Report to The Congress on
The Tax Treatment of
Bad Debts by Financial Institutions

Department of the Treasury
September 1991

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The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The Conference Report for the Tax Reform Act of 1986 directed the Treasury Department to study and report on the appropriate criteria to be used in determining whether a debt is worthless for Federal income tax purposes, and specifically to consider the circumstances under which it would be appropriate to provide a conclusive or rebuttable presumption of worthlessness (H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-316 (1986)).

Pursuant to that directive, I hereby submit this "Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

September 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

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Pursuant to that directive, I hereby submit this "Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions."

I am sending a similar letter to Senator Bob Packwood.

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I. INTRODUCTION

The Internal Revenue Code (the Code) has from its inception permitted holders of business debts to deduct the losses resulting from the nonpayment of those debts. Historically, the Code has prescribed two alternative methods for determining the amount of the business bad debt deduction allowed for any taxable year. Taxpayers generally could choose to compute their bad debt deduction either by determining on a loan-by-loan basis the debts that had become uncollectible (the specific charge-off method of accounting for bad debts)[1] or by determining the amount of the addition for the taxable year to a reserve for bad debts required to cause that reserve to equal the debts held by the taxpayer that are expected to become worthless (the reserve method of accounting for bad debts).[2] Once a taxpayer properly selected a method, the consent of the Commissioner was generally required to change it.[3]

The Tax Reform Act of 1986 (the 1986 Act) repealed the reserve method for all taxpayers other than thrift institutions and commercial banks that are not "large" banks.[4] Accordingly, large banks, non-depository financial institutions, and taxpayers generally may use only the specific charge-off method for determining their bad debt deduction. When it repealed the reserve method for most taxpayers, Congress directed the Treasury Department to study and report on the appropriate criteria to be used in determining whether a debt is worthless for Federal income tax purposes and specifically to consider the circumstances under which it would be appropriate to provide a conclusive or rebuttable presumption of worthlessness.[5]

A. Bad debt deductions

The two methods that have historically been used to compute the bad debt deduction under section 166 of the Code are the specific charge-off method and the reserve method.

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[1] I.R.C. § 166(a); Treas. Reg. §1.166-1(a)(1).

[2] See Treas. Reg. § 1.166-1(a)(2). Prior to its repeal in 1986, section 166(c) provided statutory authority for the reserve method. Special rules have governed the reserve methods available to commercial banks and savings and loan institutions (hereinafter "thrift institutions" or "thrifts"). See, e.g., I.R.C. §§ 585 and 593.

[3] Treas. Reg. § 1.166-1(b)(2).

[4] Pub. L. No. 99-514, § 805(a) (1986). A bank is a large bank if the average adjusted bases of its assets exceed $500 million or if it is a member of a controlled group the average adjusted bases of all assets of which exceed $500 million. I.R.C. § 585(c)(2). For purposes of this report, all banks not meeting the definition of a large bank are referred to as "small" banks.

[5] H. R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-316 (1986).

1. Specific charge-off method

A debt that is completely worthless may be deducted only in the year it becomes worthless.[6] Thus, the bad debt deduction claimed for any year must be supported by a showing that the debt had some value at the beginning of the year and that some change in the debtor's condition occurred during the year.[7] In determining whether a debt is worthless, "all pertinent evidence," including the adequacy of the collateral and the financial condition of the debtor, will be considered.[8] An inherent difficulty in identifying the year of deduction is that worthlessness often results from a gradual deterioration in the debtor's financial condition rather than an easily identified event. A special 7-year statute of limitations applicable to refund claims based on worthless debts mitigates the hardship that may arise when a debt is determined to have become worthless in a year earlier than the one in which the taxpayer claimed it as a bad debt deduction.[9]

If it can be determined that only part of a debt is recoverable, the worthless portion may be deducted in the year in which the taxpayer charges it off for book purposes.[10] Unlike the case of a wholly worthless debt, the taxpayer need not show that the partial worthlessness occurred in the year of deduction, thereby permitting the taxpayer a certain amount of flexibility in the timing of such deductions.[11] Another important way in which deductions for partially worthless and wholly worthless debts differ is that Congress has delegated to the Commissioner discretion to allow the deduction for a partially worthless debt.[12] As a result, the taxpayer may bear a heavier burden in establishing the correctness of the partial worthlessness write-off, because the issue in litigating a taxpayer's disallowed partial worthlessness deduction is not whether the debt is partially worthless, but whether the Commissioner's denial of the deduction is arbitrary or unreasonable.[13]

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[6]I.R.C. § 166(a)(1).

[7]See Denver & R.G.W.R.R. Co. v. Commissioner, 279 F.2d 368 (10th Cir. 1960).

[8]Treas. Reg. § 1.166-2(a). Except in the case of the special rule applicable to regulated financial institutions described below, there is no specific requirement that a wholly worthless debt be charged off for book purposes in the year it becomes worthless.

[9]I.R.C. § 6511(d)(1).

[10]I.R.C. § 166(a)(2).

[11]The extended statute of limitations under I.R.C. § 6511(d) does not apply to deductions claimed for partially worthless debts. Treas. Reg. § 301.6511(d)-1(c).

[12]I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(ii).

[13]See Brimberry v. Commissioner, 588 F.2d 975 (5th Cir. 1979).

Special rule applicable to depository institutions

Treasury regulations provide a special rule that allows regulated financial institutions a conclusive presumption that debts that are properly charged off for regulatory purposes are worthless for purposes of applying section 166 if certain conditions are met.[14] This conformity of tax and regulatory accounting generally applies only to loans classified under regulatory standards as loss assets, which are evaluated according to criteria comparable to those applied under section 166.[15] Therefore, the conclusive presumption does not apply where the institution writes down real estate or other property obtained in foreclosure in compliance with regulatory requirements that such assets be carried at the lower of net book or current market value.[16] The history and current operation of the conformity rule is discussed in greater detail at pages 16-19, below.

Amount of allowable bad debt deduction

Generally, a deduction for a wholly worthless debt is allowed to the extent of outstanding principal and previously reported but uncollected interest.[17] The amount of the deduction can therefore not exceed the taxpayer's adjusted basis in the debt, computed in the manner used for determining the loss from the sale or other disposition of the property. In the case of repossessions and foreclosures, the amount of the deduction is equal to the amount by which the taxpayer's basis in the debt exceeds the fair market value of the repossessed or foreclosed property.[18] If a bad debt deduction is allowed for a partially worthless debt, the basis of the debt is reduced by the amount of the deduction. If the taxpayer recovers an amount on a debt after having deducted it as a bad debt, the amount recovered is taxable income to the taxpayer in the year of recovery.[19]

2. Reserve method

Prior to the repeal of section 166(c) in 1986, the reserve method generally permitted a bad debt deduction for a year equal to an amount determined to be a reasonable addition to the

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[14]Treas. Reg. § 1.166-2(d).

[15]Regulators may occasionally require institutions to charge off loans that are very weak but not yet deserving of loss classification.

[16]Rev. Rul. 84-95, 1984-2 C.B. 53.

[17]I.R.C. § 166(b); Treas. Reg. § 1.166-1(d)(1).

[18]Treas. Reg. § 1.166-6; I.R.C. § 595(a).

[19]Treas. Reg. § 1.166-1(f).

taxpayer's reserve for bad debts for that year.[20] The reasonable addition to the reserve for any year was that amount necessary to bring the beginning bad debt reserve balance, adjusted for actual bad debt losses and recoveries during the year, to the permitted ending reserve balance, which had to be computed under an approved method.[21] The most widely used formula for determining the ending reserve balance was based on a six-year moving average, determined by dividing the sum of the bad debts actually charged off for tax purposes[22] (net of actual recoveries) for the most recent six years (including the current year) by the sum of the debts owed the taxpayer at the end of each year of the same six-year period. This average bad debt ratio was multiplied by the sum of the debts outstanding at the close of the year to produce the permitted ending reserve balance for the current year.[23] This method (the experience method) produces an ending reserve balance based on past experience that approximates the bad debt charge-offs expected to occur in a single taxable year.

The 1986 Act severely limited the use of the reserve method for computing bad debt deductions. It is now available only for thrifts and small banks. Small banks using the reserve method are limited to the experience method described above.[24] Thrifts eligible to use the reserve method under section 593 may use either the experience method or the percentage of taxable income method.[25] Under the percentage of taxable income method, the addition to the

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[20]See Treas. Reg. § 1.166-1(a)(2).

[21]Treas. Reg. § 1.166-4.

[22]In determining the amount of debts actually charged off, depository institutions using the reserve method were permitted to apply the conclusive presumption of worthlessness described at p. 5, above.

[23]This formula is based on the decision in Black Motor Company v. Commissioner, 41 B.T.A. 300 (1940), aff'd, 125 F.2d 977 (6th Cir. 1942).

[24]I.R.C. § 585(b)(2).

[25]I.R.C. § 593(b)(2). Until 1951, thrifts were exempt from federal income tax. Although they became subject to the corporate income tax in 1952, thrifts were generally allowed a bad debt reserve deduction for a taxable year equal to 100 percent of taxable income for the year. In 1962, Congress reduced the percentage of taxable income that could be claimed as a bad debt reserve deduction to 60 percent. This amendment was designed to produce some level of tax from thrifts and at the same time to encourage the residential real estate loans that constituted the bulk of thrifts' lending activities. Between 1969 and 1979, the allowable percentage of taxable income reserve method fell gradually from 60 percent to 40 percent. The 1986 Act reduced the allowable percentage to the present 8 percent.

reserve for a year is generally equal to 8 percent of the institution's taxable income for that year.[26] In any given year, thrifts may use either the experience method or the percentage of taxable income method, whichever is more advantageous.[27]

B. Nonaccrual of interest

An accrual method taxpayer generally takes amounts into income when the right to the income is fixed and the amount of the income can be determined with reasonable accuracy.[28] Under an exception to this general rule, income must not be accrued if, at the time the right to the income arises, the income is uncollectible.[29] In the case of interest on a loan, uncollectibility is determined based on not only whether the debtor is currently delinquent but also whether there is evidence that the income will never be paid. Therefore, mere untimeliness of payment is not necessarily substantial evidence of uncollectibility and will not alone support nonaccrual of the income.[30] Other factors, such as the solvency of the debtor and the course of dealings between the debtor and the creditor, must be taken into account. There is no special rule applicable to regulated institutions permitting a presumption of uncollectibility for interest on loans that are placed in nonaccrual status under financial institution regulatory standards.

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[26]The excess of the deduction produced by the percentage of taxable income method over the taxpayer's actual loss experience is a preference item for purposes of the corporate alternative minimum tax. I.R.C. § 57(a)(4).

[27]Treas. Reg. § 1.593-6A(a)(1); Rev. Rul. 79-123, 1979-1 C.B. 215.

[28]Treas. Reg. §§ 1.446-1(c)(ii), 1.451-1(a).

