Part I

Section 451.—General Rule for Taxable Year of Inclusion

26 CFR 1.451-1: General rule for taxable year of inclusion.
(Also: Part I, §§ 166, 446; 1.166-2, 1.446-1, 1.446-2.)

Rev. Rul. 2007-32

ISSUES

1. If federal banking rules require a bank to suspend the recognition of certain uncollected “accrued interest” as defined in § 1.446-2 of the Income Tax Regulations as income for regulatory financial statement purposes should the bank also cease recognizing uncollected accrued interest into income for federal income tax purposes?

2. If a bank uses a conformity method of accounting as provided for in § 1.166-2(d) but does not recognize uncollected accrued interest as income for regulatory financial statement purposes, when should the bank recognize a worthless debt with respect to uncollected accrued interest for federal income tax purposes?

3. If a bank receives payments on a loan where the bank for federal income tax purposes either (i) previously recognized the uncollected accrued interest as income and subsequently deducted the accrued interest receivable as a worthless debt under

section 166 or (ii) did not recognized the uncollected accrued interest on the loan as income, how should the payments be characterized for federal income tax purposes?

FACTS

X corporation is a bank as defined in § 1.166-2(d)(4)(i). X determines its taxable income using an accrual method of accounting and files its federal income tax returns on a calendar year basis. Loans made by X are subject to § 1.446-2, which determines the amount of "accrued interest" related to each loan for federal income tax purposes.

X is subject to regulatory supervision by federal banking authorities ("supervisory authorities") and is required to prepare regulatory financial statements that comply with federal banking rules. For regulatory financial statement purposes, unless a loan is both well secured and in the process of collection, federal banking rules generally require that X suspend the recognition into income of uncollected accrued interest on a loan and reverse any previously recognized uncollected interest income if:

(i) the loan is maintained on a cash basis because of deterioration in the borrower's financial condition;

(ii) payment in full of principal or interest is not expected; or

(iii) payment of principal or interest has been in default for a period of 90 days or more.

Under federal banking rules, a loan may be considered a bankable asset (i.e., not written off for regulatory financial statement purposes) even if accrued interest on the loan is no longer being recognized as income (or was previously recognized and subsequently charged off) for regulatory financial statement purposes. In this revenue ruling, the loan is referred to as a "non-accrual loan receivable."

In general, federal banking rules require a bank such as X to apply any payment received on a non-accrual loan receivable to reduce its recorded investment in the loan (*i.e.,* treat all monies that come in on the loan as a collection of loan principal) to the extent necessary to eliminate doubt as to collectibility. Therefore, for regulatory financial statement purposes, X characterizes any payment received on a non-accrual loan receivable as a payment of principal rather than a payment of the outstanding accrued interest on the loan until the remaining principal on the non-accrual loan receivable is considered to be fully collectible.

On January 16, 2007, X classifies Loan A as a non-accrual loan receivable for regulatory financial statement purposes because an amount of principal or interest has become 90 days past due. Nonetheless, X reasonably expects the borrower to continue making some but not all payments on the loan.

On January 16, 2007, the uncollected accrued interest on Loan A is $9,000 ($8,000 attributable to the calendar year ending December 31, 2006, and $1,000 attributable to the period January 1, 2007 through January 16, 2007). Prior to January 17, 2007, X recognized the $9,000 as income for regulatory financial statement purposes. During the period January 17, 2007 through December 31, 2007, an additional $23,000 of accrued interest becomes due on Loan A.

Pursuant to federal banking rules, on January 16, 2007, X reverses the $9,000 of uncollected accrued interest that had previously been recognized by making adjustments to appropriate income statement and balance sheet accounts for regulatory financial statement purposes. In addition, federal banking rules do not permit X to

recognize as income any of the $23,000 accrued interest attributable to the period January 17, 2007 through December 31, 2007.

On January 1, 2008, X receives a $31,000 payment on Loan A. For regulatory financial statement purposes, X characterizes the $31,000 payment as a recovery of principal rather than a recovery of accrued interest. Therefore, X does not recognize any of the $31,000 payment as interest income for regulatory financial statement purposes.

X's supervisory authorities, in connection with the most recent examination of X's regulatory financial statements and lending practices, have determined that X maintains and applies standards that are consistent with federal banking rules.

LAW AND ANALYSIS

Issue 1.

Section 1.446-2 provides rules for determining the amount of accrued interest (other than interest described in § 1.446-2(a)(2)) that is generated on a loan over time for federal income tax purposes.

Section 1.446-2(a)(1) provides that the period in which a taxpayer recognizes accrued interest (determined under § 1.446-2(b) or § 1.446-2(c)) in gross income is determined under the taxpayer's regular method of accounting.

