APPEALS
INDUSTRY SPECIALIZATI ON PROGRAM
COORDINATED ISSUE PAPER

Industry: COMMERCIAL BANKING, SAVINGS & LOAN

ISSUE: ACCRUAL OF INTEREST ON NON PERFORMING LOANS

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SETTLEMENT POSITION

Accrual of interest on non-performing loans.

Statement of Issue

Whether an accrual basis bank or savings and loan should continue to accrue interest on delinquent loans placed in non-accrual status.

Examination Division's Position

Examination Division's position papers recommend that interest on all loans should continue to accrue until one of two conditions exist:

1. "If a [financial institution] which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, has been given written specific instructions by a regulatory agency that a loan, in whole or part, should be charged off as a bad debt, then on the amount so charged no further interest should be accrued. Interest should continue to be accrued up until the date the account is so charged off."

2. "On loans not charged off, the taxpayer must, on a loan by loan basis, substantiate that interest is uncollectible in accord with Revenue Ruling 80-361."

Discussion

Before getting into a discussion of the merits of this issue, it is first advisable to define the circumstances under which the issue arises.

The examination division papers refer to non-performing loans as "delinquent loans placed in non-accrual status." "Non-accrual status" means that the financial institution has ceased accruing income for financial statement purposes. The use of the word "delinquent" would seem to imply that

there has been an actual delinquency in the payment of principal or interest or both. That will usually be the case, but not always. As
explained in the examination division position papers, financial institutions may treat a loan as non-performing not only when there has been an actual delinquency in payments, but also when a partial write-off has been made (perhaps because the market value of the security has fallen) or the loan is in the process of being restructured or renegotiated.

Regulation 1.451-1(a) states "... Under an accrual method of accounting income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy..."

The regulations are silent with respect to the treatment of an income amount that is uncollectible at the time the right to receive the income is fixed. The courts, however, have
established a judicial exception to the accrual rules where an income amount is uncollectible at the time the right to receive that amount becomes fixed.

In Spring City Foundry Co., 292 U.S. 182, 4 USTC 1276
(1934), the issue involved the accruability of sales income with respect to goods sold between March and September of 1920. A petition in bankruptcy was filed against a debtor of the taxpayer on December 23, 1920; the taxpayer eventually got 27 1/2 cents on a dollar three years later. In ruling that the taxpayer must include the sales income in full in its 1920 return the Supreme Court enunciated three principles:

1. It is the right to receive and not the actual receipt that determines the inclusion of the amount of the income.

2. If the accounts receivable subsequently become uncollectible, then a separate question arises as to deductibility.

3. It does not matter that the subsequent claim of loss relates to an item of gross income which had accrued in the same year, since the accrual of income and the subsequent claim of loss are two independent events.

This case was not on the books very long before it was distinguished in Atlantic Coast Line Railroad Co., 31 BTA 730 (1934), aff'd on other issues, 81 F.2d 309, 36-1 USTC 9067,
CA-4. In that case the issue involved accrual of interest in 1928, 1929 and 1930 on notes executed between 1912 and 1922. The debtor's financial condition was precarious - it had paid some of the interest due (which had been included in income by the taxpayer), but most of the interest had not been paid.

The Board of Tax Appeals sustained the taxpayer's non- accrual of the unpaid interest, distinguishing Spring City Foundry Co. thusly:

> "But where the obligation is worthless at the time the 'right to receive' arises, as in the instant case, the right to receive is without substance and there is in fact nothing to accrue. Accrual of a worthless item in such circumstances obviously would result in distortion of gross
>
> income, and in our opinion the Court did not intend its reasoning to be so applied as to reach the same result on a materially different state of facts."

The Government has accepted the rationale of Atlantic Coast Line Railroad Co. in Revenue Ruling 80-361, 1980-2 CB 164. The facts posited in that ruling were that in the later part of the same year that a loan was made the debtor became insolvent due to sudden and severe financial reverses. The ruling held that (1) the creditor must accrue interest up to the time of the insolvency (2) it may treat the accrued and unpaid interest as a bad debt if the requirements of Section 166 are satisfied, and (3) it need not accrue any future interest income after insolvency.

In summary, the applicable legal standard with respect to the nonaccrual issue is that income need not be accrued if, at the time the right to receive the income is fixed, the amount due is uncollectible. If uncollectibility is determined after the right to receive the income becomes fixed, the income must be accrued and the taxpayer may be allowed a corresponding loss deduction for the bad debt at a later point in time once uncollectibility is reestablished.

The next question that arises is how strong the proof of uncollectibility must be in order to warrant non-accrual treatment at the time of right to receive.