[29]Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

[30]See Georgia Schoolbook Depository v. Commissioner, 1 T.C. 463 (1943)(inadequacy of amounts held in state beer tax fund to be used as sole source for payment of amounts owed to taxpayer not sufficient basis for nonaccrual of income where source of funds would increase in subsequent years); Koehring Company v. United States, 421 F.2d 715 (Ct. Cl. 1970)(unpaid royalties owed to taxpayer constituted accrued income because business reverses causing nonpayment were temporary and ultimately full payment could be expected); and Union Pacific Railroad Co. v. Commissioner, 14 T.C. 401 (1950)(taxpayer's failure to receive interest income on bonds it held did not justify nonaccrual because issuer's business reverses, although protracted, were temporary).

II.   COMPARISON OF THE CHARGE-OFF AND RESERVE METHODS

A.   Reasons for repeal of the reserve method

The legislative history of the 1986 Act cites two interrelated reasons for the general repeal of the reserve method. First, Congress believed that in permitting current tax deductions for statistically computed losses that will occur in the future, the reserve for bad debts was inconsistent with the treatment of other deductions, which may generally not be taken into account for tax purposes until the event to which the deduction is economically related has occurred. Second, because the deduction for the increase in the tax bad debt reserve represents a current deduction for the full amount of losses to be incurred in the future, the reserve method results in overstated deductions.[31]

In seeking to conform the treatment of bad debt deductions to other types of deductions, Congress was revisiting certain time value of money issues it had first addressed in the Tax Reform Act of 1984, when it enacted the "economic performance" requirement of section 461(h). Section 461(h) governs the time at which accrual method taxpayers may take liabilities into account for tax purposes. Prior to 1984, accrual method taxpayers could generally deduct the amount of a liability if the fact of the liability was fixed and the amount of the liability could be determined with reasonable accuracy (the all-events test). Because the rule permitted a current deduction for amounts that might be paid far into the future and made no adjustment in the amount of the deduction to take account of the time value of money, the rule produced overstated deductions. In crafting a remedy for the overstated deduction problem in 1984, Congress recognized that the correct deduction could be reached in one of two ways -- either by allowing a deduction for the present value of the deduction at the time the all-events test is satisfied or by deferring the deduction until the liability giving rise to the deduction is satisfied. Congress opted to defer the deduction, in view of the administrative complexities that would accompany the discounting approach.[32] In repealing the reserve method and requiring most taxpayers to use the specific charge-off method for bad debts, Congress in 1986 approached the time value of money issue much as it had in 1984 -- by deferring the deduction until the event giving rise to the loss had occurred.[33]

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[31]See H.R. Rep. No. 426, 99th Cong., 1st Sess. 640 (1985) and S. Rep. No. 313, 99th Cong., 2d Sess. 155 (1986).

[32]H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1254-1255 (1984).

[33]In the case of bad debts, the discounting approach would be even more administratively unwieldy than in the case of other deductions, since the time at which the default will occur cannot be known with certainty at the time the loan is originated.

B. Accounting for loan losses

A loan is a financial contract stipulating a stream of payments to be made by the borrower to the lender. The value of the contract at any point in time is the present value of its future cash flows, discounted at a market rate of interest that represents the return on alternative uses of the lender's funds. This discount rate usually is not the contract rate of interest.[34] The value of a loan contract in any period during the life of the loan may differ from the value implied by the stated terms of the contract at the time of origination because of the possibility that those terms may not be fully satisfied. The borrower may default on the loan, producing a loss for the lender that reduces the implied value of the contract.[35] Because the lender recognizes the possibility of borrower default when he makes the loan, the terms of the lender's cash advance to the borrower will take into account the lender's expectation of future losses.

A common method of pricing a contract to account for a lender's expected loan losses is to compute for a given nominal principal a contract interest rate that incorporates a "risk premium." The addition of the risk premium yields a discounted present value for the contract's expected future payments that is equal to the nominal principal. This approach builds a cushion into the contractual payment stream to absorb the expected losses.

The effect of the charge-off and reserve methods on the value of a loan portfolio depends upon the timing of the recognition of the income associated with the risk premium and the deduction associated with the loan loss. If the timing of the income recognition does not match the timing of the loss deduction, income and tax liability will be either deferred or accelerated. The following section describes the effects of the charge-off and reserve methods on the value of a loan portfolio and compares those methods to an economically efficient income tax system in which tax is imposed on economic income.

C. The taxation of income from a portfolio with loan losses

Under an economically efficient income tax system, the imposition of tax does not distort an investor's choices among assets, because it does not change the price of the asset relative to

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[34]The market interest rate may fluctuate in response to changes in economic conditions, whereas the contract rate may be fixed for the term of the loan. Assuming that market conditions and hence interest rates do not change, the contract rate and the discount rate are expected to be equal only when there is no risk of default and the price paid for the contract is the nominal contract principal.

[35]The effect of an expected failure of the borrower to honor the terms of a financial contract generally cannot be distinguished from the effect of an unexpected increase in market interest rates during the term of the loan. In either case, the value of the contract becomes less than that implied by the terms of the loan. References in this discussion to changes in the value of loans include only changes effected by borrower defaults.

the price that would exist in the absence of the tax. In the case of investment in depreciable assets, economic efficiency requires a deduction for tax depreciation that is equal to the decline in the value of an asset, so that tax is imposed on economic income. In the case of a physical asset, such a decline in value is referred to as economic depreciation, which must be deducted from gross income to arrive at economic income.[36] Similarly, the efficient allocation of investment in financial assets also requires taxation of economic income.[37]

To determine the economic income produced by the ownership of an asset, it is necessary to track the asset's value over its life. In the case of a loan portfolio that includes debts that will become uncollectible, the value of the portfolio generally changes over time in a manner that depends upon the timing of the expected nonperformance. In each period, economic income earned on the portfolio equals the net cash flow received in that period plus the changes in the value of the portfolio. Since conceptually the current value of an asset is the present value of its expected future income stream, the decline in the value of the loan portfolio is the reduction in the present value of its expected future income stream.[38]

The present tax treatment of loan losses generally mismeasures economic income, because neither the charge-off nor reserve methods accurately reflects changes in the market value of the loan portfolio. Under both the charge-off and reserve methods, the timing of the recognition of income attributable to the risk premium differs from the timing of the recognition of the associated loss, which may result in a deferral or acceleration of income. If the present value of unrecognized income is positive, income and tax liability are deferred and the value of the portfolio increases relative to its pre-tax value. Alternatively, if the present value of the unrecognized income is negative, the after-tax value of the portfolio is less than its pre-tax value.

1. The effect of early loan losses

The effect of the charge-off and reserve methods on the value of a loan portfolio depends upon the timing of the losses during the life of a loan.[39] When losses occur early in the life

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[36]See Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," Journal of Political Economy (December 1964), pp. 604-6.

[37]See Arnold C. Harberger, "Tax Neutrality in Investment Incentives," in The Economics of Taxation, H. J. Aaron and M. J. Boskin, eds., Washington, D.C.: The Brookings Institution (1980), pp. 303-6.

[38]When economic income is taxed, the effective tax rate (the percentage reduction in the internal rate of return attributable to taxes) is equal to the statutory tax rate.

[39]The Appendix illustrates the effect of the timing of debtor nonperformance using two hypothetical loan portfolios in which losses occur early and late in the life of the loans, respectively. It analyzes the economic accrual of the loan losses and compares such accrual to the tax accounting for the loan losses. These hypothetical examples assume that the timing of

of a loan, both the charge-off and reserve methods increase the value of a loan portfolio because they defer the recognition of income attributable to the risk premium relative to the deduction for the associated loss. The present value of after-tax cash flows from the loan portfolio will exceed the present value of before-tax cash flows, because the lender has deducted defaulted amounts before he has taken into income payments reflecting the risk premium charged on all loans. Because the pre-tax and after-tax portfolio values differ, investment decisions are likely to be distorted.

The disparity between the after-tax value of the loan portfolio and its pre-tax value is greater under the reserve method than under the charge-off method, because the mismatch between the time the deductions attributable to loan losses are taken and the time the risk premium is included in income is more extreme under the reserve method. Under the charge-off method, declines in the value of the loan portfolio are recognized when loans are charged off. The reserve method anticipates future loan losses. Neither method reflects unrealized changes in the market value of the loan portfolio.

Under the charge-off and reserve methods taxable income is lower than economic income in the early years of the contract and higher in the later years. This pattern occurs because the recognition of income attributable to the risk premium covering expected losses tends to be deferred relative to the deduction for the associated loss. As a result, both methods defer income and tax liability. Under the reserve method, however, the deferred income and tax liability are larger, because the reserve method tends to accelerate deductions relative to the economic decline in the value of the portfolio to a greater extent than the charge-off method.

2. The effect of late loan losses

When loan losses occur late in the life of a loan, the charge-off and reserve methods may favor or disadvantage the loan portfolio. The charge-off method disadvantages the portfolio because it defers the recognition of loan losses relative to the recognition of income attributable to the risk premium. The reserve method favors the portfolio because it allows deductions for losses before they accrue.

Compared with economic income, taxable income under the charge-off and reserve methods is higher in the early years of the contract and lower in the later years. The charge-off method defers deductions for declines in the value of a loan portfolio attributable to defaults until the default occurs. The reserve method permits a deduction in the year of origination for defaults that occur late in the life of the contract in addition to deductions allowed under the charge-off method. As a result, taxable income under the reserve method is lower than under the charge-off method. Whereas the charge-off method reduces the value of the portfolio by deferring

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debtor nonperformance and the rate of return the lender would receive on alternative investments are known with certainty (i.e., that all "losses" are expected). These factors are difficult to ascertain in practice.

losses (the present value of deferred tax liability is negative), the reserve method increases the value of the portfolio by accelerating deductions (the present value of the deferred tax liability is positive.)

D. Conclusion

An economically efficient income tax system would measure accurately the lender's economic income, which consists of principal and interest payments and changes in the value of the portfolio. The market value of the portfolio is based on the portfolio's expected cash flow and the expected return on alternative investments. To measure economic income correctly, the value of a portfolio of loans would have to be adjusted annually to reflect changes in its market value. In practice, such adjustments would be problematic, because they would require annual price quotes or knowledge of the lender's expectations of future loan losses and rate of return on alternative investments.

Neither the charge-off nor reserve methods measure economic income accurately. The charge-off method may favor or disadvantage a loan portfolio, depending upon the timing of the loan losses. When losses occur early in the life of the contract, the charge-off method will increase the value of the portfolio by deferring income and tax liability. When losses occur late in the life of the contract, the charge-off method will disadvantage the portfolio by deferring losses. Although neither method correctly measures economic income, the reserve method tends to accelerate deductions relative to the true economic decline in the value of the portfolio, and thus favors the portfolio regardless of the timing of the losses. The best practical alternative to taxing economic income is the consistent taxation of realized income. In achieving this purpose, the charge-off method is preferable to the reserve method, because it is less distortionary for a wide variety of fully anticipated loan default characteristics.

III. CONFORMITY OF TAX TO REGULATORY STANDARDS OF WORTHLESSNESS

As described at page 3, above, there has long been a rule that debts held by depository institutions that are charged off for regulatory purposes are conclusively presumed to be worthless for purposes of the bad debt deduction if certain conditions are met. This section of the report describes the federal regulatory framework applicable to commercial banks and thrift institutions, outlines the system for classifying assets for regulatory purposes, and analyzes the history and policy considerations underlying the conformity of tax and regulatory treatment of loss assets.

