# *The New Proposed Bad Debt Regulations*

By Grant Dalbey*

Proposed regulations under Code Sec. 166[1] were published to the federal register on December 28, 2023 that provide rules addressing bad debt deductions for certain qualifying entities (the "Proposed Regulations").[2] This article gives an overview of the rules in the Proposed Regulations and includes certain observations and open questions.[3]

## Overview of Existing Rules

Code Sec. 166(a)(1) provides that a deduction is allowed for any debt that becomes worthless within the taxable year. Code Sec. 166(a)(2) permits the Secretary of the Treasury or her delegate (Secretary) to allow a taxpayer to deduct a portion of a partially worthless debt that does not exceed the amount charged off within the taxable year. The existing regulations do not define "worthless." In determining whether a debt is worthless in whole or in part, the Internal Revenue Service (IRS) considers all pertinent evidence, including the value of any collateral securing the debt and the financial condition of the debtor.[4] The existing regulations provide further that, when the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would, in all probability, not result in the satisfaction of execution on a judgment, legal action is not required in order to determine that the debt is worthless.[5]

The existing regulations provide two alternative conclusive presumptions of worthlessness for bad debt. First, Reg. §1.166-2(d)(1) generally provides that if a bank or other corporation subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either (1) in obedience to the specific orders of such authorities or (2) in accordance with the established policies of such authorities, and such authorities at the first audit subsequent to the charge-off confirm in writing that the charge-off would have been subject to specific orders, then the debt is conclusively presumed to have become worthless, in whole or in part, to the extent charged off during the taxable year.

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Second, Reg. §1.166-2(d)(3) generally provides that a bank (but not other corporations) subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, may elect to use a method of accounting that establishes a conclusive presumption of worthlessness for debts, provided the bank's supervisory authority has made an express determination (after each regulatory exam) that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority (the "Conformity Election"). Under the Conformity Election, debt is generally presumed to be worthless when charged off for regulatory purposes, and the debt is classified as a loss asset for regulatory purposes.[6]

## Overview of Proposed Regulations

The Proposed Regulations would replace the existing rules under Reg. §1.166-2(d) with what is referred to as the "Allowance Charge-Off Method" ("ACM"). Under the ACM, debt held by a "regulated financial company" or a "member of regulated financial group" (collectively, "In-Scope Entities") that uses the ACM is conclusively presumed to have become worthless for Code Sec. 166 purposes, in whole or in part, to the extent that amounts are charged off from the allowance for credit loss under U.S. Generally Accepted Accounting Principles ("GAAP") or pursuant to Statements of Statutory Accounting Principles ("SSAP"), as relevant, on an applicable financial statement.

*The Proposed Regulations would replace the existing rules under Reg. §1.166-2(d) with what is referred to as the "Allowance Charge-Off Method" ("ACM").*

A regulated financial company ("RFC") is defined under Proposed Reg. §1.166-2(d)(4)(ii) and generally includes U.S. banks, U.S. bank holding companies, U.S. intermediate holding companies ("IHCs"), U.S. regulated insurance companies,[7] certain government-sponsored enterprises, and other entities. An RFC does not include credit unions or branches of foreign banks. A regulated financial group ("RFG") is defined under Proposed Reg. §1.166-2(d)(4)(iii) and generally includes one or more chains of corporations connected through stock ownership of 80 percent with a common parent corporation that is an RFC. Real Estate Investment Trusts ("REITs"), Regulated Investment Companies ("RICs"), or certain non-financial entities cannot be included as members of an RFG.[8]

A charge-off is defined for purposes of the ACM as an accounting entry or set of accounting entries for a taxable year that reduces the basis of the debt when the debt is recorded in whole or part as a loss asset on the applicable financial statement of the In-Scope Entity.[9] The preamble to the Proposed Regulations gives brief context for the applicable financial accounting treatment and corresponding accounting entries. The Current Expected Credit Loss Standard ("CECL") generally applies to GAAP when measuring credit losses on financial instruments. The preamble explains that CECL generally requires the recognition of expected credit loss in the allowance for credit losses upon initial recognition of a financial asset, with the addition of the allowance recorded as an offset to current earnings. Subsequently, the expected credit loss must be assessed each reporting period, and both negative and positive changes to the expected credit loss must be recognized through an adjustment to the allowance and to earnings. A charge-off of a financial asset, which may be full or partial, is taken out of the allowance in the period in which a financial asset is deemed uncollectible. At that time, the carrying value of the financial asset is also written down.[10]

There is a hierarchal definition of an applicable financial statement, which includes (in the order of descending priority) a From 10-K certified as being prepared in accordance with GAAP; a financial statement that is required to be provided to a bank regulator; in the case of an insurance company, a financial statement based on GAAP provided to parties for substantial non-tax purposes (*e.g.*, given to creditors for purposes of making lending decision) and that meets certain other criteria; and, in the case of an insurance company, a financial statement prepared in accordance with the standards set out by the National Association of Insurance Commissioners and filed with insurance regulators.[11]