Section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.

In the case of an accrual method taxpayer, § 1.451-1(a) provides that income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. *See also* § 1.446-1(c)(1)(ii).

As an accrual method taxpayer, X generally is required to recognize accrued interest determined under § 1.446-2 into gross income for the taxable year in which all the events have occurred which fix the right to receive such interest and the amount thereof can be determined with reasonable accuracy. *See* § 1.451-1(a). Under the "all events" test, a taxpayer's right to receive income becomes fixed on the earlier of the date that: (1) payment is earned through performance; (2) payment is due; or (3) payment is actually received. Rev. Rul. 84-31, 1984-1 C.B.127. An amount of accrued interest determined pursuant to § 1.446-2 satisfies the "reasonable accuracy" requirement of § 1.451-1(a).

Although federal banking rules do not permit X to recognize accrued interest related to a non-accrual loan receivable as income for regulatory financial statement purposes, regulatory accounting rules are not controlling for federal income tax purposes. *See Old Colony R. Co. v. Commissioner,* 284 U.S. 552, 562 (1932).

"A fixed right to a determinable amount does not require accrual, however, if the income is uncollectible when the right to receive the income item arises. Accrual of income is not required when a fixed right to receive arises if there is not a reasonable expectancy that the claim will ever be paid." *European Am. Bank & Trust Co. v. United States,* 20 Cl. Ct. 594, 605 (1990) (footnotes omitted), *aff'd per curiam,* 940 F.2d 677 (Fed. Cir 1991); *see also Jones Lumber Co. v. Commissioner*, 404 F.2d 764, 766 (6th

Cir. 1968) (stating that "[t]he right to receive . . . determines the accrual of income unless, at the time the right arises, there exists a reasonable doubt as to its collectibility"); *Koehring Co. v. United States,* 421 F.2d 715, 721 (Ct. Cl. 1970) (stating that "a reasonable doubt as to the collectibility of a debt is a sufficient reason to justify its nonaccrual as income"); Rev. Rul. 80-361, 1980-2 C.B. 164 (citing *Jones Lumber Co., supra.*)

The "no reasonable expectancy of payment" exception to the fundamental rules of income accrual is strictly construed. "For accrual of income to be prevented, uncertainty as to collection must be substantial." *European Am. Bank & Trust Co.,* 20 Cl. Ct. at 605. To treat an item as non-accruable because of doubtful collectibility, the cases generally have required substantial evidence as to the financial instability or insolvency of the debtor. *See Jones Lumber Co.,* 404 F.2d at 766. This substantiation requirement has been applied on a loan by loan basis.

Temporary financial difficulty of a debtor cannot support non-recognition of income absent the existence of real doubt regarding ultimate payment. *Koehring Co.,* 421 F.2d 715, 721-722; *see also Harmont Plaza Inc. v. Commissioner,* 64 T.C. 632, 650 (1975), *aff'd,* 549 F.2d 414 (6th Cir. 1977) (stating that "the fact that a lapse of time is contemplated before actual satisfaction is possible does not constitute the requisite doubtful collectibility"). If there is some doubt regarding receipt of payment but a reasonable person would have an expectancy of payment, then an accrual method taxpayer is required to recognize the income.

When an income item is properly accrued and subsequently becomes uncollectible, a taxpayer's remedy is by way of a bad debt deduction under section 166

rather than through elimination of the accrual. Rev. Rul. 80-361. *See also* § 1.166-1(e) (relating to a bad debt deduction for uncollected income items included as income for the taxable year in which the bad debt deduction is claimed or for a prior taxable year); section 585 (allowing certain banks to deduct additions to a reserve for bad debts in lieu of the bad debt deduction provided by section 166) and § 1.585-2(e)(2) (excluding interest that has not been included in gross income from a loan used to determine additions to the reserve for bad debts). This rule is applicable even when the item is accrued and becomes uncollectible during the same taxable year. *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182 (1934). *See also Atlantic Coast Line Railroad Co. v. Commissioner*, 31 B.T.A. 730, 751 (1934), acq., XIV-2C.B. (1935).