A. Regulatory framework

Under the present regulatory framework, federal supervisory authority over depository institutions is exercised by several regulatory bodies that are charged with the oversight of particular groups of institutions. The distribution of supervisory responsibilities is summarized below.

1. Commercial banks

Responsibility for the regulation of commercial banks is distributed among the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (FRB) and the Federal Deposit Insurance Corporation (FDIC). The OCC charters, regulates and supervises national banks.[40] It carries out its supervisory functions through both on-site examinations and off-site review of regular reports and other relevant information that banks are required to supply.[41]

The FRB was created in 1913 to provide stability and uniformity to the banking system through a system of regional Federal Reserve Banks. All national banks are required to be members of the Federal Reserve System (FRS), and state-chartered banks may elect to become members.[42] The FRB also has sole jurisdiction over bank holding companies.[43] The FRB plays the same regulatory role with respect to its state-chartered members and their affiliates as the OCC plays with respect to national banks.[44]

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[40]12 U.S.C. § 1.

[41]Comptroller of the Currency, Handbook for National Bank Examiners -- Commercial, International (hereinafter "Handbook") § 1.1 (1979).

[42]U.S.C. §§ 222, 321.

[43]12 U.S.C. § 1844(b).

[44]12 U.S.C. §§ 325, 338, 248(a) and 483.

The FDIC was established in 1933 to insure the deposits of all FRS member banks as well as state nonmember banks.[45] It performs examination functions analogous to those of the OCC and the FRB with respect to state banks that are not members of the FRS.

2. Thrift institutions

Prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),[46] the Federal Home Loan Bank Board (FHLBB) operated the Federal Home Loan Bank System, a central bank system for the thrift industry, chartered and supervised federal thrifts, and insured the deposits of member institutions through the Federal Savings and Loan Insurance Corporation (FSLIC). FIRREA abolished the FHLBB and the FSLIC and redistributed their responsibilities.[47] Under the current structure, the Office of Thrift Supervision (OTS) supervises all federal and state thrift institutions;[48] the Federal Housing Finance Board is the principal overseer of the credit operations of Federal Home Loan Banks;[49] and the FDIC insures the deposits of member S&Ls and manages defaulted savings associations.[50]

Despite the division of regulatory responsibilities involved in the supervision of financial institutions, a high degree of consistency in the application of regulatory standards is provided by the Federal Financial Institutions Examination Council (FFIEC). The FFIEC, which was created in 1978, is an interagency entity composed of representatives of each of the federal regulatory bodies and is charged with promoting the uniform examination and supervision of banks. The FFIEC achieves this by prescribing uniform principles, standards, and reporting forms.[51] The FFIEC also provides schools for training federal examiners and makes the schools available to state regulators as well.[52]

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[45]12 U.S.C. § 1811 et. seq.

[46]Pub. L. No. 101-73, 103 Stat. 183 (1989).

[47]FIRREA § 301.

[48]FIRREA § 301.

[49]FIRREA § 702(a).

[50]FIRREA § 211, 12 U.S.C. § 1821(a)(I)-(7).

[51]12 U.S.C. § 3305(b).

[52]12 U.S.C. § 3305(d).

B. Regulatory classification of assets for determining loss asset charge-offs

Under the uniform standards adopted by the federal regulatory bodies, assets that are suspect are placed in one of the four following classifications:

1. Other assets especially mentioned (OAEM). These assets are currently protected by the paying capacity of the obligor or the pledged collateral but there are signs that the asset has the potential to become a loss asset.

2. Substandard. These assets are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral securing the assets. Substandard assets in the aggregate represent some loss potential, but this classification does not necessarily reflect loss potential in any individual asset.

3. Doubtful. These assets show all of the characteristics of substandard assets and, in addition, the facts and circumstances are such that collection or liquidation of the assets is highly questionable or improbable. Nevertheless, their classification as loss assets is deferred because of other factors that may strengthen the assets. An asset generally does not remain in the doubtful category for successive examinations.

4. Loss. These assets are considered uncollectible and, despite some potential for salvage or recovery, that potential is not sufficient to justify continued treatment as bankable assets. These assets are charged off as worthless for regulatory purposes.

An additional regulatory classification applies to loans to foreign borrowers. When the quality of an institution's international loans becomes impaired by a protracted inability of foreign borrowers to make payments on their external indebtedness, regulators require either that the institution establish an allocated transfer risk reserve (ATRR) in the amount of the portion of the loans affected or charge-off the requisite amounts as a loss.[53]

The specific regulatory criteria for determining whether a loan should be placed in loss status depend on the type of credit the institution has extended. Generally, the status of commercial and real estate loans is considered in light of the value of the collateral securing the loan or other factors affecting the current creditworthiness of the borrower.[54] Other types

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[53]Handbook, § 215.1. Although citations throughout this section III.A. will be to the OCC Handbook, comparable standards apply to institutions supervised by the FRS, the FDIC, and the OTS.

Amounts required to be added to the ATRR are treated as charge-offs to which the conclusive presumption of Treas. Reg. § 1.166-2(d) applies. Rev. Rul. 84-94, 1984-1 C.B. 34.

[54]Handbook, §§ 206.3 and 213.3.

of high-volume loans, such as consumer installment loans, credit card plans, and check credit plans, are subject to more mechanical, automatic charge-off procedures. Consumer installment paper that is delinquent 120 days or more and credit card or check credit debt that is delinquent 180 days or more are considered loss assets for regulatory purposes.[55]

Regulators determine the financial condition of institutions under their jurisdiction on the basis of quarterly reports (Call Reports) furnished by the institution[56] and on-site examinations that may occur as frequently as more than once a year or as infrequently as once every three years.

The on-site examination generally includes a review of the institution's own internal loan review and loss classification standards.[57] An institution's loan officers are responsible for ensuring that each asset is properly classified according to its current risk status. As a result, institutions typically adopt an internal loan rating system that is designed to provide senior management with an accurate current assessment of the quality of the loan portfolio. Federal examiners review the methods institutions use to evaluate the quality of their loans and test the extent to which an institution's internal loan review procedures conform to federal regulatory standards by reviewing a sampling of the institution's commercial and real estate loans and by confirming that the proper automatic charge-off procedures have been adopted for installment and credit card loans.[58]

C. Relationship of regulatory loss standard to deductibility of bad debts under section 166

For 70 years, the tax treatment of bad debts by depository institutions has been linked to the treatment of such debts for regulatory purposes. This section of the study traces the evolution of this tax/regulatory relationship and the policy considerations underlying the conformity of tax to regulatory treatment under certain circumstances.

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[55]Handbook, §§ 209.1, 211.1 and 212.1.

[56]The FFIEC has developed for use by the bank regulatory agencies uniform "Reports of Condition and Income" (Call Reports), which contain extensive information regarding the classification of the institution's assets and the condition of its income. Uniform rules set forth the proper treatment of assets and income items.

[57]Handbook, § 205.1, pp. 8-9.

[58]Handbook, § 900.205.1.

1.   History of the presumption of worthlessness for regulated financial institutions

The ability of banks and other supervised corporations to use their regulators' evaluation in determining whether debts are worthless for purposes of the bad debt deduction originated in 1921. Treasury Decision 3262, which promulgated regulations under the bad debt provisions of the 1921 Revenue Act, provided a rebuttable presumption that debts charged off in whole or in part "in obedience to the specific orders or in accordance with the general policy of" bank supervisors were worthless for purposes of the bad debt deduction. As interpreted by the Board of Tax Appeals in Murchison National Bank, this presumption did not provide banks with any particular advantage over unsupervised taxpayers, because the bank examiner's treatment did not conclusively determine the appropriate tax treatment.[59]

The Murchison approach set the tone for almost a decade. But in a 1935 case, the Fourth Circuit held that a charge-off made in obedience to a regulatory order justified a bad debt deduction, regardless of the reason for the regulatory charge-off.[60] The court's rationale was that "[t]here should be at least some semblance of co-ordination between the several branches of government in dealing with the taxpayer . . . . Otherwise the banks would be compelled to keep two sets of books, one, as directed by the bank examiner, and the other for purposes of making a tax return."[61]

Despite the opinion of the Fourth Circuit, the Board of Tax Appeals held to its earlier opinions and continued to interpret the tax regulation as providing only a rather easily rebutted presumption.[62] The conflicting interpretations were resolved in favor of the Fourth Circuit's view by a 1936 amendment to the regulation that unambiguously changed the rebuttable

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[59]1 B.T.A. 617 (1925). The Board stated its views as follows:

"The fact that the entire amount of the debt was charged off in accordance with what was assumed to be the policy of the national bank examiners, seems to us to have no bearing on the question presented here. It is well known that national bank examiners, in accordance with sound banking and good business methods, often times require banks to charge off overdue paper. This action cannot be construed as indicating in any way that the paper so charged off is worthless, but only that its value is doubtful and it is desirable that banks shall include in their balance sheet only such assets as have unquestioned value." Id. at 621.

[60]Citizens National Bank of Orange v. Commissioner, 74 F.2d 604 (4th Cir. 1935).

[61]Id. at 605.

[62]See Second National Bank of Philadelphia v. Commissioner, 33 B.T.A. 750 (1935) and Citizens National Bank of Orange v. Commissioner, 33 B.T.A. 758 (1935), rem'd, 87 F.2d 999 (4th Cir. 1937).

presumption to a conclusive presumption of worthlessness.[63]   The amended regulations provided that debts charged off, in whole or in part, in obedience to the specific orders of bank supervisors were conclusively presumed to be worthless for purposes of the bad debt deduction.

At the request of the Comptroller of the Currency, the conclusive presumption of worthlessness was amended in 1973 to expand the presumption to include charge-offs made in accordance with the established policies of the institution's regulatory authority, so long as the authority confirms in writing in connection with the first examination following the charge-off that the charge-off would have been specifically ordered if the examination had been made on the date of the charge-off.[64]   Instructions for bank examiners were issued concurrently with the amendment to the regulations.   Those instructions required that, in making the necessary review prior to issuing the confirmation letter required under the amended regulations, the loans voluntarily charged off by the institution be considered individually.

At the time of the 1973 amendment to the regulations, it was the policy of the Comptroller's office that installment loans for which no payment had been received for 90 days should be charged off.   Without the amendment, banks were not entitled to the conclusive presumption of worthlessness for such loans because their charge-off was not in obedience to a specific order but rather in voluntary compliance with a regulatory policy.   The regulations were amended specifically to allow banks adopting this procedure to enjoy the benefit of the conclusive presumption with respect to installment debt.

In 1980, the FDIC published a statement that ultimately became a new interagency standard for the classification of consumer installment credit as loss assets.   It lengthened the 90-day delinquency period to 120 days for closed-end consumer installment loans and to 180 days for open-end consumer credit card loans.   The change in the loss classification standard included the following guidance to examiners: "[t]he general classification policy recognizes that evaluating the quality of a consumer credit portfolio on a loan-by-loan basis is inefficient and unnecessary."[65]

The shift from loan-by-loan review to greater reliance on statistical surveillance made the confirmation letter procedure more difficult to administer.   The Treasury Department recently proposed that its bad debt regulations be amended to take account of these changed conditions.   Under the proposed regulation, a depository institution is permitted to make a "conformity election" under which a debt that is charged off in whole or in part on the bank's books is conclusively presumed to be worthless for tax purposes if either (1) the charge-off results from a specific order by the regulator or (2) the charge-off corresponds to the institution's

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[63]T.D. 4633 (XV-1 C.B. 118).

