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April 1, 2004

Internal Revenue Service
Office of Prefiling and Technical Services
Large and Mid-Size Business Division LM:PFT
Mint Building 3rd Floor M3-420
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Industry Issue Resolution (IIR) Program

Dear Sir or Madam:

The American Bankers Association (ABA) is pleased to submit the issue, “nonaccrual of interest on nonperforming loans”, for consideration under the Industry Issue Resolution (IIR) Program (outlined in Revenue Procedure 2003-36). The ABA brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

The ABA previously submitted the issue of nonaccrual of interest on nonperforming loans for resolution in the IIR program on May 15, 2003. We are again recommending resolution of this frequently disputed and burdensome tax issue, which we believe is most appropriate for the IIR program. Because this issue has been an ABA concern for many years and has resulted in a very high level of frustration within the banking industry, we believe that it is most appropriate for the IIR. Comprehensive guidance in this area would greatly reduce costs and alleviate routine problems due to the uncertainty that is common in a variety of factual situations.

Financial service institutions are continuously faced with rising costs associated with ensuring compliance with the existing tax laws and regulations. As a result, consumers and businesses often suffer from a corresponding increase in the price of financial products and services. Often times, tax compliance costs are attributable to examinations, appeals, settlements or litigation involving frequently disputed tax issues that are common to a significant number of taxpayers. For this particular issue, the Service’s position places burdens on the industry without any incremental benefit to the Service. Practically all banking institutions are affected by our recommended issue, and we believe that we can work together to provide a resolution that would be acceptable to the Service and help reduce both uncertainty and unnecessary burden for the industry.

The following is a description of the issue and our recommendation for resolution.

Nonaccrual of Interest on Nonperforming Loans

Summary of Recommendation. The ABA recommends book/tax conformity for the accrual of interest on nonperforming loans. The Service's current position is administratively impracticable and creates substantial uncertainty.

Technical Guidance. Generally, under the accrual method of accounting, income is included in the taxable year when all the events have occurred that fix the right to such income and the amount can be determined with reasonable accuracy. Treas. Reg. sections 1.446-1(c)(1)(ii) and 1.451-1(a). The Service's position with respect to interest accrual on nonperforming loans is articulated in Revenue Ruling 80-361, Coordinated Issue Papers at both the examination and National Appeals levels, the IRS Market Segment Specialization Program Audit Technique Guide for Commercial Banking (Audit Guide), a Field Service Advice, and an Appeals Settlement Guideline. See FSA 200018017, January 13, 2000, Accrual of Interest on Nonperforming Loans; Appeals Settlement Guideline "Accrued Interest on Nonperforming Loans (Commercial Bank)". Under Revenue Ruling 80-361, an accrual method taxpayer must include in gross income any interest that accrues prior to the time the loan becomes uncollectible. There is an exception to this rule. Interest accrual is not required if an accrual method taxpayer can establish that the interest income is uncollectible when the right to receive income arises.

The examination-level Coordinated Issue Papers require interest accrual unless: (1) the bank has been given specific written instructions by its bank regulatory agency that the loan, in whole or in part, should be charged off, or (2) on loans not charged off, the taxpayer substantiates, on a loan-by-loan basis, that the interest in "uncollectible."

The Audit Guide, which is used to assist examiners and agents, encourages them to look for certain types of loans and suggests detailed examination techniques in order to ascertain whether a particular nonperforming loan must continue to accrue interest. Similar to the Coordinated Issue Papers, the Audit Guide states that nonaccrual of interest is permitted only if: (1) taxpayers provide substantial evidence (on a loan-by-loan basis) that the interest is uncollectible, or (2) a regulatory agency requires (in writing) that a loan should be charged off.

The Appeals Settlement Guideline (discussed above) is similar in some respects to the exam-level Coordinated Issue Papers.

Industry Practice and IRS Position. The ABA acknowledges the prevailing law that book or regulatory accounting rules do not govern for tax purposes when generally accepted accounting principles (GAAP) do not result in income being

clearly reflected. However, historically, banking institutions have viewed GAAP and regulatory accounting as clearly reflecting income on loans for tax purposes. Federal banking regulators, including many state bank regulators, prescribe discontinuance of accrual on loans that are in default for a period of time (usually ninety days or more). Although GAAP provides additional rules for determining whether a loan is impaired, GAAP has historically followed bank regulatory standards for nonaccruals. The Service has taken the position that the book standard for nonaccrual is materially different from the tax standard. As a result, the Service has rejected book/tax conformity in the area of nonperforming loans. In an effort to reconcile GAAP and IRS practices, the courts have supplied differing standards concerning nonaccrual of interest on nonperforming loans. See generally, *Bank of Kirksville v. U.S.*, 934 F. Supp. 1191 (W.D. 1996) (classification of loan as "doubtful" or "substandard" along with bank regulator comments on economic conditions that can stop interest accrual).