In Corn Exchange Bank, 37 F. 2d 34, 2 USTC 455, CA-2, the Court stated that the evidence need not be as strong to justify non-accrual as is needed to write off the underlying debt and indicated that the standard to be met was that "in all probability the income will not be received." The Court also seemed to indicate that hindsight evidence is relevant by stating that "... a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received."

In Georgia School-Book Depository, Inc., 1 T.C. 463 (1943) the Court noted that postponement of payment is not enough; there must also be a showing of improbability of payment. In ruling for the Government in that case the Court was also influenced by the fact that the taxpayer continued to sell books to the debtor (the State of Georgia).

The standard enunciated in Union Pacific Railroad Co., 14 T.C 401, 410 (1950) was that "... there exists reasonable grounds for believing, at the time the right to receive

income becomes fixed, that such income will never be received." In ruling
that the taxpayer had not met that exception to the standard for accrual of bond interest the Court was obviously influenced by the fact that such interest was paid in subsequent years.

The most recent case to address an accrual of interest
income issue is European American Bank and Trust Co., 90-2 USTC
50,333, Cls. Ct., aff'd 92-1 USTC 50,026, CA-FC. The facts in the case were quite complex and need not be recited. The important point to note is that this case adopted and well summarized the prior law (much of which is quite old). In so doing it stressed that a taxpayer does not have an easy task in justifying non-accrual of income:

> "The concept of uncollectibility, originating in a 'reasonable expectancy of payment' criterion, is well established in case law. The 'reasonable expectancy of payment' exception is strictly construed. For accrual of income to be prevented, uncertainty as to collection must be substantial, and not simply technical in nature. For this exception to accrual of income to apply, substantial evidence must be presented to establish that there was no reasonable expectancy of payment."

Factors that the Court mentioned as relevant to this
question were the value of the collateral and the financial condition of the debtor.

Most banks and savings and loan institutions will probably not be able to or want to substantiate their non-accrual of interest income on a loan by loan basis. It is administratively burdensome to do so and those loan files may not have the updated information necessary - the value of the collateral if a non-recourse loan and the debtor's financial condition as well if a recourse loan. They would much prefer to have a rule that would allow them to non-accrue for federal income tax purposes whenever the regulatory agencies force them to non-accrue for financial statement purposes.

Of course, it is long established that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws (Old Colony R. Co., 284 U.S. 552, 3 USTC 880 (1932); Bellefontaine Federal Savings and Loan Association, 33 T.C. 808 (1960): J.B.N. Telephone Co., Inc., 638 F.2d 227, 81-1 USTC 9151, CA-10.

Nevertheless, the Commissioner is authorized to promulgate regulations permitting a taxpayer to elect conformity with particular regulatory treatment. Regulations 1.166-2(d) do just that with respect to the worthlessness of debts payable to financial institutions:

"(d) Banks and other regulated corporations - (1) Worthlessness presumed in year of charge-off. If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either -

(i) In obedience to the specific orders of such authorities, or

(ii) In accordance with established policies of such authorities, and , upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing the the charge-off would have been made on the date of charge-off,

then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have been become worthless, or worthless only in part, as the case may be, during such taxable year..."

The principles of this section of the regulations were extended to charge-offs of accrued but uncollected interest and accruability of interest in Rev. Rul. 81-18, 1981-1 C.B. 295. In that Ruling the facts were that a savings and loan association entered into a one-year installment loan on October 3, 1978. Interest was due on the last day of each month, but the debtor failed to make the interest payments for October 31, November 30, and December 31. The taxpayer accrued the interest income for 1978, but wrote it off as a bad debt on January 31, 1979. This charge-off was made pursuant to FHLB regulations. FHLB auditors, upon their first audit of the taxpayer after the charge-off, confirmed in writing that the charge-off was made in accordance with their established policies.

The Service ruled that not only would taxpayer be permitted to deduct the charge-offs of accrued but unpaid interest, but that taxpayer need not accrue any 1979 interest. The latter holding was based on the rationale that one need not accrue income which is presumed uncollectible on the date the right to receive income arises.

An important point to note with respect to this section of the regulations and this ruling is that they specifically require (1) an order to write off by the regulators or (2) a confirmation in writing in the next audit that the charge-off would have been subject to such specific orders if the audit had been on the date of the charge-off.

Revenue Ruling 81-18 leaves something to be desired inasmuch as it cities the FHLB regulations, but does not fully explain them. The ruling appears to rely on the general FHLB regulatory
requirement that accrued but unpaid interest more than 90 days past due be classified and accounted for as uncollectible income. The impression created by the ruling, however, is that the write-off be previously accrued interest is automatic pursuant to the FHLB regulations once the single factor of 90 days delinquency has been established.