[64]T.D. 7254, 1973-1 C.B. 77.

[65]FDIC, "Uniform Policy for Classification of Consumer Installment Credit Based on Delinquency Status" (1980).

classification of the debt, in whole or in part, as a loss asset. The second requirement is deemed to be met only if the institution's regulators have expressly determined in connection with the most recent examination of the institution's internal loan review process that the institution maintains and applies loan review and loss classification standards that are consistent with the regulatory standards of the supervisory authority.[66]

2. Policy considerations related to tax/regulatory conformity

As is evidenced by the early disagreement between the Board of Tax Appeals and the Fourth Circuit, the development of tax/regulatory conformity has been informed by two competing views. First, there is a sense that a regulated entity should not be subject to inconsistent treatment by different regulatory agencies. Although the Fourth Circuit's concern for the burdens that may be imposed by requiring the taxpayer to keep two sets of books has become less compelling with the advent of sophisticated computerized recordkeeping systems, there remains a belief that the "semblance of coordination" it sought to achieve among government agencies remains desirable.[67]

At the same time, an OCC examiner's perspective in assessing the worthlessness of an institution's loan might well differ from that of the tax auditor. The conservatism that serves the government well in its role as regulator may not produce the result that best serves the proper protection of the fisc.

In addition to these competing considerations, there is the practical question of administration. Since the specific charge-off method under section 166 and the analysis of loan portfolios for regulatory purposes both require a determination of worthlessness on a loan-by-loan basis, the absence of some sort of conformity rule would require two independent investigations of the factual basis for a particular debt's worthlessness.

As Figure 1 shows, loans constitute more than half of all assets of insured commercial banks. Moreover, as shown in Figure 2, loans charged off by insured commercial banks for regulatory purposes have risen from approximately $5 billion, just over one-fifth of net income before tax in 1980 to more than $33 billion, more than half of net income before tax in 1990.[68] In light of the large volume of loans charged off annually for regulatory purposes, ease of administration is not enough to justify a regulatory/tax conformity rule. Such a conformity rule is, however, desirable to the extent that the regulatory criteria governing the charge-off of debts are similar enough to the criteria for worthlessness under section 166 to make regulatory criteria

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[66]56 Fed. Reg. 24,154 (1991).

[67]See Rev. Rul. 80-180, 1980-2 C.B. 66.

[68]Net income before tax includes net interest income, service charges, gains on securities not held in trading accounts and certain other income and excludes provisions for loan and lease losses.

Figure 1

Loans and Assets - Insured Commercial Banks
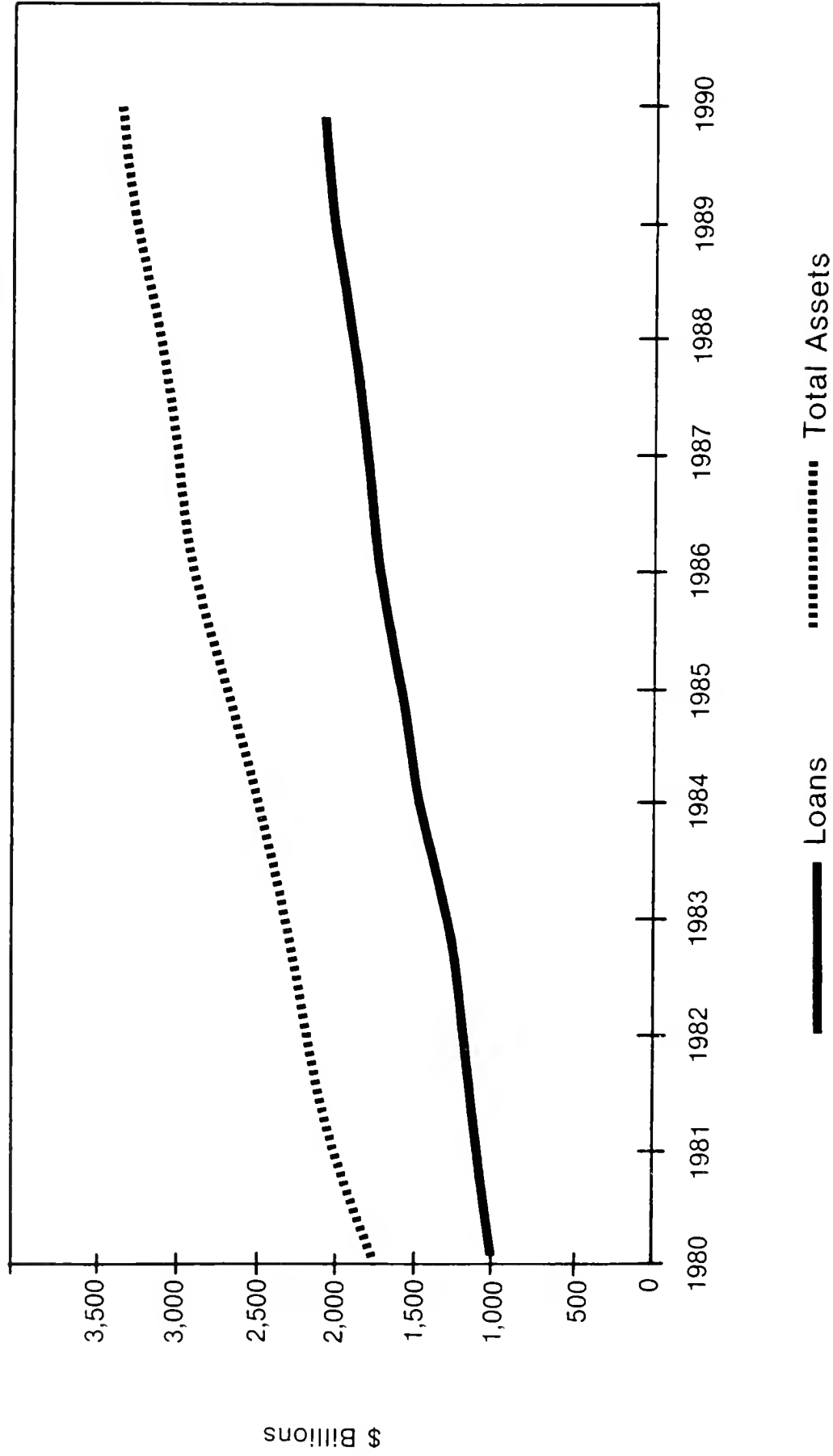
Source: Federal Deposit Insurance Corporation

Figure 2

Loans Losses and Income - Insured Commercial Banks

Source: Federal Deposit Insurance Corporation

Income before loan charge-offs

Loan charge-offs

Loan recoveries
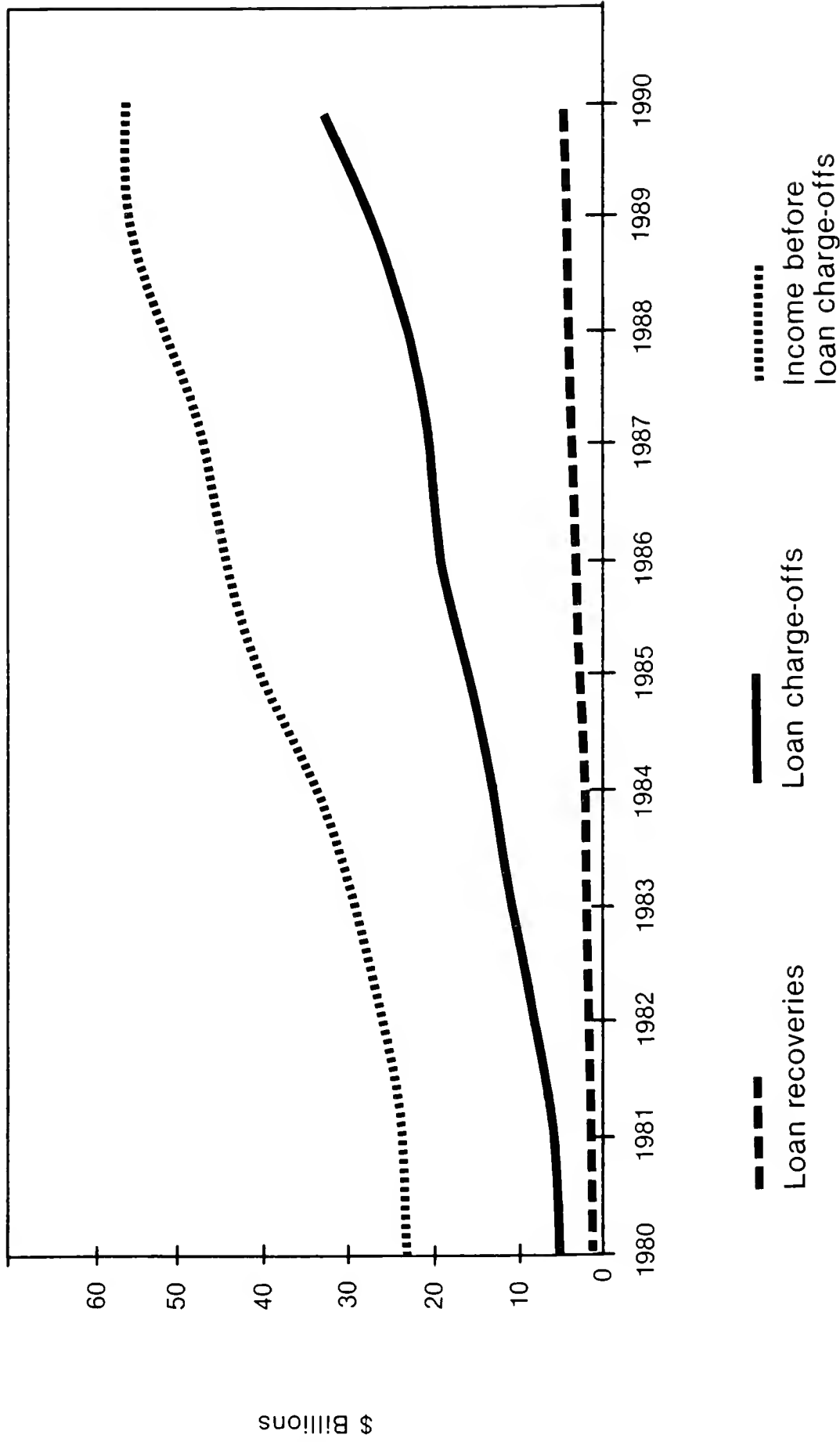
and examination by the regulatory authorities an acceptable surrogate for an independent investigation by the Internal Revenue Service.

