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American Bankers Association
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October 8, 2013

By Electronic Submission and Hand Delivery to the Courier's Desk

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
Attn: CC:PA:LPD:PR (Notice 2013-35)
Room 5203

Re: Comment Letter Submitted Pursuant to Notice 2013-35 on Conclusive Presumption Regulations

Dear Sir or Madam:

The Clearing House Association L.L.C.[1] and the American Bankers Association[2] (together, the "**Associations**") appreciate the opportunity to provide comments on whether (i) changes that have occurred in bank regulatory standards and processes since the adoption in 1991 of Treasury Regulations Section 1.166-2(d)(1) and (3) (the "**Conclusive Presumption Regulations**") require amendment of those regulations, and (ii) application of the Conclusive Presumption Regulations continues to be consistent with the principles of Section 166 of the Internal Revenue Code of 1986, as amended.[3]

I. Executive Summary

We applaud the Internal Revenue Service's (the "**IRS**") request in Notice 2013-35[4] (the "**Notice**") for input from taxpayers regarding whether and how the Conclusive Presumption Regulations should be revised. We believe that in view of the changes that occurred in bank

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[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the U.S. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees.

[3] All Section references are to the Internal Revenue Code of 1986, as amended, and Treasury Regulations promulgated thereunder, unless otherwise specified.

[4] 2013-24 I.R.B. 1240 (June 10, 2013).

regulatory standards and processes since adoption of the Conclusive Presumption Regulations, expanding application of the Conclusive Presumption Regulations in certain respects would be very helpful to both the government and taxpayers in reducing and limiting the public and private resources devoted to determining whether debt is either worthless or partially worthless for Federal income tax purposes, without a significant impact on the resulting timing of the deduction. Absent a more general rule conforming regulatory and tax treatment, there often will be two independent examinations of the one factual basis for a particular debt's worthlessness. In order to reduce and limit administrative burdens imposed on the government agencies and regulated taxpayers, we propose that the IRS extend the conformity election under Treasury Regulations Section 1.166-2(d)(3) (the "**conformity election**") to banks, bank holding companies and their non-bank subsidiaries, and potentially other regulated financial institutions, examined by such institutions' primary supervisory authority, or regulator. Further, we believe that reliance on regulatory determinations of loss assets continues to be consistent with tax law because, as discussed herein, (i) bank regulatory standards and processes for loan loss classification have largely converged with tax standards for worthlessness under Section 166 since the adoption of the Conclusive Presumption Regulations and (ii) any divergence between the two sets of standards is not significant enough to result in material acceleration of loss recognition for Federal income tax purposes. There is no net benefit or incentive for financial institutions to accelerate loss recognition due to the paramount importance of and heightened sensitivity towards regulatory capital adequacy.

II. Comments and Recommendations

A. <u>General Comments</u>

Many taxpayers are subject to regulatory oversight by different federal and/or state regulatory agencies that may make determinations regarding worthlessness of the debt owned by such taxpayers. Due to the scope of our membership and expertise, we limit our comments in this letter to the regulatory standards applicable to our member institutions—*i.e.*, banks, bank holding companies, and their non-bank subsidiaries—that are regulated by one or more of the prudential regulators.

In connection with conducting its normal business, a financial institution incurs economic losses due to bad debts. These losses are deductible for tax purposes under Section 166 and there is no dispute about their deductibility. A potential dispute around the allowance of bad debt deductions generally involves questions of timing as any deduction must be reversed if the debt is later repaid and any disallowed deduction would be allowed if a debt later conclusively deteriorates. Any discrepancy between the relevant regulatory standards and the tax standards would result in an acceleration or deferral of loss recognition, rather than in a permanent reduction of taxable income. Moreover, we believe that in the vast majority of situations, the application of the regulatory charge-off standards results in the same timing of the bad debt tax deduction as would be the case if tax standards were applied. We also believe that in the remainder of the cases, any acceleration of loss that may occur is insignificant compared to the additional administrative burdens faced by the IRS and taxpayers in applying the two different sets of standards. Furthermore, taxpayers who are subject to comprehensive oversight by regulators have no opportunity to manipulate the timing of the tax deduction. Accordingly, we believe it would be more productive for the IRS and taxpayers to reduce the resources now devoted to determining when a bad debt deduction for debts that have already been charged off under the regulatory standards is properly allowable. In this regard, we suggest that the IRS follow the determinations made by prudential

regulators that routinely and thoroughly examine the financial and accounting records and processes of financial institutions such as banks, bank holding companies and their non-bank subsidiaries.

