as a bad debt, or (2) the interest is determined to be uncollectible. In order for interest to be determined uncollectible, Taxpayer must substantiate, taking into account all the facts and circumstances, that it has no reasonable expectation of payment of the interest. This substantiation requirement is applied on a loan by loan basis.

Since the early 1990s, Coordinated Issue Papers prepared by the Service's Industry Specialization Program (ISP) teams on commercial banks and savings and loan institutions have provided industry guidance on the accrual of interest on nonperforming loans. In addition, Rev. Proc. 99-49, 1999-2 C.B. 725, provides an automatic procedure for a taxpayer to change its method of accounting for interest on nonperforming loans to comply with Code section 451 and section 1.451-1(a) of the Income Tax Regulations. This automatic procedure is effective for tax years ending on or after December 27, 1999. Before the automatic procedure took effect, CC:ITA (and later CC:FIP) routinely issued consent letters allowing taxpayers to make this type of method change.

In general, the Code section 481(a) adjustment required for this type of method change is the amount of interest on the taxpayer's nonperforming loans outstanding as of the beginning of the year of change that should have been accrued under the taxpayer's new method, in accordance with section 451 and section 1.451-1(a) of the regulations, and was not accrued. The issue in the present case is whether that section 481(a) adjustment may include interest that is uncollectible as of the beginning of the year of change. We conclude that the section 481(a) adjustment may not include such interest.

Code section 481(a) provides that in computing a taxpayer's taxable income for the tax year for which there has been a change in method of accounting, there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

Section 1.481-1(c)(1) of the regulations provides that the term "adjustments," as used in Code section 481, has reference to the net amount of the adjustments required by section 481(a). In the case of a change in over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term "net amount of the adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting.

In effect, a Code section 481(a) adjustment represents the aggregate amount of net income or expense that would have been reported in years prior to the year of change if the taxpayer had been on the new method in such prior years. Accordingly, the amount of a taxpayer's section 481(a) adjustment is generally computed at the beginning of the year of change by comparing the amounts of income and/or expense the taxpayer reported under its prior method and the amounts that the taxpayer would have reported if the taxpayer had used the new method in prior years. See section 1.481-1(c)(1) of the regulations.

Thus, in order to properly compute its Code section 481(a) adjustment, Taxpayer was required to compare, for nonperforming loans outstanding at the beginning of the year of change, the amount of qualified stated interest it reported under its prior method and the amount of qualified stated interest it would have reported if it had used the new method in prior years. Under Taxpayer's new method, qualified stated interest does not properly accrue if it is uncollectible when the right to receive it arises. It is not appropriate to include qualified stated interest in income in anticipation of receipt if there is no reasonable expectation of receipt. See Rev. Rul. 80-361, 1980-2 C.B. 164. Moreover, under Taxpayer's new method, all relevant facts and circumstances must be taken into account to ascertain whether there is a reasonable expectation of receipt. The collectibility or uncollectibility of interest may not be assumed, but must be determined.

In fact, section 5A of the Appendix of Rev. Proc. 99-49 specifically provides that a taxpayer that is a bank may file for automatic consent to change its accounting method if under the taxpayer's prior accounting method the taxpayer fails to properly accrue qualified stated interest on nonperforming loans under section 451 and section 1.451-1(a) of the regulations. Under Rev. Proc. 99-49, the taxpayer's resulting section 481(a) adjustment is equal to "the amount of qualified stated interest, on the taxpayer's nonperforming loans outstanding as of the beginning of the year of change, that should have been accrued under §§ 451 and 1.451-1(a) and was not accrued. Interest for which the taxpayer, as of the beginning of the year of change, has no reasonable expectation of payment is not taken into account in determining the amount of the § 481(a) adjustment."

In its submission, Taxpayer represents that it computed its Code section 481(a) adjustment using the information and facts that existed as of the beginning of the year of change. However, Taxpayer's statement does not include a representation that it had performed an analysis to determine whether interest that had not accrued under its prior method would have accrued under its new method. Instead, Taxpayer admits that it did not perform such an analysis when it states "it was not inappropriate for [Taxpayer to] accrue the interest and include it in the § 481 adjustment because [Taxpayer] had no reason to believe that the interest was not collectible as such an analysis had not been performed."