Rev. Rul. 81-18, 1981-1 C.B. 295, addressed an accrual basis savings and loan association operating on a calendar year for federal income tax purposes. On its 1978 income tax return, the savings and loan recognized into income uncollected accrued interest on a loan. However, no interest payments were ever received on the loan. On January 30, 1979, the savings and loan charged off the previously recognized 1978 accrued interest for regulatory financial accounting purposes and recognized a bad debt deduction for federal income tax purposes. The charge-off was made pursuant to then existing Federal Home Loan Bank Board (FHLBB) regulations. The FHLBB regulations required that interest be treated as uncollectible if any portion of the interest was due but uncollected for a period in excess of 90 days. FHLBB examiners, upon their first audit of the savings and loan after the charge-off, confirmed that the charge-off was properly recognized for regulatory financial statement purposes and made in accordance with established policies of the FHLBB. The ruling considered two issues:

(1) whether the savings and loan's claim for the uncollected 1978 interest was worthless for purposes of recognizing a section 166 bad debt deduction; and (2) whether the savings and loan was required under section 451 and § 1.451-1(a) to recognize the uncollected accrued interest on the nonperforming loan for periods after December 31, 1978 under the accrual method of accounting. The ruling concluded that for federal income tax purposes, the savings and loan's claim to the 1978 uncollected accrued interest was a worthless debt for purposes of section 166. The ruling also concluded that the savings and loan was not required to recognize any uncollected accrued interest on the loan after December 31, 1978.

Unlike the situation in Rev. Rul. 81-18, where no payments on the loan were made and there was no reasonable expectation of payment, in this revenue ruling X reasonably expects the borrower to continue making some but not all payments on Loan A. Therefore, the borrower's default on Loan A only demonstrates that timely repayment is not occurring. The late payment of interest by itself is not sufficient to demonstrate that X has no reasonable expectation of payment of the accrued interest related to Loan A. Under these circumstances, the "no reasonable expectancy of payment" exception to the general accrual rule does not apply. *See Koehring Co.,* 421 F.2d at 721-722*; Harmont Plaza Inc.,* 64 T.C. at 650.

As an accrual method taxpayer, X is required to recognize the $8,000 of uncollected 2006 accrued interest as income in X's 2006 taxable year for federal income tax purposes. X is also required to recognize the $24,000 of uncollected 2007 accrued interest in X's 2007 taxable year. The result is the same regardless of whether the bank uses a conformity method of accounting provided for in §1.166-2(d).

Issue 2.

Section 166(a)(1) provides that a deduction shall be allowed for any debt that becomes worthless during the taxable year. In addition, section 166(a)(2) provides a deduction for "partially worthless debts" not in excess of the part charged off in the taxpayer's books and records within the taxable year to the extent the Commissioner is satisfied that the debt is recoverable only in part. A deduction for a worthless debt arising from an item of taxable income shall be allowed only if the item is recognized as taxable income during the taxable year in which the deduction is claimed or a prior taxable year. *See* § 1.166-1(e).

In general, there is no bright line test for determining the period in which a debt becomes worthless. However, § 1.166-2(d) permits a bank subject to supervision by federal banking authorities to use a conformity method of accounting to determine when a debt becomes worthless. Under a conformity method, debts that are charged off, in whole or in part, for regulatory purposes are conclusively presumed to become worthless for federal income tax purposes at the time of the regulatory charge off. Under a conformity method of accounting, the bank is allowed to recognize a bad debt deduction for the taxable year in which a debt is conclusively presumed to have become worthless. *See* § 1.166-2(d)(3)(ii)(A)(2).

In connection with the most recent examination of X's regulatory financial statements, X's supervisory authorities have determined that X maintains and applies standards that are consistent with federal banking rules. *See* Rev. Proc. 92-84, 1992-2 C.B. 489 (providing the form for the determination). Therefore, X satisfies the express determination requirement of § 1.166-2(d)(3)(iii)(D).

Various procedures can be used by a bank to classify a debt, or portion thereof, as a loss asset described in § 1.166-2(d)(3)(ii)(C). Rev. Rul. 2001-59, 2001-2 C.B. 585. On January 16, 2007, X reverses the recognition of the $9,000 of pre-January 17, 2007 uncollected accrued interest as interest income on Loan A ($8,000 of 2006 interest and $1,000 of interest for the period January 1, 2007 through January 16, 2007) for regulatory financial statement purposes. X's reversal of the accrual of $9,000 of uncollected pre-January 17, 2007 accrued interest, removes the interest receivable from X's books and records for regulatory financial statement purposes. Under federal banking rules, the $9,000 interest receivable is treated as an uncollectible asset of such little value that its inclusion as a bankable asset is not warranted. The reversal of the accrual of the $9,000 of interest receivable constitutes a charge off of the interest receivable as a loss asset for purposes of § 1.166-2(d)(3)(ii)(C).

For regulatory purposes, X does not recognize as income any of the $23,000 of accrued interest attributable to the period January 17, 2007 through December 31, 2007 because X's right to the $23,000 of accrued interest has such little value that recognition of the accrued interest receivable as a bankable asset is not warranted. Under these circumstances, X's failure to recognize the $23,000 of accrued interest for regulatory financial statement purposes is tantamount to recognizing the accrued interest as income and immediately charging off the uncollected accrued interest receivable as a loss asset.