We will respond to each question set forth under Section 4 of Notice 2013-35 separately, but the overarching principle of our response is as described above.

B. Specific Comments on Enumerated Questions

1. Which corporations are regulated by a Federal or State entity that reviews and makes determinations about worthlessness of debt assets in a manner consistent with the tax standards for worthlessness under Section 166, and which of these entities should be covered by revised conclusive presumption rules?

Among our member institutions, banks, bank holding companies, and their non-bank subsidiaries are regulated by one or more of the prudential regulators that review and make determinations about worthlessness of debt assets.[5] As discussed in more detail in our response to Question 3 below, we believe that the determinations made by the prudential regulators about worthlessness of debt assets are fully consistent with the tax standards for worthlessness under Section 166.

We believe that banks, bank holding companies and their non-bank subsidiaries should be covered by the revised conclusive presumption rules.[6] A bank's non-banking subsidiaries are subject to the same supervision and oversight by Federal or State authorities as part of the regulatory review of the parent bank. Reporting is prepared and reviewed on a consolidated basis and non-bank subsidiaries are generally required to apply processes consistent with parent bank's regulatory requirements. Given the generally uniform treatment of banks and their non-banking subsidiaries for regulatory purposes, we believe that non-bank subsidiaries should be able to rely on the conformity election to the same extent as their parent bank. Consistent with the foregoing, we also believe that bank holding companies and their non-bank subsidiaries should be entitled to rely on the conformity election for the same reasons; bank holding companies and their non-bank subsidiaries are, like banks, subject to thorough and extensive regulatory oversight that is substantially similar to that imposed on banks.

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[5] As noted above, our comments are limited to the regulatory standards applicable to banks, bank holding companies, and their non-bank subsidiaries, which are regulated by one or more of the prudential regulators. We do not comment generally on any other corporation that may be regulated by a Federal or State regulatory entity. However, we believe that there are strong arguments in favor of all financial institutions regulated by prudential regulators being entitled to rely on the conclusive presumption rules. As long as the regulatory standards applied by a financial institution's prudential regulator for a determination of worthlessness are substantially the same across the different types of entities regulated under its authority, there is no reasonable basis to exclude any so regulated company from the scope of the conclusive presumption rules.

[6] Under current regulations, many operating subsidiaries of banks (*e.g.*, the mortgage operations in controlled non-bank subsidiaries) do not meet the definition of a "bank" and therefore cannot make the conformity election.

2. Should the conclusive presumption regulations be modified to reflect the changes in bank regulatory standards and processes since adoption of the regulations, and if so, how?

At the outset, it is important to note that the regulatory standards apply to regulated financial institutions in addition to accounting standards. First, financial institutions are required to follow U.S. Generally Accepted Accounting Principles ("**U.S. GAAP**"). U.S. GAAP provides an overall umbrella of accounting principles for the reporting of financial results. Financial institutions are subject to an annual audit to determine if financial statements are prepared in accordance with U.S. GAAP. Primary regulators require significant additional reporting by financial institutions and conduct extensive regulatory oversight and audits. There are additional standards and procedures that are promulgated by the Federal Financial Institutions Examination Council ("**FFIEC**"). The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards and report forms for the examination of financial institutions. Between the application of U.S. GAAP principles and the more detailed standards and procedures promulgated by the FFIEC, there is a strong reporting framework that promotes consistency. Changes in the regulatory standards tend to move in tandem with changes in the accounting standards.

Most debt instruments held by banks, bank holding companies and their non-bank subsidiaries are treated as loans for tax, regulatory and accounting purposes and, as discussed in greater detail in our responses to Questions 3 and 7, since the adoption of the Conclusive Presumption Regulations, the substantive regulatory standards for these loan charge-offs have remained generally unchanged. A limited number of debt instruments are treated as loans for tax purposes and securities for accounting and regulatory purposes and the regulatory standards for charges-offs for "other than temporary impairments" ("**OTTI**") for these debt instruments generally have converged with tax standards since the adoption of the Conclusive Presumption Regulations.