Issue 2

The second issue raised in the technical advice request involves the value of collateral as a factor in determining the extent to which loans secured by the collateral are worthless and whether interest due on those loans is collectible. Taxpayer (a bank using an overall accrual method of accounting) held nonperforming loans that were mostly commercial real estate loans. In assessing the extent to which the loans were worthless and whether interest due on the loans was collectible, Taxpayer took into account various factors, including an estimated value of the collateral. Taxpayer's methodology for valuing collateral included discounting the appraised value or list price of property for estimated sales costs and an estimated reduction in amount realized due to a possible distress sale.

Under section 166(a) of the Code, a taxpayer may deduct any debt that becomes worthless within the taxable year. Section 1.166-2 of the regulations provides guidance in determining whether a debt is worthless. Specifically, section 1.166-2(a) provides the following general rule:

> In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

As Taxpayer in the present case agrees, the phrase "the value of the collateral" in section 1.166-2(a) means the fair market value of the collateral.

In <u>United States v. Cartwright</u>, 411 U.S. 546 (1973), the United States Supreme Court defined the fair market value of property for federal tax purposes. That definition is as follows:

> The fair market value [of property] is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

411 U.S. at 551 (quoting section 20.2031-1(b) of the Estate and Gift Tax Regulations). In <u>Cartwright</u>, the Supreme Court noted that this "willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves." 411 U.S. at 551. Thus, fair market value is the <u>price</u> at which property would change hands between a willing buyer and willing seller, <u>neither being under any compulsion to buy or sell</u> and both having reasonable knowledge of relevant facts. The foregoing definition of fair market value does not permit consideration of estimated sales costs or an estimated reduction in amount realized due to a possible distress sale.

Taxpayer's approach not only violates the Supreme Court's definition of fair market value, but also has the effect of allowing current deductions for future costs that may never be incurred. Under section 1.461-1(a)(2) of the regulations, an accrual method taxpayer generally may not take into account a liability until "all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability." Allowing hypothetical sales costs to reduce fair market value would result in improper determinations of worthlessness that would, in effect, produce current deductions for costs that are uncertain and speculative. Like other costs, sales costs are taken into account only when actually incurred, in accordance with section 1.461-1(a)(2).

Taxpayer's approach also contradicts section 1.166-6 of the regulations, which provides rules for determining bad debts on the sale of mortgaged or pledged property. Under section 1.166-6(a)(1), if such property is sold for less than the amount of the debt and the debt remaining unsatisfied after the sale is uncollectible, that remaining debt is deductible in the year it becomes worthless. Under section 1.166-6(b)(1), if mortgaged or pledged property is bought in by the creditor, gain or loss to the creditor is measured by the difference between the fair market value of the property and any obligations of the debtor that are applied to the purchase or bid price of the property. For this purpose, however, section 1.166-6(b)(2) specifically provides that the fair market value of property is presumed to be the amount for which the creditor bids it in. Thus, the regulations contemplate that the creditor will bid the fair market value of the property and that the creditor's bad debt deduction will represent the excess of its basis in the debt over that fair market value. Moreover, section 1.166-6(c) gives the creditor a fair market value basis in the property. Accordingly, if the amount the creditor realizes from the property's disposition is less than fair market value because of sales costs or a distress sale, a loss generally would be recognized <u>at that time</u>.

In sum, Taxpayer should not be permitted to reduce the estimated fair market value of collateral securing its loans to reflect estimated sales costs or an estimated reduction in amount realized due to a possible distress sale. Such reductions violate the Supreme Court's definition of fair market value, and they also contradict the requirements of section 1.461-1(a)(2) of the regulations on the timing of costs, and section 1.166-6 on the sale of mortgaged or pledged property.

We note that a single federal district court has allowed the estimated fair market value of collateral to be reduced by possible future costs of foreclosure and sale. <u>Bank of Kirksville v. United States</u>, 943 F.Supp. 1191 (W.D. Mo. 1996). For the reasons outlined above, we believe that conclusion is incorrect as a matter of law and should not be followed by the Service.

<u>Issue 3</u>

The third issue we decide is whether the amount of the Code section 481(a) adjustment deducted by Taxpayer in Year X as partially worthless debt is limited to the amount of the adjustment included in income in that year. Because of the manner in which the first two issues have been decided, this issue is moot.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to Taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.