As described above at page 13, federal regulatory standards classify an institution's problem loans along a prescribed descending scale of probable collectibility. Generally, an asset is charged off for regulatory purposes to the extent it is classified as a loss asset. Accordingly, in considering the appropriate scope of tax and regulatory conformity, we must compare the regulatory standards governing loss classification with the tax criteria for worthlessness. The proximity of these two standards of worthlessness can be analyzed at several levels. First, to what extent are the objective definitions of loss assets and worthless debts compatible? Second, is the factual basis on which a regulatory loss classification rests similar to that which would be required to support a deduction under section 166? Finally, is a bank examiner's assessment (or the assessment of a bank officer applying regulatory criteria) of whether an asset is a loss asset a satisfactory substitute for that of a tax auditor?

First, we turn to a comparison of the definitions of worthlessness employed for regulatory and tax purposes. 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.

Worthlessness for section 166 purposes has no succinct definition; it is determined on the basis of "all pertinent evidence." In making the determination of worthlessness, however, "the taxpayer must follow a rule of reason, avoiding alike the Scyllian role of the 'incorrigible optimist' and the Charybdian character of the 'stygian pessimist.' [Citations omitted.] . . . The taxpayer is not required to postpone his entitlement to a deduction in the expectancy of uncertain future events nor is he called to wait until some turn of the wheel of fortune may bring the debtor into affluence."[69] Thus, the regulatory and tax definitions of assets that should be charged off are quite similar in that they are both based on apparent uncollectibility, notwithstanding the possibility of partial recovery at some time in the future.

Given similar definitions, the next question is whether the factual basis that supports classification of an asset as a loss asset for regulatory purposes approximates the facts and circumstances that would support a finding of worthlessness under section 166. 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

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[69]Minneapolis, St. P. & S. Ste. M. R.R. v. United States, 164 Cl. Ct. 226, 241 (1964).

business success, and the overall economic conditions affecting the borrower.[70] By contrast, high volume consumer installment loans and credit card plans are classified solely on the basis of the length of delinquency.

The breadth of circumstances taken into account in classifying commercial and real estate loans for regulatory purposes is comparable to the inquiry that would be appropriate for a finding of worthlessness for purposes of section 166. Although the classification of consumer installment loans and credit card plans depends on a single fact, length of delinquency, the unsecured (or as may be the case with consumer loans secured by household items, undersecured) nature of these loans may cause that single fact to be an adequate measure of worthlessness for tax purposes. In any event, the high volume of such loans and their comparatively low face value would make an in-depth inquiry into all relevant facts and circumstances a very burdensome task for the lending institution. In the absence of persuasive evidence, such as an unusually high recovery rate for such loans, that the automatic charge-off criteria for these types of high volume loans results in overstated losses, it is appropriate to permit the regulatory loss classification to determine the worthlessness of such debts for tax purposes.

The last issue is whether an examiner or a bank loan officer would find the loss asset definition satisfied at a time when the Internal Revenue Service auditor would consider a determination of worthlessness premature. There are inherent in the roles of the two agencies divergent inclinations with respect to the timing of a charge-off. A bank examiner charged with preserving the safety and soundness of a financial institution is more apt to lean toward the "stygian pessimist" view of a loan showing signs of weakness; the tax auditor, as the collector of revenue and protector of the fisc, should necessarily incline more to the "incorrigible optimist" role. Adoption of a regulatory conformity rule necessarily favors, however slightly, the more conservative approach.

It is unlikely, however, that regulated institutions generally would exploit the conservatism of the regulators to the serious detriment of the tax system. An institution could obtain excessive bad debt deductions by charging off loans only at the price of adverse consequences to its apparent financial soundness. The diminished earnings and capital that would result from excessive charge-offs could create adverse perceptions in the securities markets and, ultimately,

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[70]Handbook, §§ 206.3, 213.3, and 217.1.

weaken consumer confidence in the institution's stability. Failure to meet regulatory capital requirements would have similar adverse consequences.[71] These conclusions led the Treasury Department to issue the recent proposed regulations discussed at pages 18-19.

D. Regulatory standards for nonaccrual of interest

OCC guidance and FFIEC Call Report forms require that institutions not accrue on their required quarterly reports interest income on nonperforming loans. A loan is put into nonaccrual status if principal or interest payments are in default for 90 days or more, unless the loan is well secured and in the process of collection.[72] A debt is "well secured" if the principal and accrued interest are fully collateralized or guaranteed by a financially responsible person.[73] A debt is "in the process of collection" if collection is proceeding either through legal action, including judgment enforcement procedures, or other collection efforts that are reasonably expected to result in repayment of the debt or restoration to current status.[74] The treatment of previously accrued but uncollected interest and subsequent payments are governed by generally accepted accounting principles.[75] These principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. Under OCC guidance, a nonaccrual loan may be returned to accrual status when (1) principal and interest are no longer due and unpaid or it otherwise becomes well secured and in the process of collection, and (2) prospects for future payment are no longer in doubt.[76]

The FFIEC standards for accounting for nonaccrual loans do not apply to consumer loans

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[71]In addition, the threat of impending bank failures has resulted in an increasingly important emphasis on capital. See FDIC, Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies; Report to Congressional Committees, 55 Fed. Reg. 34,339 (1990). New standards will require higher capital-to-asset ratios and will require the ratios to be computed on a risk-adjusted basis.

It appears therefore that the eagerness of regulated financial institutions to satisfy regulatory capital requirements and maintain the appearance of financial health would provide an adequate safeguard against abuse of a conformity rule.

[72]Handbook, § 205.1, p. 8.

[73]12 C.F.R. § 5.61(c)(2).

[74]12 C.F.R. § 5.61(c)(3).

[75]Handbook, § 205.1, p.8.

[76]Id. The FRB and the FDIC have adopted parallel accounting standards for institutions under their jurisdiction.

or residential real estate loans secured by one to four dwellings. OCC guidance directsinstitutions to formulate their own nonaccrual policies with respect to such loans to ensure that net income is not overstated.[77] Institutions file their required quarterly reports on the basis of the nonaccrual policy they have adopted.

The FFIEC has recently requested comment on a proposed change to the reporting standard applicable to nonaccrual loans.[78] The proposed standard would ease the ability of an institution to return a nonaccrual loan to accrual status without waiting for the loan to come into current payment status. Under this "loan-splitting" rule, institutions could charge off that portion of a nonaccrual loan that is not currently protected by pledged collateral or a dedicated income stream and return to accrual status the reduced loan balance that can be fully protected by the collateral or other security.[79] Only one such partial charge-off may be made with respect to a loan in nonaccrual status. If a loan restored to accrual status under the proposed standard is subsequently placed in nonaccrual status, the current criteria apply for returning the loan to accrual status.[80]

The proposed FFIEC rule in effect allows an institution to write off an asset that has not been classified as a loss asset. Under the conformity election of the proposed regulations under section 166, discussed above at pages 18-19, the conclusive presumption that generally applies to charge-offs made in conformity with regulatory treatment would not apply to charge-offs permitted under the proposed rule unless they were specifically ordered, because the conformity election extends only to the charge-off of assets classified as loss assets for regulatory purposes.[81] As a result, a bad debt deduction claimed in connection with a partial charge-off under the proposed FFIEC rule would generally have to be supported with the facts and circumstances required in connection with a claim of partial worthlessness under general tax principles.

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[77]Id. Similar guidelines apply for FRS- and FDIC-regulated institutions.

[78] Federal Financial Institutions Examination Council, Reporting Standard Concerning the Return of a Loan With a Partial Charge-off to Accrual Status, 56 Fed. Reg. 11,441 (1991).

[79]Id. at 11,442.

[80]Id. at 11,443.

[81]To permit a bad debt deduction for the partial charge-off of nonaccrual loans contemplated under the proposed FFIEC rule would be effectively to embrace market value accounting for diminutions in value. If there is to be some movement in the regulatory area from a realization based system to a market value accounting system, the tax treatment of assets can be tied to such a system only if it applies equally to augmentations and diminutions in value.

E. Relationship of regulatory nonaccrual standard to tax accrual rules

As described above at page 5, current law generally requires that an accrual method taxpayer include an accrued item in income unless it is uncollectible at the time the lender's right to it becomes fixed. Thus, unless there is no reasonable expectancy that the accrued but unpaid interest on a debt will be paid, an accrual basis lender must include it in income, notwithstanding the debtor's delinquency.[82]

The income accrual rules of section 61 and section 451 of the Code have historically been applied independently of the treatment of nonperforming loans for regulatory purposes. Accordingly, the Internal Revenue Service makes its own investigation of whether the standard for nonaccrual of interest is met regardless of whether the loan may have been placed in nonaccrual status for regulatory purposes.

The Treasury Department has been urged to adopt a conclusive presumption that interest on loans placed in nonaccrual status in accordance with Call Report rules be considered uncollectible for tax purposes and, therefore, not taken into account as income. In support of this proposal, advocates argue that such a policy would provide greater efficiency and uniformity in the administration of the relevant tax laws and reduce disputes and litigation; would substitute the experience of bank examiners, who are credit experts, for what advocates assert may be the less specialized judgment of Internal Revenue Service agents; would relieve the tax managers of banking institutions of the burden of a loan-by-loan review for compliance with what may be vague Internal Revenue Service criteria; and would allow banking institutions to determine their tax liability with greater certainty.

Current law does not provide for any conformity of the regulatory and tax treatment of interest on nonaccrual loans that have not been classified as loss assets.[83] Indeed, as the proposed conformity election amendment to the bad debt regulation makes clear, absent a specific charge-off order, the conclusive presumption under section 166 does not extend even

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[82]See Georgia Schoolbook Depository v. Commissioner; Koehring Company v. United States; and Union Pacific Railroad Company v. Commissioner, note 30, supra.

[83]Rev. Rul. 81-18, 1981-1 C.B. 295, involved the charge-off of interest on a loan that was earned but uncollected for a period in excess of 90 days. At the time of the charge-off, FHLBB regulations required that such interest be classified and accounted for as uncollectible income. See 12 C.F.R. § 563c.11 (1978). The ruling found that the cited regulation established a policy to which the conclusive presumption of Treas. Reg. § 1.166-2(d) applied, and held that the interest charged off as uncollectible that had already been accrued was deductible under section 166 and that interest that had not yet been reported in income need not be accrued. No other federal regulator of depository institutions has promulgated such a regulation, and 12 C.F.R. § 563c.11 has been withdrawn, effective January 1, 1989. See 53 Fed. Reg. 337 (1988). Rev. Rul. 81-18 is therefore obsolete.

to regulatory charge-offs that are not made as a consequence of the classification of an asset as a loss asset.[84] In considering whether it would be desirable to depart from current law by providing a presumption that interest on loans placed in nonaccrual status for regulatory purposes be considered uncollectible for purposes of section 61 and section 451, we look to the policy basis on which rests our support of the conformity rule in the case of determining the worthlessness of debts.

Whether conformity of tax and regulatory accounting in the case of nonaccrual loans is desirable tax policy depends on the criteria used by regulators in determining that interest income should not be accrued for regulatory accounting purposes. These criteria should approximate the criteria that would be required under the Internal Revenue Code to conclude that interest income should not be included in taxable income.

