IRS Issues Field Attorney Advice on Partially Worthless Debt Deductions

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A recent IRS Field Attorney Advice memorandum (FAA 20153501F) confirms the agency's position on the deductibility of partially worthless debts incurred by taxpayers. Financial institutions routinely claim bad-debt deductions for partially worthless loans. While the FAA applies only to a specific taxpayer's situation, it provides insight into what type of support the IRS expects for deductions of partially worthless debts.

The Relevant Law

Under IRC Section 166(a)(2) and Treasury Regulation Section 1.166-3(a)(2), a taxpayer can claim a bad-debt deduction for a partially worthless debt only up to the amount charged off during the taxable year. The charge-off requirement is intended to provide evidence that the taxpayer has abandoned that part of the debt as an asset.

To support the deductibility of a partially worthless debt that is a business debt not evidenced by a security, a taxpayer must demonstrate partial worthlessness and that the worthless amount of debt actually was charged off. If a taxpayer can't demonstrate the partial worthlessness in the year in which it records a charge-off, the charge-off will be deemed to occur in the subsequent tax year in which worthlessness is established.

Evidence of Actual Charge-Off

In the FAA, the IRS first considered whether the taxpayer had charged off the worthless portion of the debt. It relied on International Proprietaries Inc. v. Commissioner, in which the U.S. Tax Court held that the taxpayer's bookkeeping entries didn't comply with the statutory charge-off requirement.

As in the case at issue in the FAA, the taxpayer in the court case increased a reserve account for the worthless portion of the debt. The Tax Court, however, ruled that the asset (debt) must be written down in the taxpayer's books and records to meet the charge-off requirement. Merely increasing a reserve account doesn't satisfy the requirement to demonstrate that a charge-off occurred.

The IRS's position in the FAA emphasizes that taxpayers must establish that the amount of the loan being claimed as a bad-debt deduction has been removed as an asset from the books and records. Specifically, the amount of the loan asset must be credited for the worthless portion; a bank typically would record a corresponding debit to a
reserve account such as the allowance for loan and lease losses (ALLL). It won’t suffice, however, to simply credit the reserve account and debit expense without decreasing the loan asset on the books. In the situation addressed in the FAA, the taxpayer’s books reflected an increase in a reserve for an anticipated future loss, rather than a loss already sustained. The taxpayer didn’t demonstrate that it had abandoned the amounts claimed as partial bad debts.

Ironically, absent the protection provided by a bad-debt conformity election under Treasury Regulation Section 1.166-2(d)(3) or, more recently, by the “LB&I Directive Related to § 166 Deductions for Eligible Debt and Eligible Debt Securities,” IRS examining agents previously didn’t seem to feel compelled to accept that all “book” charge-offs were valid bad-debt deductions for tax purposes. Both the bad-debt conformity election and the LB&I Directive suggest a greater willingness on the part of the IRS to follow the timing of book charge-offs. In the FAA, the IRS again places importance on the mechanics of actual charge-offs in the taxpayer’s books and records.

Note that the IRS didn’t discuss situations where the book basis of loans differs from the tax basis, which could occur, for example, in an acquisition transaction in which loans are recorded in the books and records at their fair market value (FMV) while their tax basis might be carried over from the target entity or determined under IRC Section 597 (in the case of loans acquired under a loss sharing agreement with the Federal Deposit Insurance Corporation). Even if recorded in the books at face value with the FMV adjustment in a contra-asset account, a book charge-off of a partially worthless debt could differ in amount from the desired deduction of tax basis.

Evidence of Partial Worthlessness

In the FAA, the IRS also addresses the question of the evidence necessary to support the amount of bad-debt deduction claimed. The IRS advised that the taxpayer’s use of internal calculations of the impairment of the asset (debt), which used a discount factor applied to a stream of expected cash flows, didn’t establish partial worthlessness. The IRS generally disfavors the discount factor approach, preferring that taxpayers provide evidence that the debt’s face value exceeded the FMV of the collateral property.

Lessons Learned

The recent FAA serves as a valuable reminder of the vital role taxpayer books and records play in supporting tax deductions of worthless debts. The books and records must clearly show that the taxpayer has abandoned, or written down, the worthless portion of an asset, as opposed to just increasing a reserve account. The taxpayer also must be able to demonstrate the amount of worthlessness by providing evidence that the face value of the debt exceeds the FMV of the underlying collateral. An attempt to support a bad-debt deduction with a calculation that discounts expected cash flows likely will fail.