A change to the ACM constitutes a change in the method of accounting because it would determine the timing of a bad debt deduction.[12] Accordingly, an In-Scope Entity that changes its method of accounting to the ACM is required to secure the consent of the Commissioner under Code Sec. 446(e) by filing Form 3115. A change to the ACM must be made on an entity-by-entity basis. As of the date of this writing, the ACM is not included on the list of automatic method changes.[13]

The Proposed Regulations indicate that if an In-Scope Entity does not claim a deduction under Code Sec. 166 for

a totally or partially worthless debt on its Federal income tax return for the taxable year in which the charge-off takes place but claims the deduction for a later taxable year, then the charge-off in the prior taxable year is deemed to have been involuntary and the deduction under Code Sec. 166 is allowed for the taxable year for which claimed.[14]

The Proposed Regulations apply to charge-offs made by an In-Scope Entity on its applicable financial statement that occur in taxable years ending on or after the date final regulations are published. However, an In-Scope Entity may choose to apply the Proposed Regulations to charge-offs on its applicable financial statement that occur in taxable years ending on or after December 28, 2023.[15]

## Observations and Open Questions

The ACM seems to apply principles that are similar to the Conformity Election but departs in several ways. Unlike the Conformity Election, the ACM would not require an express determination letter from regulators upon each regulatory exam. This would simplify the compliance process and eliminate the potential for accounting method implications on account of not receiving an express determination letter. The Conformity Election is also only available to banks. The ACM would be available to a much larger population of taxpayers, including bank holding companies, subsidiaries of bank holding companies, and insurance companies. The ACM also appears to be available to controlled foreign corporations[16] to the extent that the relevant stock ownership requirements are met. As discussed above, however, the ACM would not apply to REITs or RICs. The application of the ACM to securitized debt instruments would depend on the form of the securitization. For example, loans held in an investment trust structure could be in-scope, but potentially only if on balance sheet. However, loans held in a Real Estate Mortgage Investment Conduit (a "REMIC")[17] or a partnership would appear to not be covered by the ACM since these entities cannot be included in an RFG.

The Proposed Regulations do not address or modify when a debt instrument qualifies as a security within the meaning of Code Sec. 165(g)(2)(C) and therefore would not change the scope of debt instruments to which Code Sec. 166 applies. For background, a debt instrument is a security under Code Sec. 165(g)(2)(C) if it is issued in registered form by a corporation or by a government or political subdivision thereof (a "Debt Security"). Bad debt deductions for Debt Securities are generally governed under Code Sec. 165 rather than Code Sec. 166, which requires the Debt Security to be wholly worthless (a facts and circumstances-based test).[18] The loss resulting therefrom is generally treated as a loss from the sale or exchange of a capital asset, if the Debt Security is a capital asset in the hands of the taxpayer.[19] Banks, however, are not subject to the rules under Code Sec. 165(g) and Debt Securities are instead subject to the bad debt rules under Code Sec. 166.[20] Accordingly, non-bank entities (*e.g.*, non-bank subsidiaries that hold municipal debt) would still be required to apply the wholly worthless standards for Debt Securities. Bank entities, however, would continue to apply Code Sec. 166 rather than Code Sec. 165. The expanded scope of the ACM to non-bank entities in an RFG likely would not have a significant impact if such members primarily hold Debt Securities.

The proposed regulations define a charge-off as occurring when, among other things, the debt is recorded in whole or in part as a loss asset on the applicable financial statement. It is unclear what criteria or coordination is necessary to establish that a loan is classified as a "loss asset" on an applicable financial statement. Loss asset classification under the Conformity Election is a regulatory determination that banks must demonstrate is tied to financial accounting determination.[21] Additionally, it appears that the conclusive presumption in the Proposed Regulations would only apply to reductions in basis of in-scope loans and securities when the reduction is charged against the allowance for credit loss. There appear to be scenarios under CECL where the reduction is not charged against the allowance. Such situations may not be eligible for conclusive presumption and, if so, may have to be evaluated under the general test under Code Sec. 166.

The preamble to the Proposed Regulations clarifies that the rules would not address the timing for when a taxpayer takes into account a recovery of a previously recognized bad debt deduction.[22] Thus, under the ACM, book-tax differences could arise with respect to amounts recorded as recoveries for financial accounting and included in the net charge-off.

It is not completely clear how nonaccrual interest should be accounted for under the ACM. The IRS has indicated in Rev. Rul. 2007-32,[23] in the context of the Conformity Election, that the nonaccrual of interest is tantamount to a charge-off (and is therefore deductible under Code Sec. 166 if a Conformity Election is in place). It would be helpful if the IRS confirmed how the nonaccrual interest rules should apply in the context of the ACM. The language in the Proposed Regulations requires there to be a reduction in the basis of a loan through the allowance for loan loss, which may not technically occur in the context of nonaccrual interest.