In determining whether a conclusive presumption for nonaccrual loans is appropriate, the relevant questions are (1) whether the regulatory definition of a nonaccrual loan is compatible with the tax definition of interest that may be omitted from an accrual method taxpayer's income; (2) whether the factual basis for a regulatory finding that a loan should be in nonaccrual status comports with the facts and circumstances that justify the nonaccrual of interest for tax purposes; and (3) whether the regulator's assessment of the appropriateness of ceasing to accrue interest is a satisfactory substitute for the judgment of a tax auditor.

The definition of a nonaccrual loan for regulatory purposes is one that is delinquent in interest or principal payments for some stated period (unless it is fully secured or guaranteed or in the active process of collection). Bank examiners require loans to be placed in nonaccrual status to avoid overstatement of the bank's current income, not necessarily to reflect a judgment as to their ultimate collectibility. By contrast, the definition of interest that a lender may omit from accrued income for tax purposes is interest the ultimate collectibility of which is in doubt. Nonaccrual of interest in this context is a recognition that the value of the right to income held by the lender when the interest comes due may never be realized and therefore should not be taken into account for tax purposes. Thus, there is not the comparability of basic definitions that is present in the case of the conclusive presumption of worthlessness of debts under section 166.

Given the differences in the basic definitions, it is not surprising that the factual basis that underlies classification as a nonaccrual loan for regulatory purposes also differs from the facts required to support nonaccrual of interest for tax purposes. Loans are placed in nonaccrual status for regulatory purposes on the basis of delinquency in principal or interest payments that extends beyond a certain period, usually 90 days. The 90-day threshold does not apply, however, to consumer loans and certain residential mortgage loans. The formulation of a nonaccrual policy with respect to these types of loans is left to the individual institution. For

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[84]This is consistent with the principles of Rev. Rul. 84-95, cited at note 16, supra, holding that the presumption encompasses only those charge-offs that are based on bad debt criteria under section 166.

tax purposes, because ultimate uncollectibility is the standard for nonaccrual, delinquency alone would not justify the omission of unpaid interest from income.

Finally, it appears that the judgments made in accordance with the regulatory standards governing nonaccrual would not provide an adequate substitute for the judgment of a revenue agent regarding whether the interest from such a loan must be included in income. The regulatory standards governing the classification of nonaccrual loans lack the uniformity of standards that is present in the classification of loss assets. Because individual institutions are free to set their own nonaccrual policies with regard to consumer loans and certain residential mortgage loans, standards for such loans may vary from institution to institution. In those cases, a conformity rule would tie tax treatment to a regulatory standard that cannot be readily identified.

In light of these factors, the Treasury Department has concluded that it is not appropriate to adopt a conclusive presumption that accrued but unpaid interest on loans that are placed in nonaccrual status for regulatory purposes be considered uncollectible for tax purposes.

IV. STANDARDS FOR UNREGULATED INSTITUTIONS

In addition to the depository institutions that are the subject of Part III of this study, there are a great many nondepository providers of consumer financial services. These companies range from independently owned consumer finance offices to very large financial services and retail and automobile companies and hold approximately one quarter of all consumer credit debt outstanding in the United States.

These nondepository institutions resemble regulated lenders in a number of ways. They typically hold large portfolios of homogeneous loan receivables. Like large banks, they are not permitted to use the reserve method in computing the deduction for bad debts. As a consequence, they face similar difficulties in evaluating the quality of the assets in their portfolios on a loan-by-loan basis for purposes of determining their bad debt deductions. But because they are not subject to the regime of state and federal regulation that governs depository institutions, the conclusive presumption allowing conformity of tax and book treatment of worthless debts is not available to them. Therefore, in the absence of the reserve method, these taxpayers must use the specific charge-off method for deducting worthless debts and support such deductions with "all pertinent evidence" if challenged by the Internal Revenue Service.

In view of many similarities between these unregulated lenders and depository institutions and the burdens imposed by the loan-by-loan analysis required under the specific charge-off method, it is worthwhile to consider whether such lenders should have some sort of book/tax conformity rule comparable to the conformity rule now available to banks and thrifts.

As discussed at page 23 above, excessive charge-offs under the conformity rule are restrained by the very real tension that exists between the tax benefits resulting from the charge-offs and the adverse effects such charge-offs would have on an institution's regulatory rating and depositor confidence. In considering whether some type of conformity rule would be appropriate for the worthless debts of unregulated lenders, an important factor is whether, in the absence of federal regulatory requirements, there would be some comparable restraint on overly aggressive charge-off policies.

Recoveries on bad debts must be included in income, hence a lender's net deductions for bad debts over time will not exceed the amount of debts that are not repaid, regardless of how aggressive the taxpayer's charge-off policy may be. Nevertheless, a deduction taken in an early year on a loan on which recovery is realized (and taken into income) in some later year has the effect of deferring tax on the amounts recovered for the period between the year of charge-off and the year of recovery. This deferral can have serious revenue consequences. The effects of such deferral are exacerbated during periods of declining tax rates and high interest rates.

It has been suggested that unregulated lenders are effectively discouraged from taking an overly aggressive charge-off position by administrative and recordkeeping considerations, the disincentive effect that charge-offs have on collection efforts and the negative impact of charge-offs on book income. In many cases these concerns may not be an adequate substitute for the

oversight of federal and state regulators and the watchfulness of depositors. Accordingly, the Treasury Department does not believe that a conclusive presumption that would permit unqualified conformity of book and tax treatment is appropriate. Some additional governor on the timing of charge-offs is needed to protect the fisc.

Described below are several approaches that might be considered in developing a proxy for regulatory oversight that would address these concerns: (1) a "look-back" approach; (2) an "identical standards" approach; and (3) a "recovery rate safe harbor" approach.

The "look-back" approach

One way of assuring that the fisc is not disadvantaged by taxpayers' charge-off policies is to permit charge-offs at any time, but to require that the government be made whole for any loss it suffers as a consequence of the erroneous (in hindsight) charge-off.[85] Under this look-back approach, recoveries would be taxed at no less than the marginal rates at which the deduction reduced tax in the year of the charge-off and an interest charge would be imposed on the taxes deferred from the year of deduction until the year of recovery.

Because the government would ultimately be receiving the "right" amount, regardless of the year of the charge-off, the look-back approach would effectively eliminate timing concerns regarding excessive charge-offs. Nevertheless, we are aware that the look-back approach would require lenders to track the vintages of their loans and perform interest and other tax calculations. For lenders holding large numbers of relatively small loans, the recordkeeping requirements of this approach could well outweigh the benefits.

The "identical standards" approach

The identical standards approach would look to the standards for worthlessness applied to consumer debt held by regulated institutions and would grant a conclusive presumption of worthlessness for similar debts of an unregulated lender that are charged off according to

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[85]For an analysis of this approach, see Committee on Income Management of the American Taxation Association, "A Time Value of Money Approach to Bad Debts," 40 Tax Notes 1075 (1988) and Crane, "Refining the Time Value Approach to Bad Debts," 42 Tax Notes 803. The look-back approach eliminates concerns relating to the timing of bad debt deductions. Although the discussion of the look-back approach appears in the section of the study dealing with the treatment of unregulated lenders, it would be equally efficacious if generally applied to all taxpayers, including regulated lenders.

The look-back approach would not solve the problem of premature charge-off of loans that ultimately become uncollectible. The Treasury Department believes that the combination of administrative efficiency and revenue protection that would result from the look-back approach would compensate for losses attributable to that problem.

identical standards. Under this approach, a consumer installment loan held by a finance company would be conclusively presumed to be worthless for purposes of section 166 if it (1) had been delinquent for 120 days or more in the case of a closed-end installment loan or 180 days or more in the case of an open-end installment loan, and (2) had been written off as uncollectible for financial reporting purposes in accordance with the taxpayer's established policy set forth in the taxpayer's audited financial statements. These thresholds for determining worthlessness mirror the regulatory standards applied by the OCC in determining whether consumer installment loans, credit card plans and check credit are loss assets.[86]

For purposes of the proposed presumption, "finance companies" would include companies that derive 80 percent or more of their gross income from the business of making consumer loans. "Consumer installment loans" would generally include loans or lines of credit calling for monthly payments of principal and interest that have been extended to individuals for household or personal expenditures. Loans or lines of credit either secured by collateral in the possession of the lender or secured by real estate would not be treated as consumer installment loans for this purpose because of the likelihood that the lender will recover a substantial portion of such loans even if amounts are uncollectible from the debtor.

The identical standards approach is appealing in that it adopts identifiable objective standards for determining worthlessness and seeks to create parity between the treatment of regulated and unregulated lenders with respect to similar types of loans. A drawback of this approach, however, is that any Internal Revenue Service audit of compliance with the conditions required for eligibility for the conclusive presumption would require the loan-by-loan review that the conclusive presumption is intended to eliminate. That is, there would be no way to confirm that the debts charged off satisfied the requisite delinquency periods short of a review of the individual debt histories. Administrative efficiency, one of the major benefits of conformity, could therefore be substantially reduced. Nevertheless, we believe the substance of this proposal may provide a promising basis for the development of a workable conformity rule and would have an insignificant revenue effect.[87]

The "recovery rate safe harbor" approach

The recovery rate safe harbor approach is based on the premise that the most reliable measure of the validity of a lender's charge-off policies is its own recovery rate on charged-off loans. This approach would take into account the fact that unregulated lenders, as a group, do not apply uniform criteria in charging off loans. Loans may be charged off at various stages of

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[86]See discussion at pages 13-14, above. To maintain the desired parity with regulated institutions, the criteria for worthlessness would have to be adjusted to take account of changes in the regulatory debt classification criteria.

[87]We estimate that this approach would produce a revenue loss of less than $50 million over five years.

delinquency (90 - 180 days), on the occurrence of certain events or conditions, on foreclosure or repossession, or upon the sale of repossessed or foreclosed collateral. Because such lenders may evaluate the effectiveness of their particular charge-off standards by monitoring the level of their bad debt recoveries, it has been suggested that a conclusive presumption limited by safe harbor recovery rates is appropriate.

Under this approach, holders of high-volume homogeneous receivables and loans would enjoy a rebuttable presumption that both partially and wholly worthless debts that are written off for book purposes are worthless debts for purposes of section 166. This presumption would become conclusive if a taxpayer met a safe harbor under which the taxpayer's average recoveries over the six-year period up to and including the taxable year of the claimed chargeoff did not exceed 25 percent of average charge-offs for the same six-year period. If the safe harbor were not met, the Service could rebut the presumption by applying a facts and circumstances test on a loan-by-loan basis. A pure facts and circumstances test would remain available for taxpayers whose particular circumstances may make book conformity inappropriate.

The effectiveness of this proposal depends very heavily on the precision with which the appropriate safe harbor percentage could be determined. Based on the experience of a sample of the unregulated lending industry, it appears that the determination of the proper percentage should take into account a number of factors. First, there are disparities in average recovery rates, depending on the type of loan outstanding. The average recovery rate on car loans for the 1985-1989 period, for example, has been approximately 12 percent. This is substantially lower than the average rate for unsecured personal loans (15.5 percent), which is lower than the average rate for consumer installment loans (17.4 percent). There are also disparities in recovery rates, depending on the size of the lender; companies with over $1 billion in assets have lower average recovery rates than companies under that threshold. Because large companies experience lower recovery rates, the averages stated above represent a very broad range of rates experienced by the industry as a whole. For example, although the average recovery rate on automobile loans is 12 percent, rates for some lenders on such loans are in the 50-60 percent range. Similar patterns are present in the case of personal loans and consumer installment loans.

