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Tax Aspects of Nonperforming Assets

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The recent turmoil in the financial markets has sparked a renewed interest in the tax rules covering nonperforming assets. For insurance companies, the rules take on added significance because of the interplay between statutory accounting and tax. This is an appropriate time for a brief review and comparison of the statutory and tax accounting rules.

Accrual of Investment Income

On the investment income side, SSAP No. 34 requires a two-step process for the accrual of income when collection is in doubt. First, investment income must be written off if it is probable that it will not be collected. The "probable" standard is derived from SSAP No. 5. As used in SSAP No. 5, "probable" refers to "that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." (SSAP No. 5, fn. 1.) Second, SSAP No. 34 requires that investment income over 90 days (or 180 days for mortgages) past due must be treated as a non-admitted asset on the balance sheet. Because the second step has no effect on income, the relevant standard for comparison with the tax rules is the "probable" standard under the first step.

How does the "probable" standard compare with the tax standard for accrual of income? For income tax purposes, Treas. Reg. § 1.451-1(a) applies the accrual method to interest income, requiring an income inclusion when all events have occurred that fix the right to receive the interest income and the amount can be determined with reasonable accuracy. The accrual standard for the income inclusion is satisfied when the interest is economically earned, payment is due or payment is received.[1] An exception applies, however, if there is a "reasonable doubt as to collectibility" at the time the accrual standard otherwise would be satisfied.[2] The "reasonable doubt as to collectibility" standard is a lesser standard than the wholly worthless standard for the write-off of principal discussed below. Although there is little or no guidance comparing the statutory and tax standards, the Internal Revenue Service (IRS) can be expected to apply the "reasonable doubt as to collectibility" standard in a more stringent manner than the statutory accounting "probable" standard. In Rev. Rul. 2007-32,[3] applicable to banks, the IRS strictly construed the exception from accrual, holding that the uncertainty as to collection must be "substantial." The IRS also reiterated case law providing that a temporary financial difficulty of the debtor is not sufficient to avoid accrual of income and that it is the taxpayer's burden to demonstrate substantial uncertainty as to collection. Thus, it is up to the taxpayer to accumulate and preserve the evidence regarding the debtor's financial instability to substantiate the nonaccrual of interest and avoid an IRS audit adjustment. Furthermore, the IRS appears to have designated this as a Tier II issue under its Issue Focus Program, meaning that the issue may draw increased attention and some level of coordination from the IRS National Office.[4]

It is unclear how these write-off rules apply in the case of original issue discount (OID). The IRS has taken the position in a Technical Advice Memorandum (TAM) that the "reasonable doubt as to collectibility" standard does not apply to OID income inclusions under I.R.C. § 1272.[5] According to the IRS, OID accruals cannot be written off until the underlying debt instrument meets the worthlessness standard. This result is adverse in terms of the timing and characterization of the loss. The timing is delayed and the loss effectively is converted to a capital loss, which cannot be offset against ordinary income. The capital/ordinary income mismatch potentially could be a significant problem for taxpayers with large losses resulting from the credit crisis and is a hot topic among tax professionals who specialize in financial products taxation. However, there is a question as to whether the TAM result applies to life insurance companies. Under I.R.C. § 811, life insurance companies apply statutory accounting rules for bond premium and OID accruals. So, arguably there should be no OID accrual for tax purposes when it has stopped on the annual statement.[6]

On the tax planning side, it is important to invoke non-accrual of interest because, once income has been accrued, it can only be written off when the debt becomes worthless—a much more difficult standard to satisfy (discussed below).

Write-down of Principal

Like the nonaccrual of investment income, recognition of loss in the principal of an investment in statutory accounting is governed by a "probable" standard. However, measurement of the loss is determined using a fair value standard. SSAP No. 26 contains the statutory accounting rules for bonds, except for loan-backed securities, structured securities and partnerships, joint ventures and LLCs (*see* SSAP Nos. 43 and 48). Under SSAP No. 26, if the decline in the value of a bond is not temporary, the cost basis in the bond is written down to fair value and a loss is realized. Impairment is deemed to occur if (1) noncollection of a portion of the debt is "probable" or (2) a decision is made to sell at a loss before maturity. SSAP No. 36 contains the statutory accounting rules for troubled debt restructurings. Once again, the "probable" standard derived from SSAP No. 5 applies here. The transfer of assets to creditors is accounted for at fair value, as are modifications of the debt. If fair value is less than book value, a loss is realized. SSAP No. 37 applies to mortgage loans. Impairment occurs when it is probable the company will be unable to collect all amounts due, including interest. Again, the familiar SSAP No. 5 "probable" standard applies here. If the impairment standard is met, there is a write-down to fair value measured by the collateral (less the estimated costs to obtain and sell the collateral). If interest is 180 days past due, but collectible, it is accrued on the balance sheet as a non-admitted asset.

The comparison with tax standards is a little more complex for principal write-downs than for non-accrual of interest income. Differences between statutory and tax standards can occur not only in the timing of recognition of the loss, but also in the measurement of the loss and in its character.

For tax purposes, there are two general types of write-downs for principal. The first and most common is a worthless security deduction under I.R.C. § 165(g). That section allows a capital loss for the basis of the debt instrument if it is a "security." A security is defined as a stock, subscription right or bond, debenture, note or certificate or other evidence of indebtedness with interest coupons or in registered form. Treas. Reg. § 5f.103-1(c)(1) defines registered form. According to the regulation, an obligation is in registered form if the debt may be transferred only through a book entry system maintained by the issuer or if the obligation is registered with the issuer as to both principal and any stated interest and any transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder. As a general rule of thumb, corporate bonds, and anything subject to a public offering, are securities. Investments that do not belong in the "securities" basket may include private placements, individual mortgages and partnership interests.