Unlike the current Conformity Election, it is not clear whether the ACM is elective. The language of the Proposed Regulations could potentially suggest that all In-Scope Entities would be required to adopt the method. If the ACM is mandatory, it is unclear whether and how such taxpayers could continue to follow the general rules under Code Sec. 166 to claim bad debt deductions for specific reserves, for example. Notably, however, the Proposed Regulations plainly indicate that if an In-Scope Entity does not claim a bad debt deduction when a charge-off takes place but claims the tax deduction in a later year, the charge-off in the prior year is deemed involuntary, and a deduction is allowed under Code Sec. 166 in the year it is claimed. It is unclear what the scope and purpose of this rule is.

As stated above, changing to the ACM requires a method change that is not currently on the list of automatic changes. Thus, In-Scope Entities that want to rely on the Proposed Regulations will generally have to wait until 2024 to adopt the ACM unless the IRS releases subsequent guidance to include the ACM on the list of automatic changes.[24]

## Conclusion

The ACM seems to generally be good news for the banking and insurance industries, as it seems to generally be an effort by the IRS to simplify the tax compliance process for In-Scope Entities. However, it would be helpful if the IRS addressed the open questions and issues raised above. Interestingly, this is yet another area where tax authorities have sought to align the principles of financial accounting with U.S. Federal income tax.[25] In-Scope Entities should evaluate the potential impact that the Proposed Regulations (along with the associated open items and questions) could have if finalized or if such taxpayers are interested in adopting the rules prior to their finalization. Such an evaluation should include a review of current practices surrounding the financial accounting treatment of debt instruments and the associated journal entries that could impact the application of the ACM.

### ENDNOTES

* Grant Dalbey thanks Joshua Tompkins for this thoughtful review of this article. Joshua Tompkins is a Managing Director in the Financial Institutions and Products Group of the Washington National Tax Practice of KPMG LLP. Joshua Tompkins is also the Co-Editor-in-Chief of the JOURNAL.



1 Unless otherwise indicated, Code Sec. references are to the Internal Revenue Code of 1986, as amended (the "Code") and Reg. § references are to the applicable regulations promulgated pursuant to the Code (the "regulations").

2 88 FR 89363-01.

3 The observations and open questions discussed below are primarily tailored towards banks and members of a regulated financial group (defined below) that includes a bank.

4 *See* Reg. §1.166-2(a).

5 *See* Reg. §1.166-2(b).

6 Note that this brief discussion of the existing rules is also provided in the preamble to the Proposed Regulations (with certain modifications). 88 FR 89363-01.

7 A separate definition for regulated insurance companies is provided in Proposed Reg. §1.166-2(d)(4)(vii).

8 REITs and RICs are defined in Code Secs. 856 and 851, respectively. Reference to non-financial entities is corporations held by an RFC pursuant to 12 USC 1843(k)(1)(B), 12 USC 1843(k)(4)(H), or 12 USC 1843(o).

9 Proposed Reg. §1.166-2(d)(4)(i). For an RFC that is a regulated insurance company that has as its applicable financial statement a financial statement, the term charge-off means an accounting entry or set of accounting entries that reduce the debt's carrying value and results in a realized loss or a charge to the statement of operations (as opposed to recognition of unrealized loss) that is recorded on the regulated insurance company's annual statement. *Id*.

10 88 FR 89363-01, 89637. The preamble also discusses the financial accounting rules applicable to insurance companies.

11 Proposed Reg. §1.166-2(d)(4)(ix). A financial statement includes any supplement or amendment to that financial statement. *Id*. The financial statement may be a separate company financial statement of any member of an RFG, if prepared in the ordinary course of business; otherwise, it is the consolidated financial statement that includes the assets, portion of the assets, or annual total revenue of any member of an RFG. Proposed Reg. §1.166-2(d)(4)(viii).

12 Proposed Reg. §1.166-2(d)(2).

13 *See* Rev. Proc. 2023-24, IRB 2023-28, 1207 for a current list of automatic changes.

14 Proposed Reg. §1.166-2(d)(3).

15 Proposed Reg. §1.166-2(d)(5).

16 Controlled foreign corporations are defined in Code Sec. 957(a).

17 *See* Code. Sec. 860D for the definition of a REMIC.

18 Code Sec. 165(g)(1).

19 *Id*.

20 Code Sec. 582(a).

21 *See* Rev. Rul. 2001-59, 2001-2 CB 585.

22 88 FR 89363-01, 89640.

23 2007-1 CB 1278.

24 Of course, if a taxpayer quickly filed a nonautomatic method change in 2023 after the Proposed Regulations were published to the federal register on December 28, 2023, they would be able to apply the ACM in 2023 if the change is accepted.

25 The corporate alternative minimum tax and Code Sec. 451(b) are other areas where tax authorities have sought alignment between financial accounting and U.S. Federal income tax.