We believe that the consistency between the accounting and regulatory standards for worthlessness and the tax standards for worthlessness under Section 166 has increased since the adoption of the Conclusive Presumption Regulations. However, the specific details of the regulatory standards and processes have changed. The current regulations refer to regulatory standards[7] and processes[8] that are no longer in effect and, therefore, are outdated in that regard. Given the historic convergence, our expectation is that regulatory and tax standards will continue to be consistent. Accordingly, we believe that the regulations should be revised in a manner to ensure that the

[7] For example, the current regulations reference the loan classification standards in the April 26, 1991, version of the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (the "**1991 Uniform Agreement**"), which has since been rescinded and replaced by the 2004 Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the "**2004 Uniform Agreement**"). *See* Treas. Regs. § 1.166-2(d)(3)(ii)(C).

[8] For example, bank regulators now rarely order banks to charge off particular loans or provide written confirmation that a bank took an appropriate charge-off on a loan as required by the Specific Order Method.

regulations are not rendered inoperative upon further changes in regulatory standards and processes.[9]

3. Are the current bank regulatory standards incorporating U.S. GAAP sufficiently similar to the standard of worthlessness under Section 166 that they may appropriately be used in formulating revised conclusive presumption rules?

We believe that the current bank regulatory standards incorporating U.S. GAAP are sufficiently similar to the standard of worthlessness under Section 166 and may appropriately be used in formulating revised conclusive presumption rules. Furthermore, we believe that since the time of the adoption of the Conclusive Presumption Regulations, the overall consistency between the accounting and regulatory standards for determining worthlessness and the tax standards has increased. The following discussion is divided into two parts. The first part provides an overview of the changes that have occurred in bank regulatory standards and processes since adoption of the Conclusive Presumption Regulations. The second part compares the current bank regulatory standards and processes for loan loss classification to the tax standards for worthlessness under Section 166.

In considering the following discussion, we emphasize that the most significant and common types of losses that are incurred relate to common lending transactions. A taxpayer lends to a customer, records the loan asset and works to collect the principal with interest over the contractual life of the loan. The taxpayer evaluates the loan on an ongoing basis to determine whether it continues to be collectible in whole or part. If the taxpayer determines that all or part of the loan is not collectible, it is required to partially or wholly charge off the loan against the allowance for loan losses. This is required under U.S. GAAP practices and regulatory accounting principles.

As the markets evolved, accounting and regulatory standards have also been updated and expanded to recognize the unique nature of different types of debt assets. In particular, the evolution of the treatment of debt instruments other than common loan assets under the OTTI rules has been a relatively new development. Accordingly, we describe that treatment in more detail below, even though the proportion of assets subject to that treatment is relatively minor compared to more traditional loan assets subject to the more traditional charge-off rules.

a) Asset Classification under Bank Regulatory Standards Incorporating U.S. GAAP

In 1991, the Department of the Treasury ("**Treasury**") submitted a report to Congress on the tax treatment of bad debts by financial institutions (the "**1991 Treasury Report**"),[10] in which Treasury concluded that regulatory standards and processes for loan classification were similar enough to the criteria for worthlessness under Section 166 to make regulatory standards and

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[9] For example, we believe that "loss asset" should be defined by reference to the loan loss classification standards that are in effect in the given taxable year.

[10] *See* DEPARTMENT OF THE TREASURY, REPORT TO THE CONGRESS ON THE TAX TREATMENT OF BAD DEBTS BY FINANCIAL INSTITUTIONS (Sept. 1991).

processes an "acceptable surrogate" for independent investigation by the IRS. In evaluating the similarities, the 1991 Treasury Report provided an apt description of the regulatory standards then in effect:

> For regulatory purposes, loss assets are those that, on the basis of specific factual criteria, are deemed "uncollectible" and of such little value that their retention as bankable assets is not warranted. Classification as a loss asset does not preclude the possibility of partial recovery, but deems the possibility too small to provide a sufficient reason for deferring a write-off.
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> . . . .
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> In general, institutions classify commercial and real estate loans on the basis of the borrower's financial statements, the borrower's condition compared to the industry average, whether a borrower has complied with the repayment terms of the loan, the adequacy of the collateral or income stream that secures repayment, the existence of contingent liabilities, the likelihood of the borrower's business success, and the overall economic conditions affecting the borrower.[11]

This view was informed by a uniform agreement among bank regulators regarding supervisory standards on the classification of assets (the "**1991 Uniform Agreement**").[12]

In 2004, bank regulators rescinded the 1991 Uniform Agreement and set forth revised uniform supervisory standards on the classification of assets (the "**2004 Uniform Agreement**").[13] The 2004 Uniform Agreement retained the general definition of a loss asset. The statement includes the following definition of a loss asset:

> Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.[14]

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[11] *See* 1991 Treasury Report, pp.22–23.

