



Proposed regulations expand the conclusive presumption of worthlessness for debt held by regulated financial companies under section 166

Tax Alert

Overview

Proposed regulations ([REG-121010-17](#)) published in the Federal Register on December 28, 2023 revise the circumstances in which indebtedness is conclusively presumed to be worthless to the extent of a charge-off on an applicable financial statement. The conclusive presumption of worthlessness applies for purposes of determining a taxpayer's eligibility to claim a bad debt deduction under [section 166](#). The proposed regulations apply to certain regulated financial companies and other members of certain regulated financial groups.

Eligible companies may choose to apply the proposed regulations to claim bad debt deductions in taxable years ending on or after December 28, 2023; however, a taxpayer must obtain IRS consent to change to the method of accounting for bad debts provided by the proposed regulations before using this method.

Background

Section 166 bad debt deductions

Section 166 allows taxpayers a deduction for any debt that becomes wholly worthless within the taxable year. It also permits a corporation to deduct a portion of a partially worthless debt that does not exceed the amount charged off within the taxable year. In determining the extent to which a debt is worthless, the Internal Revenue Service (IRS) generally considers all pertinent evidence and surrounding circumstances, such as the value of the collateral securing the debt and the financial condition of the debtor.

Conclusive presumptions for banks and other regulated corporations

Under current [Treas. Reg. § 1.166-2\(d\)](#), a debt held by an eligible corporation is conclusively presumed to be worthless, without the need for considering all the evidence and circumstances, provided certain requirements are met. [Treas. Reg. § 1.166-2\(d\)\(1\)](#) provides that if banks and other regulated corporations charge off a debt (in whole or in part) pursuant to specific orders or established policies of their regulators in accordance with certain requirements, then the debt is conclusively presumed worthless to the extent of the charge off during the taxable year. Additionally, [Treas. Reg. § 1.166-2\(d\)\(3\)](#) provides that a bank may elect to use a “conformity” method of accounting to establish a conclusive presumption of worthlessness for debt charged off for regulatory purposes if certain regulatory standards are met as expressly determined by its regulator.

In 2013, the IRS issued [Notice 2013-35](#), which requested comments on whether the conclusive presumption regulations should be amended because of changes in bank regulatory standards and processes subsequent to the issuance of [Treas. Reg. § 1.166-2\(d\)](#). It also sought comments on whether the scope of the conclusive presumption regulations should include other corporations such as insurance companies and government-sponsored enterprises.

Large Business & International Division directives

In 2012, in order to reduce audit administrative burden on both insurance companies and the IRS’s Large Business and International Division (LB&I), the IRS issued an insurance industry directive. The directive states that LB&I examiners should not challenge an insurance company’s partial worthlessness deduction under section 166 for the amount of Statements of Statutory Accounting Principles (SSAP) 43R credit-related impairment charge-offs of “eligible securities” reported on the annual statement according to SSAP 43R. Eligible securities covered under the directive include only investments in loan-backed and structured securities within the scope of SSAP 43R, including real estate mortgage investment conduit (REMIC) regular interests.

In 2014, pending future guidance on possible changes to the conclusive presumption regulations, the IRS issued an industry directive specific to banks that generally allows loss deductions for partial and wholly worthless debts to follow losses reported for generally accepted accounting principles (GAAP) and regulatory purposes.

Proposed regulations

Under the proposed regulations, which would revise [Treas. Reg. § 1.166-2\(d\)](#), a regulated financial company or member of a regulated financial group that uses an “Allowance Charge-Off Method” benefits from a conclusive presumption that debt it holds is worthless to the extent that the debt is charged off on its applicable financial statement and the amount charged off is deducted under section 166 for the taxable year of the charge off or a subsequent taxable year.

Observation

[Section 166\(e\)](#) provides that section 166 does not apply to a debt which is evidenced by a security as defined in [section 165\(g\)\(2\)](#) (including a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form). Consequently, for a debt to be subject to the Allowance Charge-off Method, the debt must not be a security within the meaning of [section 165\(g\)\(2\)](#).

Regulated financial company and regulated financial group

The Allowance Charge-Off Method may be used only by a regulated financial company or a member of a regulated financial group.

The term “regulated financial company” includes enumerated banking-related corporations, regulated insurance companies, Fannie Mae and Freddie Mac; however, it does not include credit unions, US branches of foreign banks or other non-bank “systemically important financial institutions.” For this purpose, regulated insurance companies must be domestic corporations subject to the Code provisions applicable to insurance companies that are licensed, authorized, or regulated by one or more states to sell insurance, reinsurance, or annuity contracts to unrelated persons and that engage in regular issuances of (or are subject to ongoing liability with respect to) such contracts.