Analysis. The Service's position, as described in the Coordinated Issue Papers and the Audit Guide, should be revised to permit book/tax conformity for nonaccrual loans. The two-part threshold standard in those documents is problematic for the following reasons:

- The requirement to accrue interest unless the bank has been given specific written instructions by its bank regulatory agency to charge off the loan is problematic because: (1) it is based upon an erroneous application of the law, and (2) it is unusual for a bank to receive written instructions to charge off a loan. The Service's approach, which adopts a bad debt charge off standard for interest accrual, is contrary to statutory provisions and judicial decisions. This bad debt standard, which is under section 166 of the Code, is not the correct standard for determining when accrual should be discontinued. Instead, the income accrual standard under section 451 of the Code is the correct standard. See *Corn Exchange Bank V. United States*, 37 F. 2d 34 (2d Cir. 1930), *European American Bank & Trust Co. v. U.S.*, 20 Cl. Ct. 594 (1990) (holding that no interest is realized unless there is a reason to believe that the income will be paid or collected or reasonable expectancy that the claim will be paid). In the Field Service Advice and the Appeals Settlement Guideline (discussed above), the Service also recognized that the determination of the proper accrual of interest on nonperforming loans should be considered separately from the issue of bad debt deductions.
- The requirement to substantiate that the interest is uncollectible on a loan-by-loan basis is administratively unfeasible, particularly for smaller, unsecured loans. Many commercial banks manage a significant number of consumer loans, including credit card debts. Substantiating uncollectibility on a loan-by-loan basis for these types of debts is administratively impractical. In general, the loan files for these smaller consumer debts do not contain the same level of detail as complex

commercial loans. Often times, the loan file consists of a single sheet of paper with little or no detail, and payment information is listed on the bank's loan accounting system. Therefore, it is extremely difficult for many banks to provide sufficient information in the event the Service requests substantiation of uncollectibility.

Agents routinely audit nonaccrual issues with respect to nonperforming loans, and presumably apply the two-part threshold standard in determining whether interest income should have accrued on certain loans or categories or loans. However, in practice, we understand that the Service's audit approach for dealing with interest accrual on nonperforming loans varies. Nonetheless, unnecessary audit activity continues. This frequent audit activity has resulted in numerous factual disputes with taxpayers as to whether a particular loan was "uncollectible" at the time the right to income arose. In many cases, this approach ignores sound credit judgments of experienced bank officers and their bank regulators. The audit approach is also contrary to prior case law decisions holding that interest accrual is not required if there is a reasonable expectancy that it is uncollectible at the time the lender's right becomes fixed. As a result, financial institutions and their tax advisors are unable to accurately reconcile the inconsistency among the true economics (GAAP), IRS guidance and laws – resulting in problems that have created even more uncertainties and frustration.

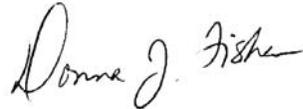
Recommendation. In order to establish consistency, reduce costs, and protect banks from unnecessary audit adjustments, bank regulatory accrual practices should be recognized for nonperforming loans. The GAAP and banking regulatory accounting standards have evolved over the years and now closely resemble tax standards with respect to interest nonaccrual. Similar to the tax standard, these standards continue to focus on whether in all likelihood the interest will be collectible. (For example: Statement of Financial Accounting Standards (SFAS) No. 5 requires that a contingent loss be recognized when it is probable and reasonably estimable; SFAS No. 114, which has been effective since the beginning of 1995, provides that a loan is impaired when it is probable that a creditor will be unable to collect all amounts due.) In addition, the banking regulatory rules relating to discontinuance of interest on loans where interest and principal are in default for more than ninety days are based upon analysis and information relating to the issue of collectibility. Therefore, it is reasonable, prudent, administratively practicable and consistent with applicable law to conform with bank financial accounting treatment for interest on nonperforming loans. From a tax policy perspective, conforming bank regulatory treatment of nonaccrual loan interest could have a positive impact on the ability to build capital and make loans. This is accomplished by not only removing uncertainty, but by relieving banking institutions of the need to set aside unnecessary reserves for taxes on interest income that they, in fact, never receive.

Conclusion. The audit problems associated with the accrual of interest on nonperforming loans should be resolved quickly and as a matter of sound tax

administration. This issue has been a problematic and routine tax accounting issue for banking institutions for many years. The significant increase in the volume of loans held by banking institutions of all types and sizes during the last five years, combined with an understandable frustration over the Service's audit practices in this area, highlights the importance of resolving this long-disputed issue. Banking institutions continue to be examined on this issue, and the uncertainty of the tax treatment has resulted in frequent and, often times, unanticipated audit adjustments. There is no sound rationale articulated by the Service for requiring institutions to continue accruing interest on loans that are clearly nonperforming.

The ABA looks forward to working with the Service on this issue, and we will be pleased to provide additional information. Should further clarification be needed, please contact Mark Baran at (202) 663-5317 or me.

Sincerely,

A handwritten signature in cursive script that reads "Donna J. Fisher". The signature is written in black ink and is positioned to the right of the word "Sincerely,".

Donna J. Fisher