[12] *See* OCC Banking Circular 127, Attachment, Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (April 26, 1991).

[13] *See* OCC Bulletin No. 2004-25, Attachment, Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (June 15, 2004).

[14] *See* 2004 Uniform Agreement; *see also* 1991 Uniform Agreement (same).

These are the rules that apply to the most significant and common types of losses incurred by taxpayers. Accordingly, the general standard for evaluating loan losses, which represent the vast majority of all worthlessness deductions for banks and their non-bank subsidiaries, currently is fundamentally the same as when the Conclusive Presumption Regulations were adopted.

As noted above, the accounting and regulatory standards were also updated to recognize changes in the markets and different types of debt assets that were held by taxpayers and were subject to a different U.S. GAAP treatment than the common loan assets held by a bank. As a result, the 2004 Uniform Agreement revised debt asset classifications to ensure consistency with U.S. GAAP principles. Under the 2004 Uniform Agreement, when the decline in fair value on a debt security represents OTTI under U.S. GAAP principles, an impairment loss was recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. The OTTI treatment generally does not apply to the common loan assets, which represent the vast majority of the debt assets held by a bank or a non-bank subsidiary.

Subsequent changes to U.S. GAAP altered how an entity evaluates whether an impairment is other-than-temporary with respect to debt securities (other than loans) and how to recognize an OTTI. Under Statement of Financial Accounting Standards No. 115 ("**Statement 115**")[15] and related guidance,[16] the assessment of whether an impairment is other-than-temporary required consideration of whether the holders demonstrated the "intent and ability" to hold the debt security for a reasonable period of time sufficient for a forecasted recovery of fair value. However, Financial Accounting Standards Board ("**FASB**") Staff Position No. 115-2 ("**FSP 115-2**")[17] replaced the requirement that a holder must assert both the intent and ability to hold an impaired debt security until recovery by specifying that an impairment will be an OTTI if (i) a holder intends to sell the debt security, or (ii) it is more likely than not that the holder will be required to sell the debt security before the recovery of its amortized cost basis (*e.g.*, whether its cash or working capital requirements, or contractual or regulatory obligations indicate that the debt security will be required to be sold before a forecasted recovery occurs).

Additionally, even if the prior conditions are not met, an impairment is an OTTI if a holder does not expect to recover the entire amortized basis of the debt security. To determine whether the entire amortized cost basis of the debt security will be recovered, FSP 115-2 requires the holder to compare the present value of cash flows expected to be collected to the amortized cost basis of the security. The holder is required to use its best estimate of the present value of cash flows expected to be collected from the debt security. It is important to note that the present value of cash flows is generally based upon the effective interest rate at the time the loan was acquired, meaning that the credit loss will not reflect changes in interest rates.

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[15] *See* FASB, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993).

[16] *See* Financial Accounting Standards Board Staff Positions, No. FAS 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (November 3, 2005) ("**FSP 115-1**").

[17] *See* Financial Accounting Standards Board Staff Positions, No. FAS 115-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 9, 2009), codified as part of Accounting Standards Codification 320 ("**FSP 115-2**").

In making the OTTI assessment, a holder is required to consider "all available information relevant to the collectibility of the debt security, including information about past events, current conditions, and reasonable and supportable forecasts." That information should generally include "the remaining payment terms of the debt security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral."[18] Further, in determining whether a credit loss exists and the period over which the debt security is expected to recover, FSP 115-2 provides the following non-inclusive list of factors:

> a. The length of time and the extent to which the fair value has been less than the amortized cost basis
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> b. Adverse conditions specifically related to the security, an industry, or geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement)
>
> c. The historical and implied volatility of the fair value of the security
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> d. The payment structure of the debt security (for example, nontraditional loan terms as described in FSP SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk*) and the likelihood of the issuer being able to make payments that increase in the future. Failure of the issuer of the security to make scheduled interest or principal payments
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> f. Any changes to the rating of the security by a rating agency
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> g. Recoveries or additional declines in fair value subsequent to the balance sheet date.[19]