As a result of X's conformity method of accounting under § 1.166-2(d), X will be entitled to claim a worthless debt deduction under section 166 in X's tax year ending December 31, 2007 for the $32,000 of uncollected accrued interest on Loan A ($8,000

of uncollected accrued interest in 2006 and $24,000 of uncollected accrued interest in 2007).

Issue 3.

In general, §1.446-2(e) provides that each payment made on a loan (other than payments of additional interest or similar charges with regard to amounts that are not paid when due) is treated as a payment of interest to the extent of any accrued interest that is uncollected on the date the payment becomes due. The interest characterization provided for in §1.446-2(e) applies to all payments made on a loan regardless of the taxpayer's overall method of accounting. For example, the interest characterization provided for in § 1.446-2(e) would apply to a payment on a loan for which the uncollected accrued interest was not previously recognized as income for federal income tax purposes. Similarly, the interest characterization provided for in § 1.446-2(e) would apply to a payment on a loan for which the uncollected accrued interest was previously recognized as income for federal income tax purposes and subsequently deducted as a worthless debt under the taxpayer's method of accounting.

Under § 1.166-1(f), any amount attributable to a recovery of a bad debt, or of a portion of a bad debt, which was allowed as a deduction from gross income in a prior taxable year, is included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of section 111 and § 1.111-1.

On January 1, 2008, X receives a $31,000 payment on Loan A. For regulatory financial statement purposes, X characterizes the $31,000 as a payment of loan principal. However, under § 1.446-2(e), X is required to characterize any payment

received on Loan A (other than payments of additional interest or similar charges with regard to amounts that are not paid when due) as a payment of interest for federal income tax purposes to the extent there is uncollected accrued interest outstanding on Loan A.

Immediately prior to the receipt of the $31,000 payment on January 1, 2008, the uncollected accrued interest on Loan A is $32,000 ($8,000 attributable to 2006 and $24,000 attributable to 2007). Therefore, §1.446-2(e) requires that X characterize the $31,000 payment on Loan A as a payment of interest for federal income tax purposes. The characterization of the $31,000 payment as interest under §1.446-2(e) would be the same regardless of whether: (i) X had not yet recognized the $32,000 of uncollected accrued interest on Loan A as income under its method of accounting for federal income tax purposes, (ii) X had recognized the $32,000 of uncollected accrued interest on Loan A as income for federal tax purposes but subsequently deducted the interest receivable as a bad debt under section 166 under its method of accounting, or (iii) X used a conformity method of accounting under § 1.166-2(d).

HOLDINGS

1. X is required to recognize in gross income the uncollected accrued interest on Loan A for federal income tax purposes notwithstanding that federal banking rules required X to suspend the recognition of accrued interest on Loan A into income for regulatory financial statement purposes. For the taxable year ending December 31, 2006, X must recognize in gross income the $8,000 of uncollected accrued interest on Loan A that was generated during 2006. For the taxable year ending December 31, 2007, X must recognize in gross income the $24,000 of uncollected accrued interest on

Loan A that was generated during 2007. X must recognize the uncollected accrued interest as gross income in 2006 and 2007 regardless of whether X has elected a conformity method of accounting under § 1.166-2(d)(3) to determine when a debt becomes worthless.

2. As X uses a conformity method of accounting under §1.166-2(d), X's $32,000 accrued interest receivable related to Loan A ($8,000 of uncollected accrued interest in 2006 and $24,000 of uncollected accrued interest in 2007) is considered worthless for purposes of section 166 in the year the amount is charged off for regulatory financial statement purposes. Therefore, for federal income tax purposes, X is allowed a worthless debt deduction for the $32,000 of uncollected accrued interest written off for regulatory financial statement purposes in the tax year ending December 31, 2007.

3. X is required to characterize the $31,000 payment received on Loan A in 2008 as a payment of interest for federal income tax purposes. The result would be the same whether (i) X had not yet recognized the $32,000 of uncollected accrued interest on Loan A as gross income under its method of accounting for federal income tax purposes, (ii) X had recognized the $32,000 of uncollected accrued interest on Loan A as gross income for federal tax purposes but subsequently deducted the receivable as a bad debt under section 166, or (iii) X used a conformity method of accounting under § 1.166-2(d). If X had previously deducted the $32,000 of uncollected accrued interest as a bad debt for federal income tax purposes then the subsequent $31,000 payment on the loan will be characterized as a partial recovery of that bad debt.

EFFECT ON OTHER RULINGS

Rev. Rul. 81-18 is distinguished with regard to when interest accrues for federal income tax purposes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Timothy Sebastian of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Sebastian (202) 622-7417.