Given the disparities in unregulated lenders' experience, the benefits of the adoption of a single 25 percent safe harbor rate would fall unevenly on lenders, depending on the type of debt they hold and their size. It would also provide significant flexibility in charge-off policies, and accompanying income management opportunities, for companies whose historical experience has been substantially below the 25 percent safe harbor rate. At the same time, fashioning and administering multiple safe harbor rates based on loan type would introduce unacceptable complexity into an approach designed to provide simplicity and administrability. Based on the available data, it appears that a 25 percent safe harbor recovery rate would provide a conclusive

presumption for a substantial majority of unregulated lenders. It would also have measurable revenue consequences.[88]

Although we are not persuaded that recovery rates alone provide an effective basis for a conformity rule, we believe they do provide a useful measure of the validity of charge-off policies. Accordingly, should Congress enact a conformity proposal for unregulated lenders, we believe that the benefit of the conformity rule that would be provided by the identical standards approach should be limited to those lenders whose recovery rates do not exceed a prescribed recovery rate ceiling. Were the recovery rate limit and identical standards approaches combined as suggested, the revenue loss arising from adoption of such a proposal would be negligible.[89]

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[88]We estimate that the proposal would produce a revenue loss of between \$35-\$100 million over five years. This revenue estimate includes consumer credit held by finance companies and excludes debt held by retailers and gasoline companies.

[89]The revenue loss for this proposal would be slightly less than the revenue loss resulting from the identical standards approach. See footnote 87.

V. CONCLUSION

As stated above, proposed regulations are pending to implement the Treasury Department's conclusions concerning needed changes in the longstanding regulatory conformity rules for banks. Extension of the conformity rules to unregulated lenders would be a significant departure from settled policy and practice. We believe that extension of the conformity rule to unregulated lenders is a question for the Congress and should not be resolved by unilateral regulatory action.

APPENDIX

Illustration of Economic and Tax Accounting
for Loan Portfolios with Loan Losses

A. Accounting for loan losses

Table 1 illustrates the pricing of a loan portfolio which includes a risk premium in the contract interest rate to cover the lender's expected loan losses using a hypothetical portfolio of loans, each with the same contractual terms. Assume that the lender expects complete contract fulfillment -- receipt of four payments of $126.80 and one payment of $1,126.80 -- for 85 percent of the loans (Class A loans). The lender also expects that five percent of the contracts will pay $126.80 per year for Years 1 and 2, $25.36 per year for Years 3 and 4, and $1,025.36 for Year 5 (Class B loans); five percent of the loans will pay full interest in Year 1 and default at the end of Year 2, leading to a realization of $100 of principal (Class C loans); and five percent of the loans will default in Year 1 with $200 realized (Class D loans). With these expectations and a 10 percent market rate of interest, the lender would set the contract interest rate at 12.68 percent to be assured that he will earn 10 percent on a portfolio of loans, with 2.68 percentage points constituting his risk premium.[90] Table 1 shows the stream of payments for this portfolio. With this risk premium included in the contract, the lender would be willing to pay $1,000 for a portfolio with a $1,000 principal.

B. Taxation of income from a portfolio with early loan losses

Table 2 shows the calculation of economic income for the portfolio described in Table 1 and demonstrates that the taxation of economic income does not change the value of the portfolio and thus does not distort investment choices. The income of the lender is the sum of the payments received from the borrower, whether characterized as principal or interest, and the change in the market value of the portfolio. During the first holding period (Year 1), the economic income is $100 ($130.46 - $30.46). The value of the portfolio in each year is the present discounted value of the future expected cash flows.[91] As noted in Table 2, the present discounted value of the portfolio before and after taxes is the same ($1,000). The price of the portfolio is unaffected by taxation, because when the annual decline in the value of the portfolio is used to

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[90]In order to identify the risk premium, it is assumed that there is no market risk attributable to changes in overall economic conditions, or changes over time in factors specifically related to the risk characteristics of the loans in the portfolio.

[91]The lender's after-tax discount rate (6.6 percent) is used to discount the after-tax cash flows.

Table 1

Illustration of the Pricing of a Loan Portfolio

Principal	$1,000.00						
Contract Rate (percent)	12.68						
Discount Rate (percent)	10.00						

	Fraction of Loan Class in Portfolio	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Payments received on loans in each class per $1,000 of loan principal							
Class A Loans	0.85		$126.80	$126.80	$126.80	$126.80	$1,126.80
Class B Loans	0.05		126.80	126.80	25.36	25.36	1,025.36
Class C Loans	0.05		126.80	100.00	0.00	0.00	0.00
Class D Loans	0.05		200.00	0.00	0.00	0.00	0.00
Payments received on loan portfolio per $1,000 of portfolio principal[1]							
Class A Loans	0.85		107.78	107.78	107.78	107.78	957.78
Class B Loans	0.05		6.34	6.34	1.27	1.27	51.27
Class C Loans	0.05		6.34	5.00	0.00	0.00	0.00
Class D Loans	0.05		10.00	0.00	0.00	0.00	0.00
Total payments			130.46	119.12	109.05	109.05	1,009.05
Present value		$1,000					

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[1]Payments shown are the weighted average of loan payments for each loan class, weighted by the share of each loan class in the portfolio.

Table 2

Illustration of Economic and Tax Accounting for the Loan Portfolio With Early Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Total payments[1]		$130.46	$119.12	$109.05	$109.05	$1,009.05
ECONOMIC ACCOUNTING:						
2. Before tax value[2]	$1,000.00	969.54	947.37	933.06	917.32	0.00
3. Decline in value[3]		30.46	22.17	14.31	15.74	917.32
4. Economic income [(1)-(3)]		100.00	96.95	94.74	93.31	91.73
5. Income tax [(4)x.34]		34.00	32.96	32.21	31.72	31.19
6. After-tax payments [(1)-(5)]		96.46	86.16	76.84	77.32	977.86
7. Present value after tax[4]	1,000.00					
TAX ACCOUNTING:[6]						
8. Beginning principal[7]		1,000.00	950.00	900.00	905.07	910.79
9. Interest accrued[8]		120.46	114.12	114.12	114.76	109.05
10. Interest received[1]		120.46	114.12	109.05	109.05	109.05
Charge-Off Method:						
11. Deduction[9]		40.00	45.00	0.00	0.00	10.79
12. Taxable income [(10)-(12)]		80.46	69.12	114.12	114.76	98.26
13. Income tax [(13)x.34]		27.36	23.50	38.80	39.02	33.41
14. After tax payments [(1)-(14)]		103.10	95.62	70.25	70.03	975.64
15. Present value after tax[4]	1,001.85					
Reserve Method:						
16. Ending reserve[10]	0.00	20.53	19.50	18.48	18.58	18.70
17. Deduction (addition to reserve)[11]		60.53	43.97	-1.03	0.10	10.90
18. Taxable income [(10)-(19)]		59.93	70.15	115.15	114.66	98.14
19. Income tax [(20)x.34]		20.38	23.85	39.12	38.98	33.37
20. After tax payments [(1)-(21)]		110.08	95.27	69.90	70.06	975.68
21. Present value after tax[4]	1,007.86					

Table 2 (continued)

[1]The amounts shown are based upon the loan portfolio shown on Table 1.

[2]Present value of remaining future payments shown on line (1).

[3]Difference between the before-tax value (line 2) for the current year and the previous year.

[4]Present value of after-tax payments (line 6) discounted at the lender's after-tax rate of return (6.6 percent).

[5]Ratio of the present value of the tax payments (lines 5, 13, or 19) to the present value of the economic income (line 4).

[6]Assumes that the taxpayer uses the accrual method of accounting.

[7]Nominal principal less loans retired plus additions to principal attributable to interest accrued but not received.

[8]Beginning principal (line 8) multiplied by the contract rate of interest (12.68 percent).

[9]Loss of principal defaults during the year.

[10]Reserve fraction multiplied by loans outstanding at end of prior year (line 8). The reserve fraction was estimated by dividing the sum of loan losses (line 11) by the sum of loans outstanding (line 8) for Years 1 through 5.

[11]The sum of the loss and the excess of the ending reserve the reserve for the prior year. Total deductions appear to exceed the losses shown in line 11 because deductions in excess of actual losses are not fully recaptured until all loans outstanding mature or default.

compute taxable income, the lower after-tax payments received are offset by the lower discount rate used to evaluate these reduced cash flows.

Under the specific charge-off method, a taxpayer may generally take a bad debt deduction with respect to a loan (or part of a loan) in the year that it becomes worthless. Table 2 demonstrates the application of the specific charge-off method by an accrual method taxpayer to the $1,000 loan portfolio described in Table 1. In Year 1, Class D loans default. The borrowers pay no interest and only $10.00 of the $50.00 principal owed. The lender deducts the $40.00 of unpaid principal. In Year 2, Class C loans default. The lender receives no interest, receives $5.00 of the $50.00 principal due, and deducts $45.00 of unpaid principal. For Years 3 through 5, Class B loans pay $1.27 of interest. The interest accrued but not received ($5.07) is included in the lender's income each year and added to the principal of the loan, in effect extending more credit to the borrower. In Year 5, the lender deducts the increase in principal attributable to accrued but unreceived interest.

In this example, the present value of the after-tax cash flows from the portfolio of investments exceeds the present value of the before-tax cash flows, because the lender has deducted defaulted amounts before he has taken into income payments reflecting the risk premium charged on all loans. As a result of this mismatch, the value of the loan contract increases from $1,000.00 (before tax) to $1,001.85 (after tax). Because the pre-tax and after-tax portfolio values differ, investment decisions are likely to be distorted.

Table 2 also illustrates the effect of the reserve method for an accrual method taxpayer. The reserve method allows a deduction for the amount necessary to produce the appropriate reserve balance. Based upon the lender's historical experience with loan losses, which is assumed to be identical to the expected losses for the portfolio illustrated in Table 1, the lender would maintain an end-of-year reserve equal to 2.053 percent of his outstanding loans at the beginning of the year.[92] In Year 1, the lender would be permitted a deduction of $60.53, the sum of the excess of the ending reserve ($20.53) over the ending reserve for the prior year ($0) and the loss incurred during the year ($40.00). In Year 2, the lender charges the loss of principal on Class C loans ($45.00) against the $20.53 reserve balance at the beginning of the year. The lender would be permitted a bad debt deduction of $43.97, the amount needed to restore the reserve balance to $19.50.[93] In Years 3 and 4, the lender adds the accrued but unreceived interest on Class B loans to the principal of the loan, in effect extending more credit to the borrower. In

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[92]The reserve fraction was estimated by dividing the sum of loan losses determined under the charge-off method (line 11) by the sum of loans outstanding (line 8) for the five years shown on Table 2. In actual practice, a moving average rather than a fixed average is used, but this should not have an appreciable effect on the results shown.