The amount of OTTI recognized in earnings depends on whether or not the holder intends to sell the impaired debt security or it is more likely that not will be required to sell the debt security before recovery of its amortized cost basis. If sale is intended or more likely than not, then the full amount of the OTTI (*i.e.*, the entire difference between the debt security's cost and its fair value at the balance sheet date) is recognized in earnings. If not, the impairment is separated into two parts: (1) the difference between the present value of the cash flows expected to be collected from the debt security and the amortized cost basis of the debt security (the "**credit loss**"), and (2) the amount of the impairment related to all other factors (the "**other loss**"). The credit loss is recognized in earnings (*i.e.*, on the income statement), while the non-credit component of OTTI is

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[18] *See* FSP 115-2 ¶ 26.

[19] *See* FSP 115-2 ¶ 25.

recognized in "other comprehensive income" ("**OCI**") (*i.e.*, on the balance sheet). Only the portion of the impairment that is recognized in earnings for U.S. GAAP purposes reduces regulatory capital.[20]

b) Consistency with Standards for Worthlessness under Section 166

"Worthlessness for Section 166 purposes has no succinct definition; it is determined on the basis of 'all pertinent evidence.'"[21] Many courts follow a standard based upon sound business judgment.[22] In using this judgment, the taxpayer must follow a rule of reason, balancing between the roles of the "incorrigible optimist"[23] and the "stygian pessimist."[24] That is, the taxpayer must "strike a middle course between optimism and pessimism and determine debts to be worthless in the exercise of sound business judgment based upon as complete information as is reasonably obtainable."[25]

We believe that the bank regulatory standards incorporating U.S. GAAP principles are consistent with the standards for worthlessness under Section 166. In the discussion below we consider the U.S. GAAP principles for both (i) "plain" loans, which give rise to the majority of loan charge-offs, and (ii) more complex debt assets subject to OTTI treatment.

With respect to "plain" loans and debt instruments, we believe that the plain language of the definition of Loss recited above tracks very closely the definition of worthlessness under tax law. The 1991 Treasury Report acknowledged as much when evaluating the same definition of Loss and concluding that it was consistent with tax standards for worthlessness.[26] Accordingly, we believe the U.S. GAAP principles that currently apply, and have applied since the adoption of the Conclusive Presumption Regulations, are consistent with tax standards for worthlessness.

With respect to the more complex debt assets subject to the OTTI treatment, we believe that the U.S. GAAP principles that apply are consistent with tax standards for worthlessness for several reasons discussed in the paragraphs that follow. At the outset, it is important to note that the OTTI treatment is reserved for those instruments that are treated as a loan for tax purposes and a

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20 *See, e.g.*, OCC Bulletin 2009-11 (April 17, 2009); SEC Staff Accounting Bulletin No. 111 (April 13, 2009); Board of Governors of the Federal Reserve System, Supplemental Instructions for June 2009.

21 *See* 1991 Treasury Report, p.22 (citing *Minneapolis, St. P. & S. Ste. M. R.R.* v. *United States*, 164 Cl. Ct. 226, 241 (1964)).

22 *See, e.g.*, *Mann Est.* v. *United States*, 731 F.2d 267 (5th Cir. 1984); *Minneapolis, St. Paul & Sault Ste. Marie R.R. Co.* v. *United States*, 164 Ct. Cl. 226 (1964); *Washington Inst. of Technology, Inc.* v. *Comm'r*, 10 T.C.M. 17, 20 (1951).

23 *See United States* v. *S. S. White Dental Mfg. Co.*, 274 U.S. 398, 403 (1927).

24 *See Ruppert* v. *United States*, 22 F. Supp. 428, 431 (Ct. Cl. 1938).

25 *See Minneapolis, St. Paul & Sault Ste. Marie R.R. Co.* v. *United States*, 164 Ct. Cl. 226 (1964).

26 *See* 1991 Treasury Report, p.22.

security for regulatory purposes, and a relatively small minority of charge-offs are attributable to such complex debt assets.

First, the FASB intentionally chose the term "other-than-temporary" to describe impairments that fall between temporary and permanent,[27] which is consistent with the tax authorities when they state that worthlessness for tax purposes is bounded by the "incorrigible optimist" and the "stygian pessimist."

