American Bankers Association
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Walter Harris
Industry Director
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Internal Revenue Service
290 Broadway, FL 12
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Dear Walter:

The purpose of this letter is to bring to your attention an issue that we are hearing about from our members. I will provide a brief summary of the issue in this letter. However, I would like to request a meeting with you and members of your team at your earliest convenience to discuss this matter in further detail.

The issue relates to two presumptions of worthlessness in IRS Regulation 1.166-2(d). The long-standing historical presumption in (d)(1) states in relevant part:

"(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, ... (i) in obedience to the specific orders of such authorities, or (ii) in accordance with established policies of such authorities, ... to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year. ..."

This Regulation is essentially unchanged since 1959. The other presumption of worthlessness is "the conformity election" in (d)(3), adopted in final regulations published with Treasury Decision T.D. 8492 on October 18, 1993.

The issue with both presumptions arises out of the current loan losses being incurred by banks during the recession.

First, with respect to the presumption in subsection (d)(1), IRS field agents examining bank returns indicate that the only way to "access" the conclusive presumption of worthlessness in (d)(1) is to show the examining agent that the banking safety and soundness examiners actually ordered the amounts charged off by providing the relevant pages from the bank's examination reports. Bank examination reports are confidential, and IRS field examiners are aware of that and are respecting the confidentiality procedures. Thus, "access" to the conclusive presumption of worthlessness is, in effect, unusable.

A representative of one of the federal banking agencies has also raised an issue whether under the Right to Financial Privacy Act the bank may show the pages regarding charge-offs to the IRS without either (i) the express written permission of the customer [which of course the bank would not want to ask for], or (ii) a legal subpoena, warrant, et. al. of which the customer is given notice and the right to object.

The result is that IRS field agents are examining *de novo* the same loans that were already examined in detail by the banking regulatory examiners, which is a material duplication of effort by the government, is a material cost to the bank, and, unfortunately, experience shows is resulting in inconsistent conclusions – in some cases by two agencies (OCC and IRS) of the Treasury Department.

Second, with respect to the conformity election, the recession has created a problem with the Express Determination Letter that was not contemplated in 1993 when that election was added to the Regulation.

The Conformity Election was designed to deal with a change in banking practice. In earlier years, some banks had waited for a safety and soundness examination to take charge-offs. This is the historic relevance of the "conclusive presumption" in subsection (d)(1). Especially after the energy and agricultural crisis in the 1980s, banks changed to a more pro-active policy of recording charge-offs monthly or quarterly as the loss assets are identified.

However, the current version of the Express Determination Letter does not include an exception for *additional* charge-offs ordered during safety and soundness examinations. We are hearing from members that the safety and soundness examiners are refusing to issue Express Determination Letters if there are material additional charge-offs ordered as a result of the examination. The refusal by the safety and soundness examiners to issue the Express Determination Letter revokes the bank's conformity election retroactive to at least the beginning of the year of the examination, which is just when the conformity election is most helpful to both the Service and to the banks.

Additional charge-offs during a safety and soundness examination should not result in any additional risk to the Service of banks understating their tax liabilities, or any additional enforcement cost to the Service. Assuming that the problem regarding the presumption in (d)(1) can be resolved, any additional charge-offs ordered by the safety and soundness examiners during an examination should be covered by the presumption in (d)(1)(i).

Revising the Express Determination Letter to accommodate an exception for additional charge-offs ordered by the safety and soundness examiners would benefit both the Service and the banks by maintaining the banks' conformity elections, which representatives of the Service routinely encourage the banking industry to consider.

We believe that these issues need to be addressed as soon as possible. The difficulty in implementing these two presumptions in the Regulation creates a significant issue for both the IRS and banks.

Please feel free to contact me at anytime at fmordi@aba.com or 202.663.5317. We would like to discuss this with you, and I will contact you to set up a time that is convenient for you.

Sincerely,

Francisca N. Mordi