The ruling does state in its facts that the regulations pertain to "conventional" loans, but does not define that term. The FHLB regulations basically provide that a "conventional" loan is one that is not insured or guaranteed.

More importantly, the ruling does not disclose that if the loan is a home loan, interest should continue to be regarded as collectible if (1) the total owed does not exceed 90 percent of the appraised value of the security (2) active collection efforts are being made and (3) there is a reasonable expectation of delinquent-interest collection.

It is noted that the FHLB regulation requiring the charge- off of accrued but uncollected interest at the time delinquency reaches 90-days was withdrawn effective January 1, 1989.
According to the "Report to Congress on the Tax Treatment of Bad Debts by Financial Institutions" no other federal regulator of depository institutions has promulgated such a regulation.

The Section 166 bad debt regulations were amended on February 21, 1992, adding 1.166-2(d)(3) and (4). These
amendments basically permit a bank or savings and loan association to make a "conformity election" to deduct bad debts if those debts have been classified as "loss assets" for regulatory purposes.

Treasury Decision 8396, accompanying the publication of the amended regulations, refers to interest on non-performing loans thusly:

> "Several commentators requested that the conformity
> presumption be extended to the nonaccrual of interest on nonperforming loans. This issue is beyond the scope of
> these regulations. For an in-depth analysis of the appropriateness of applying a book-tax conformity standard to interest accruals on nonperforming loans, see Report to
> the Congress on the Tax Treatment of Bad Debts by Financial Institutions."

The report referred to above concludes 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." The reason behind this conclusion derives from the two differing criteria. It is appropriate to omit accrual of
interest if the right to that interest is a worthless right.
But the regulatory classification of "nonperforming" generally is based on delinquency, not ultimate worthlessness.

In this respect it is noted that there is no regulation in the commercial banking area equivalent to the now rescinded FHLB regulations. The "Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions" does note that both Office of the Controller of the Currency guidance and Federal Financial Institutions Examination Council Call Report forms require that institutions not accrue on their required quarterly

reports interest income on nonperforming loans. Although the time period for determining "nonperformance" status is also 90 days, there is no automatic write-off of previously accrued but uncollected interest.

To summarize, the law is fairly well established that income need not be accrued if it can be shown that it is uncollectible at the time of accrual. How strong the showing of uncollectibility must be is not clear. The language used by the courts ranges from "reasonable grounds for believing ... that such income will never be received" (Union Pacific Railroad Co.) to "in all probability the income will not be received. (Corn Exchange Bank, supra) Certainly, if the underlying loan is properly written off, that standard has met (Revenue Ruling 80-361, supra).

The federal tax laws are not controlled by regulatory agency rules as to when income should be accrued. Of course, the Internal Revenue Service may choose to allow taxpayers to rely on regulatory rules if it so chooses. The Service has done that in the following three circumstances:

1. The original bad debt regulations permit the write-offs of debts in accordance with regulatory standards if the write-off is in obedience to specific orders or the first subsequent audit confirms the write-off.

2. The February, 1992 amended regulations also permit the write-off of bad debts classified as "loss assets" if done in accordance with a valid "conformity election".

3. Revenue Ruling 81-18 permits the nonaccrual of future interest if previously accrued interest has been written off in accordance with that section of the bad debt regulations permitting such a write-off based upon regulatory standards.

If either of the first two situations exist, then the taxpayer should be permitted to non-accrue in accordance with the principles of Rev. Rul. 80-361.

If the third situation exists, then the taxpayer should similarly be entitled to non-accrue, but the following caveats are in order:

1. The taxpayer must be a savings and loan association, FHLB regulations do not apply to banks.

2. The time of accrual must be prior to January 1, 1989, when the FHLB regulations were withdrawn.

3. The loans must be conventional loans.

4. The Federal Home Loan Bank Board must have ordered the write-off of the previously accrued interest or upon the first subsequent audit confirmed in writing that it

would have so ordered had the audit been made on the date of the charge-off. This is more than a perfunctory requirement (at least with regard to home loans) since the FHLB requirements do not depend solely on 90 days delinquency, but also upon the value of the security, collection efforts, and the probability of recovery. But even if the requirement of an FHLB order or confirmation is regarded as perfunctory, that should not matter. The IRS did not have to issue Revenue Ruling 81-18 permitting reliance on regulatory standards and can impose whatever conditions it wants on qualification.