Second, we believe that the OTTI assessment requires precisely what is described in tax law as the "exercise of sound business judgment based upon as complete information as is readily obtainable."[28] Specifically, the OTTI assessment requires a holder to "consider all available information relevant to the collectibility of the debt security, including information about past events, current conditions, and reasonable and supportable forecasts, when developing the estimate of cash flows expected to be collected."[29] Further, the specific factors evaluated pursuant to an OTTI assessment, *i.e.*, "the remaining payment terms of the security, prepayment speeds, the financial condition of the issuer(s), expected defaults, and the value of any underlying collateral,"[30] are consistent with tax standards for worthlessness. For example, tax authorities have upheld a deduction for worthlessness under Section 166 where there was a decline in the debtor's business[31] or a decline in value of property securing the debt.[32]

Third, the 1991 Treasury Report concluded that factors similar to those for determining an OTTI were sufficiently similar to tax standards for worthlessness. Specifically, the 1991 Treasury Report identified the following factors that were taken into consideration for asset classification for regulatory purposes:

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27 *See, e.g.*, SEC Staff Accounting Bulletin Series Topic 5.M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities (May 16, 2003) ("**Topic 5.M**").

> Question: Does the staff believe that the phrase "other than temporary" should be interpreted to mean "permanent"?
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> Interpretive Response: No. The staff believes that the FASB consciously chose the phrase "other than temporary" because it did not intend that the test be "permanent impairment," as has been used elsewhere in accounting practice.

See id. In April 13, 2009, Topic 5.M was amended in response to FSP 115-2 to apply only to equity securities. *See* SEC Staff Accounting Bulletin No. 111 (April 13, 2009).

28 *See Minneapolis, St. Paul & Sault Ste. Marie R.R. Co.* v. *United States*, 164 Ct. Cl. 226 (1964).

29 *See* FSP 115-2 ¶ 26.

30 *See* FSP 115-2 ¶ 26.

31 *See, e.g.*, *Washington Inst. of Technology, Inc.* v. *Comm'r*, 10 T.C.M. 17 (1951); *Continental Illinois Nat'l Bank & Trust Co.* v. *United States*, 81-1 USTC ¶ 9185 (N.D. Ill. 1981).

32 *See, e.g.*, *Murchison Nat'l Bank* v. *Grissom*, 50 F.2d 1056 (4th Cir. 1931).

> In general, institutions classify commercial and real estate loans on the basis of the borrower's financial statements, the borrower's condition compared to the industry average, whether a borrower has complied with the repayment terms of the loan, the adequacy of the collateral or income stream that secures repayment, the existence of contingent liabilities, the likelihood of the borrower's business success, and the overall economic conditions affecting the borrower.[33]

These factors are similar to the factors utilized under current U.S. GAAP principles to determine whether there has been an OTTI.[34]

Superficially, however, it may appear that the standards for recognition of the OTTI may be inconsistent with the tax standards requiring that debt become worthless within the taxable year of the deduction, because they take into account the probability of a future sale of a debt asset or the taxpayer's ability to hold the debt to term necessary to collect the scheduled cash flows (*i.e.*, may be viewed as relying on a probabilistic view of events that have not yet realized). In addition, in the case of debt assets the holder intends to sell or more likely than not will be required to sell, the deduction could exceed the credit loss. (As discussed above, in general, the credit loss is recognized in earnings and reduces regulatory capital, while the non-credit component is recognized in OCI on the balance sheet.) We believe, however, that as a practical matter, any acceleration of credit loss recognition in reliance on the OTTI principles would be minimal, if any, because in most instances, the debt asset would indeed be disposed of shortly after the regulatory determination, thereby leading to a full tax realization event. Importantly, because of constant regulatory scrutiny, any potential for manipulation of the timing of the deduction is virtually nonexistent. Therefore, even in cases where the standards may superficially seem to diverge, we believe that the administrative efficiency outweighs any benefit gained from achieving marginally more accurate timing in the tax deduction.

We therefore believe that the current regulatory standards for impairment are sufficiently similar to tax standards for worthlessness for the reasons that the 1991 Treasury Report concluded the same with respect to regulatory standards then in effect. Accordingly, we recommend that the conformity election should allow a taxpayer to deduct an amount of losses equal to the loans determined worthless under the current regulatory standards and, with respect to any OTTI assets, to deduct an amount equal to the amount of the reduction in regulatory capital.

4. Should § 1.166-2(d)(1) and (3) be replaced with a single rule or should the regulations retain more than one conclusive presumption of worthlessness?