Classification of the investment as a security is a disadvantage for purposes of a tax write-down because the security must be wholly worthless to qualify for a loss. Treas. Reg. § 1.165-4(a) provides that a deduction cannot be taken for a mere decline in value of the security. A security is worthless if a reasonable person in the exercise of sound business judgment would regard collection as hopeless. The investment is not worthless if there is a liquidation value or the possibility of future recovery. For tax planning purposes, if an instrument that is a security subject to I.R.C. § 165(g) has a large embedded loss but is not completely worthless, the holder should consider selling or abandoning the instrument to trigger a loss deduction.

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The second general type of write-down for an impaired asset is a bad debt deduction under I.R.C. § 166 applicable to a worthless debt that is not a security subject to I.R.C. § 165(g). The character of a bad debt deduction is ordinary, rather than capital, as in the case of a worthless security. The taxpayer can claim a bad debt deduction either when the debt is wholly worthless or can claim a partial bad debt deduction. To claim a deduction for a partial bad debt, the taxpayer must charge off the value on its books and records.

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The deduction for partial worthlessness is subject to the same hopelessness standard as the wholly worthless standard. This creates a problem because the portion of principal that actually is worthless frequently is less than the statutory write-down to fair value. Therefore, a claim for partial worthlessness can involve a book/tax difference. It is possible, however, to avoid this result under special bad debt rules. Banks and certain other regulated companies enjoy a conclusive presumption of worthlessness based on the charge-offs on their books and records. The conclusive presumption, found in Treas. Reg. § 1.166-2(d), applies to a charge-off of principal or accrued interest[7] that the regulatory agency orders for charge-offs made under established policies and procedures that the agency confirms in writing in its first audit of the taxpayer after the charge-off. The presumption applies to banks or other corporations that are subject to supervision by federal authorities or state authorities that maintain substantially equivalent standards. Some IRS agents have taken the position on audit that the presumption does not apply to insurance companies even though they are regulated. In one unreported case, however, the Court of Federal Claims held that the presumption applied to a write-off of a reinsurance receivable, based on findings that the Ohio Department of Insurance order was in writing and that Ohio's standards for bad debts were similar to the federal banking standard.[8] For this presumption to apply, it is essential that written confirmation be obtained from the state insurance regulators that a write-off is required.

The statutory rules for troubled debt restructurings under SSAP No. 36 are less likely to generate a book/tax difference. For tax purposes, a debt restructuring generally is treated as a sale of a capital asset, giving rise to an exchange under I.R.C. § 1001.[9] For such restructurings, tax accounting generally is equal to the statutory accounting.

Timing Issues

The differences in standards between statutory and tax accounting give rise to timing and evidentiary issues. For tax purposes, worthless securities, worthless bad debt and partial bad debt deductions that are not subject to the regulatory charge-off presumption must be taken in the year the debt or portion of debt becomes worthless. A taxpayer may have enough information to support a statutory write-down, but may not have sufficient information or documentary evidence to support the write-down under the more stringent tax standard. Therefore, taxpayers should continually monitor a write-down of principal or previously accrued interest that satisfies the statutory "probable" standard, but may be challenged under the tax standard. Where there is any question as to the year in which a worthlessness loss or bad debt deduction is allowable, we sometimes recommend that protective claims for refund be filed for any year in which it is arguable that the worthlessness occurred. Bad debt and worthless securities deductions are subject to a special seven-year statute of limitations for refund claims;[10] however, IRS agents have sometimes taken the questionable position that the seven-year statute of limitations does not apply in all cases, at least in the context of partial bad debt deductions. Therefore, taxpayers should consider filing any protective refund claims within the usual three-year statute of limitations in order to preserve their right to the deduction and to avoid an unnecessary dispute with IRS agents.

End Notes

1 Rev. Rul. 74-479, 1974-2 C.B. 148.
2 *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th. Cir. 1968).
3 2007-21 I.R.B. 1278.
4 *See IRS Issues Exam Guidelines to Promote Consistency,* T³: Taxing Times Tidbits, 33 *Taxing Times*, Vol. 3, Issue 3 (Sept. 2007). As mentioned in the earlier Tidbit, the IRS designated Nonperforming Loans as a Tier II issue and appointed an issue owner executive to coordinate examinations on the issue, but has not issued a directive. Without a directive, we cannot be certain of the scope of the issue and whether it applies outside the banking industry.
5 TAM 9538007 (June 13, 1995).
6 In a 1993 Field Service Advice, the IRS Chief Counsel's Office advised that a life insurance company was not required to accrue OID on debt instruments that were not adequately secured by the underlying real estate collateral provided that the company's accounting treatment was consistent with NAIC standards. FSA 460, 1993 WL 1469687 (IRS FSA).
7 Rev. Rul. 2007-32, *supra*, holds that the presumption applies to accrued interest as well as principal.
8 *See Credit Life Ins. Co. v. United States*, 948 F.2d 723 (Fed. Cir. 1991), at fn 3, where the appeals court referred to the lower court's unpublished finding.
9 In *Cottage Savings Ass'n v. United States*, 499 U.S. 554 (1991), the Supreme Court held that a material change in entitlements under a contract resulted in an exchange. Following this rule, the regulations under I.R.C. § 1001 provide that significant modifications result in a deemed sale. Treas. Reg. § 1.1001-3(b).
10 The normal statute of limitations for tax paid with a return is three years from the date of the filing of the return, subject to mutually agreed-to extensions of the three-year period to assess the tax and file claim refunds. See I.R.C. § 6511(b)(2). I.R.C. § 6511(d) extends the basic deadline to seven years for worthless securities and bad debt deductions.