

AN ALERT FROM THE BDO FINANCIAL INSTITUTIONS
& SPECIALTY FINANCE PRACTICE

BDO KNOWS:

FINANCIAL INSTITUTIONS & SPECIALTY FINANCE

► SUBJECT

A UNIFIED FEDERAL GOVERNMENT STANDARD FOR BANK BAD DEBTS AT LAST

► DETAILS

How often have we regarded with puzzlement the peculiar relationship, or rather the lack thereof, between federal bank regulators' definition of a loss asset requiring a charge-off and the IRS definition of a tax-deductible bad debt? It may be that this curious relationship will finally become an oddity of history.

On Oct. 24, 2014, IRS Large Business & International Division (LB&I) released directive 04-1014-008 to its auditors instructing them not to challenge bad debt deductions of banks using the specific charge-off method provided that the deductions do not exceed the loan charge-offs and debt securities impairment charges reported by the bank to its regulators. The directive is not applicable to banks using the reserve method of determining their bad debt tax deductions.

It should be noted that a directive to auditors is not the expression of an IRS position or an official pronouncement of legal precedence. Consequently, the directive can be withdrawn at the discretion of the Division Director.

As a practical matter, most community banks have been following the methodology of the Directive for years. So, in a sense, the Directive is simply a concession to prevailing practice. However, the Directive does contain several points of relief that banks will find beneficial.

First, the Directive applies both to banks and their non-bank subsidiaries qualifying as "affiliates" under the Internal Revenue Code, treating them both as banks except in relation to charge-offs with respect to "debt securities" which only the bank itself may treat as a bad debt. Accordingly, a non-bank subsidiary must still dispose of the debt security in order to deduct a loss.

Second, the Directive accedes to the accounting standard valuing OREO taken in foreclosure on a net-of-estimated-selling-cost basis, which cost typically forms a portion of the final charge-off related to the original loan.

► [Read more](#)



CONTACT:

JIM CARTER

Partner - Richmond
804-330-3092 / jcarter@bdo.com

DAVE WEISKITTEL

Partner - Grand Rapids
616-776-3766 / dweiskittel@bdo.com

JOEL ROBINSON

Partner - New York
212-885-8415 / jorobinson@bdo.com

ERNIE SAUMELL

Partner - Miami
305-420-8068 / esaumell@bdo.com

PAUL BRIDGE

Partner - Spokane
509-747-8095 / pbridge@bdo.com

ANTHONY FERGUSON

Partner - Los Angeles
310-557-8258 / aferguson@bdo.com

BARRY PELAGATTI

Partner - Philadelphia
215-564-1900 / bpelagatti@bdo.com

TERRY LEHMAN

Director - Harrisburg
717-233-8800 / tlehman@bdo.com

GLENN JAMES

Partner - New York
215-241-8959 / gjames@bdo.com

Third, with respect to banks which have made a "proper" bad debt conformity election to use regulatory standards to determine deductible bad debts, the Directive relieves them of the necessity of obtaining an express determination letter from their regulator after each subsequent exam. Bank regulators have demonstrated a reluctance to provide such letters to banks experiencing asset quality issues, which of course is precisely when the bad debt conformity election would prove to be the most useful.

The Directive does leave at least one element of lingering discordancy between regulatory loss and tax deduction, that being in relation to the non-credit-impairment portion of a debt securities impairment charge, for which banks which have not made a bad debt conformity election are still not permitted a deduction. Additionally, in the rare situation where a bank regulator has ordered the charge-off or confirmed it in writing, even a bank without a conformity election in place may deduct the non-credit-impairment portion of the debt securities impairment charge.

The Directive allows banks to "implement" its provisions by amended return or current year adjustment, neither before the 2010 tax year nor after the 2014 tax year. As to calendar year banks, the statute will have closed on the 2010 tax year as of Sept. 15, 2014. Accordingly, only those calendar year banks with a statute extension in place are able to go back to the 2010 tax year to implement the Directive, which would be banks under exam for that year. With respect to banks under IRS examination, the Directive essentially instructs its Division auditors to work out with the taxpayer under exam whether to implement the Directive via amended return(s) or examination adjustment(s).

The rather lengthy instructions for implementation provided in the Directive can be distilled to this: Separately compare the adjustment year tax basis of loans and the adjustment year tax basis of debt securities, in each case without any charge-off bad debt deductions for the year, to the end-of-adjustment-year book basis of loans and the end-of-adjustment-year book basis of debt securities. The differences in each case plus any adjustment required for non-deductible non-credit-impairment of the debt securities are the book to tax differences for bad debts in respect of loans and bad debts in respect of debt securities for the adjustment year.

In an apparent gesture of respect for the confidentiality of regulatory examination results, the Directive provides for a novel "taxpayer certification" in lieu of the need to provide, at least initially, regulatory documentation to support the tax return bad debt deduction. However, the certification includes a commitment on the part of the taxpayer to provide source documentation should the IRS auditor decide to request it.

Perhaps the most important conclusion to take from the Directive is the utility of a bad debt conformity election, which provides the largest immediate deductions and which, if the bank has already made the election, obviates the need to implement the Directive with any adjustment.

If you have questions about the Directive, please contact us.

BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

BDO's Financial Institutions & Specialty Finance practice has extensive experience providing audit, tax and consulting services with a focus on the financial institutions industry, including banks, savings institutions, credit unions and foreign banking organizations.

ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 52 offices and over 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,264 offices in 144 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit www.bdo.com.

Material discussed in this alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.