We believe that the Conclusive Presumption Regulations and the conformity election should be replaced with a single rule that applies equally to all banks, bank holding companies and their non-bank subsidiaries, and potentially to all regulated companies, and to all debt assets subject to Section 166. Specifically, we believe that, if an election is made, debt should be conclusively

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[33] *See* 1991 Treasury Report, pp.22–23.

[34] *See* FSP 115-2 ¶ 26.

presumed to be worthless if and to the extent that such debt is classified as a loss asset and gives rise to a loss recognized in earnings on financial statements subject to review by the financial institution's primary regulator. As discussed in part (b) of our response to Question 3, above, the regulatory standards and accounting standards under which worthlessness of debt is determined for banks, bank holding companies, and their non-bank subsidiaries are sufficiently consistent with the tax standards for determining the worthlessness of debt. In addition, as discussed in our response to Question 1, above, banks, bank holding companies, and their non-bank subsidiaries are subject to the same extensive scrutiny from primary regulators. The administrative efficiency that can be gained from the tax treatment uniformly and consistently following the regulatory and accounting determination of worthlessness in this context greatly outweighs any marginal precision in timing of the tax deductions. Accordingly, we believe that there is no principled reason for any difference in crafting of the rules with respect to taxpayers that are regulated banks, bank holding companies, or their non-bank subsidiaries or with respect to different types of debt assets that such taxpayers may hold.

5. What process should be required by any new conclusive presumption regulations to verify that the regulated entity applied appropriate regulatory standards in taking a charge-off?

We believe that verification should be achieved by an attestation from the taxpayer that the taxpayer has reported worthless debts consistently for tax and regulatory reporting purposes and that the regulators have not adjusted such write-offs.

The purpose of the conclusive presumption rules is to provide administrative convenience in that debt assets treated consistently for regulatory and tax reporting purposes are examined by only one agency. Burdensome verification reduces the efficiency the conclusive presumption rules are intended to provide resulting in a double audit if the taxpayer is unable to produce the required regulatory verification. The verification requirements under the Conclusive Presumption Regulations (*i.e.*, a written confirmation that regulators either ordered a specific charge-off or that the regulated entity maintains and applies loan loss classification standards consistent with regulatory standards) are burdensome, because regulators generally are reluctant to provide written confirmation.[35] Therefore, we recommend that the current verification requirements be eliminated and replaced by a uniform attestation requirement described above.

6. Are there limits that should be placed on the extent to which the timing of a deduction under Section 166 may vary from the time when the regulatory standards mandate a charge-off?

We believe that the timing of such charge-off for regulatory reporting purposes generally should be respected for tax purposes. We agree with the Treasury Department when it acknowledged that, while regulators and the IRS have different inclinations with respect to the timing

[35] We note in this regard that it is unlawful to disclose certain confidential regulatory orders and reports and that regulators are generally hesitant to provide any additional written confirmation. Further, certain regulators, including the FDIC, have confirmed that they have a policy of not issuing any letters other than an "express determination letter", and the IRS has in certain circumstances refused to accept such express determination letters for the purposes of verifying a specific charge-off made by a bank that had not made the conformity election.

of a charge-off, "[i]t is unlikely . . . that regulated institutions generally would exploit the conservatism of the regulators to the serious detriment of the tax system," because "[t]he diminished earnings and capital that would result from excessive charge-offs could create adverse perceptions in the securities markets" and would have "similar adverse consequences" with respect to regulatory capital requirements.[36] The potential detriments of any such manipulation to a regulated institution have compounded since 1991 due to greatly increased regulatory capital requirements.

We anticipate that, under the revised conclusive presumption rules, most taxpayers would choose to make a conformity election in order to benefit from the significant administrative efficiencies and conserve resources. However, this may not always be the case. We believe that the revised conclusive presumption rules should preserve the elective nature of conformity method and thereby preserve taxpayers' ability to rely solely on tax standards in determining the amount and timing of a deduction under Section 166. This is consistent with the current regulations, wherein the conformity method is elective and a taxpayer not making the election may, in certain circumstances, take the position that a deduction under Section 166 occurs at a time that varies from the time that regulatory standards mandate a charge-off.

7. Are there impediments to the uniform application of a loss standard across different U.S. GAAP debt classifications?

As noted in our discussion responding to the other questions, there are a variety of types of debt assets that financial institutions hold. For the reasons discussed below, we believe that there are no impediments to the uniform application of the same loss standard across different U.S. GAAP debt classifications and the losses with respect to all these assets should be permitted to be recognized for tax purposes at the same time as they are recognized for regulatory purposes.