[93]The tax deduction is the sum of the loss ($45.00) and the excess of the ending reserve ($19.50) over the ending reserve for the prior year ($20.53).

Year 5, the additional principal attributable to the accrued but unreceived interest payments are charged against the reserve.

Under the reserve method, the present value after-tax of the loan portfolio exceeds its pre-tax value ($1,007.86 v. $1,000.00). The disparity between the after-tax value of the loan portfolio and its pre-tax value is greater under the reserve method than under the charge-off method, because the mismatch between the time the deductions attributable to loan losses are taken and the time the risk premium is included in income is more extreme under the reserve method.[94]

Table 3 compares economic and taxable income for the loan portfolio shown on Table 1. The charge-off and reserve methods defer income and tax liability, because the recognition of income attributable to the risk premium covering the expected losses tends to be deferred relative to the deduction associated with the loss. Under the reserve method the present value of the deferred income and tax liability are larger than under the charge-off method--$7.87 under the reserve method and $1.86 under the charge-off method.[95] These deferred tax liabilities account for the increase in the after-tax values of the loan portfolio over its pre-tax value shown on Table 2.

C. Effect of loan losses late in the life of the contract

The example described above shows that both the charge-off and reserve methods favor a loan portfolio characterized by early defaults. This section illustrates the effects for an alternative portfolio where defaults occur late in the life of the loans. It shows that the taxation of economic income does not affect the price of the portfolio, whereas the charge-off and reserve methods may favor or disadvantage a portfolio with late loan losses.

In this example, shown on Table 4, Class A loans (85 percent of the total) fulfill the terms of the contract -- four payments of $122.73 and a fifth payment of $1,122.73. Class B loans five percent of the total) pay the full amount of interest $122.73 for Years 1 and 2 and $24.55

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[94]The calculations in Table 2 assume that the taxpayer continues to acquire in future years a loan portfolio with the same characteristics as the portfolio illustrated in Table 1, and thus was able to establish a loss reserve at the end of Year 5 of $18.70. Were it instead assumed that the taxpayer discontinues his lending operations and thus reduces the loss reserve to zero, the after-tax value of the portfolio would be $1,003.27. Even in this extreme case the reserve method is more distortionary than the charge-off method.

[95]Total deductions under the reserve method will appear to exceed total deductions under the charge-off method, because the excess deductions under the reserve method are not fully recaptured until all loans outstanding mature or default.

Table 3

Income and Tax Deferral for the Loan Portfolio With Early Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Economic income[2]		$100.00	$96.95	$94.74	$93.31	$91.73
Charge-Off Method:[3]						
2. Taxable income[4]		80.46	69.12	114.12	114.76	98.26
3. Deferred income [(1)-(2)]		19.54	27.83	-19.38	-21.46	-6.53
4. Deferred tax [(3)x.34]		6.64	9.46	-6.59	-7.30	-2.22
5. Present value of deferred tax[5]	$1.86					
Reserve Method:[3]						
6. Taxable income[6]		59.93	70.15	115.15	114.66	98.14
7. Deferred income [(1)-(6)]		40.07	26.81	-20.41	-21.35	-6.41
8. Deferred tax [(7)x.34]		13.62	9.11	-6.94	-7.26	-2.18
9. Present value of deferred tax[5]	7.87					

[1]The amounts shown are based upon the $1,000 loan portfolio shown on Table 1.
[2]Line 4 from Table 2.
[3]Assumes the taxpayer uses the accrual method of accounting.
[4]Line 12 from Table 2.
[5]Present value of the deferred taxes shown on the preceding line discounted at the lender's after-tax discount rate (6.6 percent).
[6]Line 18 from Table 2.

Table 4

Illustration of the Pricing of a Loan Portfolio With Late Loan Losses

	Fraction of Loan Class in Portfolio	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Payments received on loans in each class per $1,000 of loan principal							
Class A Loans	0.85		$122.73	$122.73	$122.73	$122.73	$1,122.73
Class B Loans	0.05		122.73	122.73	24.55	24.55	1,024.55
Class C Loans	0.05		122.73	0.00	0.00	295.00	0.00
Class D Loans	0.05		0.00	0.00	450.00	0.00	0.00
Payments received on loan portfolio per $1,000 of portfolio principal[1]							
Class A Loans	0.85		104.32	104.32	104.32	104.32	954.32
Class B Loans	0.05		6.14	6.14	1.23	1.23	51.23
Class C Loans	0.05		6.14	0.00	0.00	14.75	0.00
Class D Loans	0.05		0.00	0.00	22.50	0.00	0.00
Total payments			116.59	110.45	128.04	120.29	5.54
Present value		$1,000					

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[1]Payments shown are the weighted average of loan payments for each loan class, weighted by the share of each loan class in the portfolio.

per year for Years 3 through 5, and the full principal ($1,000) in Year 5. Class C loans (five percent) pay the full amount of interest for Year 1, no interest for years 2 and 3, and default in year 4. The lender recovers $295 of the $1,000 principal owed. Class D loans pay no interest for Years 1 and 2 and default in Year 3. The lender recovers $450 of the principal in Year 3. Assuming that the lender would earn 10 percent on alternative investments, he would set the contract interest rate at 12.273 percent, for which 2.273 percentage points constitute the lender's risk premium. With this risk premium included in the contract, the lender would be willing to pay $1,000 for a portfolio with a $1,000 principal.

Table 5 shows the economic and tax accounting for the loan portfolio shown on Table 4. The taxation of economic income recognizes declines in the value of the portfolio in the early years attributable to accrued but unreceived interest and the late loan defaults. Under the charge-off method, such declines in the value of the portfolio are not recognized until the loans default (Years 3 and 4). Thus, under the charge-off method the value of the portfolio declines from a pre-tax value of $1,000.00 to an after-tax value of $998.25. Since the reserve method recognizes losses attributable to the late defaults in the year of origination, the value of the portfolio increases from $1,000.00 (before tax) to $1004.24 (after tax).

Table 6 shows the unrecognized income and losses under the charge-off and reserve methods for the portfolio with late loan losses. Taxable income under the charge-off and reserve methods is higher than economic income in the early years of the contract and lower in the later years. However, taxable income under the reserve method is lower than taxable income under the charge-off method. The reserve method permits a deduction in the year of origination for defaults that occur late in the life of the contract in addition to deductions allowed under the charge-off method. Thus, the present value of the deferred tax liability under the charge-off method reduces the value of the portfolio relative to its pre-tax value by $1.75. Under the reserve method, the present value of the deferred taxes increases the value of the portfolio by $4.24.[96]

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[96]Table 5 assumes that the taxpayer continues to acquire a loan portfolio in the future that has the same characteristics as the portfolio shown on Table 4. Alternatively, if the taxpayer were assumed to discontinue his lending activities and thus reduce his ending reserve in Year 5 to zero, the after-tax value of the portfolio would be $999.70.

Table 5

Illustration of Economic and Tax Accounting for the Loan Portfolio With Late Loan Losses

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Total payments[1]		$116.59	$110.45	$128.04	$120.29	$1,005.54
ECONOMIC ACCOUNTING:						
2. Before tax value[2]	$1,000.00	983.41	971.30	940.39	914.13	0.00
3. Decline in value[3]		16.59	12.11	30.91	26.25	914.13
4. Economic income [(1)-(3)]		100.00	98.34	97.13	94.04	91.41
5. Income tax [(4)x.34]		34.00	33.44	33.02	31.97	31.08
6. After-tax payments [(1)-(5)]		82.59	77.02	95.02	88.32	974.46
7. Present value after tax[4]	1,000.00					
TAX ACCOUNTING:[6]						
8. Beginning principal[7]		1,000.00	1,006.14	1,019.16	967.94	910.42
9. Interest accrued[8]		122.73	123.48	117.34	111.06	105.54
10. Interest received[1]		116.59	110.45	105.54	105.54	105.54
Charge-Off Method:						
11. Deduction[9]		0.00	0.00	40.53	48.28	10.42
12. Taxable income [(10)-(12)]		122.73	123.48	76.82	62.78	95.12
13. Income tax [(13)x.34]		41.73	41.98	26.12	21.34	32.34
14. After tax payments [(1)-(14)]		74.86	68.47	101.93	98.95	973.20
15. Present value after tax[4]	998.25					
Reserve Method:						
16. Beginning reserve[10]		0.00	20.23	20.36	20.62	19.59
17. Deduction (addition to reserve)[11]		20.23	0.12	40.79	47.24	9.26
18. Taxable income [(10)-(19)]		102.49	123.35	76.55	63.82	96.29
19. Income tax [(20)x.34]		34.85	41.94	26.03	21.70	32.74
20. After tax payments [(1)-(21)]		81.74	68.51	102.02	98.60	972.81
21. Present value after tax[4]	1,004.24					

Table 5 (continued)

[1]The amounts shown are based upon the loan portfolio shown in Table 4.

[2]Present value of remaining future payments shown on line (1).

[3]Difference between the before-tax value (line 2) for the current year and the previous year.

[4]Present value of after-tax payments (line 6) discounted at the lender's after-tax rate of return (6.6 percent).

[5]Ratio of the present value of the tax payments (lines 5, 13, or 19) to the present value of the economic income (line 4).

[6]Assumes that the taxpayer uses the accrual method of accounting.

[7]Nominal principal less loans retired plus additions to principal attributable to interest accrued but not received.

[8]Beginning principal (line 8) multiplied by the contract rate of interest (12.68 percent).

[9]Loss of principal defaults during the year.

[10]Reserve fraction multiplied by loans outstanding at end of prior year (line 8). The reserve fraction was estimated by dividing the sum of loan losses (line 11) by the sum of loans outstanding (line 9) for Years 1 through 5.

[11]The sum of the loss and the excess of the ending reserve the reserve for the prior year. Total deductions appear to exceed the losses shown in line 11 because deductions in excess of actual losses are not fully recaptured until all loans outstanding mature or default.

Table 6

Income and Tax Deferral for the Portfolio With Late Loan Losses[1]

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
1. Economic income[2]		$100.00	$98.34	$97.13	$94.04	$91.41
Charge-Off Method:[3]						
2. Taxable income[4]		122.73	123.48	76.82	62.78	95.12
3. Deferred income [(1)-(2)]		-22.73	-25.14	20.31	31.26	-3.71
4. Deferred tax [(3)x.34]		-7.73	-8.55	6.91	10.63	-1.26
5. Present value of deferred tax[5]	$-1.75					
Reserve Method:[3]						
6. Taxable income[6]		102.49	123.35	76.55	63.82	96.29
7. Deferred income [(1)-(2)]		-2.49	-25.01	20.58	30.22	-4.87
8. Deferred tax [(3)x.34]		-0.85	-8.50	7.00	10.28	-1.66
9. Present value of deferred tax[5]	4.24					

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[1]The amounts shown are based upon the $1,000 loan portfolio shown on Table 4.
[2]Line 4 from Table 5.
[3]Assumes the taxpayer uses the accrual method of accounting.
[4]Line 12 from Table 5.
[5]Present value of the amounts shown on the preceding line discounted at the lender's after-tax discount rate (6.6 percent).
[6]Line 18 from Table 5.

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