The term “regulated financial group” means one or more chains of corporations connected through stock ownership with a common parent corporation that (1) is not a regulated investment company (RIC) or real estate investment trust (REIT) and (2) is a regulated financial company that is not owned, directly or indirectly, by another regulated financial company, but only if:

- (A) the regulated financial group parent owns directly or indirectly stock meeting the stock ownership requirements of [section 1504\(a\)\(2\)](#) (80% of total voting power and value) in at least one of the other corporations; and
- (B) stock meeting such ownership requirements in each of the other corporations (except the regulated financial group parent) is owned directly or indirectly by one or more of the other corporations.

In determining stock ownership under (A) and (B), stock has the same meaning as in [section 1504](#) but without regard to the rules for options and similar instruments in [Treas. Reg. § 1.1504-4](#) (such that [section 1504\(a\)\(4\)](#) preferred stock would not be taken into account). Indirect stock ownership is determined by applying the constructive ownership rules of [section 318\(a\)](#).

To be a member of a regulated financial group, a corporation must be in the chain of corporations of a regulated financial group, must not be a RIC or REIT and must not be held by a regulated financial company pursuant to [12 U.S.C. § 1843\(k\)\(1\)\(B\)](#), [\(k\)\(4\)\(H\)](#) or [\(o\)](#).

Charge-off on an applicable financial statement

For a corporation applying the Allowance Charge-off Method, a debt is conclusively presumed to be worthless to the extent (1) the debt is charged off from the allowance for credit losses in accordance with GAAP and recorded in the period in which the debt is deemed uncollectible on its applicable financial statement, or (2) in the case of a regulated insurance company that has an applicable financial statement prepared in accordance with the standards set out by the National Association of Insurance Commissioners (NAIC) and filed with the insurance regulatory authorities of a state that is the principal insurance regulator of the insurance company (a “NAIC financial statement”), the debt is charged off to reduce the debt’s carrying value and result in a realized loss or a charge to the statement of operations (as opposed to recognition of an unrealized loss) that is recorded on the insurance company’s annual statement.

The term “charge-off” is defined to mean an accounting entry or set of accounting entries for a taxable year that reduces the basis of the debt when the debt is recorded in whole or in part as a loss asset on the applicable financial statement of the regulated financial company or the member of a regulated financial group for that year. For a regulated insurance company that has a NAIC financial statement as its applicable financial statement, a “charge-

off” means an accounting entry or set of accounting entries that reduce the debt’s carrying value and result in a realized loss or a charge to the statement of operations (as opposed to recognition of unrealized loss) that is recorded on the company’s annual statement.

An “applicable financial statement” may be a separate company financial statement prepared in the ordinary course of business or a consolidated financial statement that includes the assets, a portion of the assets or annual total revenue of any member of a regulated financial group. A corporation must use a financial statement certified as being prepared in accordance with GAAP that is a Form 10-K (or successor form) or annual statement to shareholders required to be filed with the Securities and Exchange Commission (SEC), if available, as its applicable financial statement. If it does not have such a statement, then the applicable financial statement may be a financial statement required to be provided to a bank regulator. In the case of an insurance company, if an SEC-filed financial statement is unavailable, the applicable financial statement may be a GAAP financial statement anticipated to be relied upon when given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investments in the company or provided for other substantial non-tax purposes and that is prepared contemporaneously with a NAIC financial statement. In the case of an insurance company that does not have a GAAP financial statement, a NAIC financial statement may be the applicable financial statement.

Change in method of accounting and effective date

A change to the Allowance Charge-off Method constitutes a change in method of accounting for which the consent of the Commissioner under [section 446\(e\)](#) must be obtained before using this method for Federal income tax purposes. A taxpayer that changes its method of accounting to the Allowance Charge-off Method is treated as making a change in method initiated by the taxpayer for purposes of [section 481](#), and appropriate adjustments must be made under this section. Additionally, the change is made on an entity-by-entity basis. The proposed regulations will become effective for taxable years ending on or after the date they are finalized. A regulated financial company or a member of a regulated financial group may choose to rely on Prop. Treas. Reg. § 1.166-2(d) for charge-offs made on its applicable financial statement that occur in taxable years ending on or after December 28, 2023, and before the date of publication of final regulations in the Federal Register.



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