Accounting and regulatory rules and processes may vary somewhat based on the type of debt. That being said, we believe a common principle applies to determining the recognition of worthlessness on these assets. When circumstances suggest that an economic loss has occurred, prescribed methodologies and measurements are performed to determine if the asset is wholly or partially worthless. If these standards are met, the loss must be recorded either as a charge off or as an expense in the income statement. Banks and their non-bank subsidiaries face a significant detriment in recording charge-offs (both from the standpoint of financial earnings and regulatory capital) that ensures that there is minimal incentive to manipulate the regulatory determination to accelerate a tax deduction. Furthermore, such determinations are routinely scrutinized by the regulators. As discussed further below, for loan assets, which produce the majority of losses incurred by a bank, the regulatory standards for worthlessness determination remain substantially similar to the tax standards. And, as described above, for the OTTI assets, any potential acceleration in the worthlessness recognition in reliance on the expectation of an impending sale would be immaterial, because the probability that such sale would occur shortly is significant. Thus, a tax realization event would follow shortly that would crystallize the amount of any loss.

In considering the uniform application of the loss standards to different types of debt, we recognize the complexities depending on the accounting and regulatory considerations.

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[36] *See* 1991 Treasury Report, pp.23–24.

Below, we include brief descriptions of various types of debt assets and related accounting and tax considerations and restate our recommendations:[37]

- Traditional loans. As noted above, most financial institutions hold a portfolio of traditional loans. For U.S. GAAP purposes, an allowance for loan loss is established for potential losses through a charge to book expense. This U.S. GAAP expense is initially not an allowable loss for tax purposes. When an asset becomes wholly or partially worthless, a charge off is taken against the book allowance for loan losses. We believe that the accounting and regulatory standards for determining when the charge off should occur are substantially similar to the worthlessness standards under Section 166 and the tax loss should be allowed at the time of the book charge off.

- Debt assets that are marked to market ("**MTM**") for U.S. GAAP. There are a variety of situations in which a debt asset may be MTM for U.S. GAAP. This may include trading assets, assets that are in the process of being sold, etc. The accounting treatment of MTM adjustments may include a credit component and also other valuation drivers. For a taxpayer that is eligible to elect and has properly applied the tax MTM treatment to debt assets that are subject to Section 475, tax treatment would generally conform to U.S. GAAP treatment. If tax MTM treatment is not applicable, a taxpayer would have to determine the portion of a mark, if any, that meets the OTTI criterion set forth above. We believe a tax loss should be allowed at the time of the book charge off with respect to the OTTI portion related to credit loss, which reduces regulatory capital.

- Debt assets that are classified as available for sale ("**AFS**"). For U.S. GAAP, these assets are marked to their fair value each reporting period with the change in value included in OCI, unless there is an OTTI event. The value change in OCI is not reflected in U.S. GAAP earnings. If there is an OTTI event, the expense is recorded in the income statement. We believe a tax loss should be allowed at the time of the profit and loss charge off.

- Debt assets that are classified as held to maturity ("**HTM**"). These assets are not MTM for U.S. GAAP purposes either through the income statement or OCI. If there is an OTTI event, the expense is recorded in the income statement. We believe a tax loss should be allowed at the time of the profit and loss charge off.

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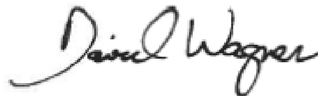
[37] The discussion below does not address loans and debt assets purchased at a premium or a discount. We believe that the determination of a loan's initial U.S. GAAP carrying value in a purchase transaction considers many factors and does not clearly represent a standard of worthlessness. We do not expect that the conformity election under the revised conclusive presumption rules would require a taxpayer having made such election to conform the regulatory and tax treatment of such purchased loans and debt assets.

We greatly appreciate your consideration of our comments and would welcome the opportunity to discuss them further with you at your convenience. If we can facilitate arranging those discussions, or if you have any question or are in need of any further information, please contact David Wagner at 212.613.9883 (email: david.wagner@theclearinghouse.org) or Fran Mordi at 202.663.5317 (email: fmordi@aba.com).

Respectfully submitted,



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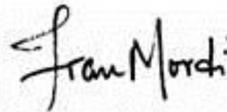

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