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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JEFF P. EHRLICH
DISTRICT COUNSEL, DELAWARE-MARYLAND
CC:SER:DEM:BAL
Attn: Clare Brooks

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Bad Debt Reserve Recapture

This Field Service Advice responds to your memorandum dated November 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Acquiring Parent =
Acquiring Subsidiary =
Target Parent 1 =
Target Subsidiary 1 =
Target Parent 2 =
Target Subsidiary 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Date 6	=
Year 1	=
Year 2	=
Year 3	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=

ISSUES

1. Whether Target Subsidiaries 1 and 2 were required to recapture all of their bad debt reserves in computing the I.R.C. § 481(a) adjustments necessitated by a change in accounting method in connection with a section 381(a)(2) transaction.

2. In what tax year or years were the section 481(a) adjustments described above to be taken into account?

3. Whether section 593(g) applied to the transactions in issue.

CONCLUSIONS

1. Yes. Target Subsidiaries 1 and 2 should have recaptured the entire balances of their bad debt reserves for purposes of computing their section 481(a) adjustments.

2. Acquiring parent should have taken into account the entire increase in tax attributable to the method change and to the section 481(a) adjustments in the year in which the acquisitions occurred, which is Year 3.

3. No. Section 593(g) was not effective for the tax years in issue.

FACTS

On Date 1 Acquiring Parent became a “large bank” as defined in section 585(c)(2). At the time, Acquiring Parent’s bad debt reserve was $a. Acquiring Parent recaptured its reserve in accordance with section 585(c)(3)(A) beginning with its Year 2 tax return. Acquiring Parent was a calendar year taxpayer.

Acquiring Subsidiary became a large bank within the meaning of section 585(c)(2) on Date 2, the date it was acquired by Acquiring Parent. Acquiring Subsidiary's bad debt reserve at the time was $b. Acquiring Subsidiary recaptured its reserve in accordance with section 585(c)(3)(A) beginning with its Year 2 tax return. Acquiring Subsidiary was a calendar year taxpayer.

On Date 3, Target Parent 1 merged into Acquiring Parent. Pursuant to the merger, Target Subsidiary 1, an institution described in section 593(a), was merged into Acquiring Subsidiary. The mergers constituted section 368(a)(1)(A) mergers. On Date 3, Target Subsidiary 1's bad debt reserve was $c. Included in the $c was $d which represented the balance of Target Subsidiary 1's bad debt reserve prior to Year 1. Beginning with its Year 3 tax return, Target Subsidiary 1 used the method set forth in section 585(c)(3)(A) to recapture $e (the excess of $c over $d). Target Subsidiary 1 did not recapture $d. Prior to its merger, Target Parent 1 employed a Date 4 fiscal year.

On Date 5, Acquiring Parent purchased all of the outstanding stock of Target Parent 2 in a taxable stock purchase. Acquiring Parent did not make a section 338 election. Given the lack of facts that we have received with respect to this transaction, we have assumed for purposes of this memorandum that Target Subsidiary 2, an institution described in section 593(a), was subsequently merged into Acquiring Subsidiary in a section 368(a)(1)(A) merger. At the time of the merger, Target Subsidiary 2 had a total bad debt reserve of $f. Included in the $f was $g which represented the balance of Target Subsidiary 2's bad debt reserve prior to Year 1. Target Subsidiary 2 has not recaptured any portion of its bad debt reserve. Prior to its merger, Target Parent 2 employed a Date 6 fiscal year.

LAW AND ANALYSIS

During the taxable years in issue for the target subsidiaries, a thrift institution described in section 593(a) was permitted to use the reserve method of accounting set forth in section 593. To be eligible to use the section 593 reserve method of accounting, a taxpayer had to be a domestic building and loan association, a mutual savings bank, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit. The taxpayer also had to meet the total asset requirements of section 7701(a)(19)(C). Pursuant to section 585(c), large banks, as defined in section 585(c)(2), must use the specific charge-off method of accounting for bad debts.

1. Target Subsidiaries Must Recapture the Entire Balance of Their Bad Debt Reserves for Purposes of Computing Their Section 481(a) Adjustments

Section 381(c)(4) provides that the acquiring corporation in a reorganization to which section 368(a)(1) applies shall use the method of accounting used by the transferor corporation unless the acquiring corporation and the transferor used different methods. In that instance, the acquiring corporation shall use the method prescribed by regulations.

Reg. § 1.381(c)(4)-1(a)(1)(ii) provides that the acquiring corporation shall take into account the dollar balances of those accounts of the transferor corporation which represent reserves in respect of which the transferor has taken a deduction for taxable years ending on or before the date of transfer. The amount of the adjustment necessary to reflect a method change, the manner in which the reserves are to be taken into account, and the tax attributable to such reserves shall be determined and computed under section 481, subject to the rules provided in Reg. § 1.381(c)(4)-1(c) and (d). See also, Rev. Rul. 85-171, 1985-2 C.B. 148.

Reg. § 1.381(c)(4)-1(c)(2)(iii) sets forth rules for determining the principal method of accounting for bad debts when the transferor and the acquiring corporation use different methods. Reg. § 1.381(c)(4)-1(c)(1) provides that when an acquiring corporation must use a different method of accounting for an acquired business than its transferor did, the adjustments necessary to reflect such change and any resulting increase or decrease in tax are determined as if the transferor had initiated a change in method of accounting on the date of transfer. The increase or decrease in tax shall be taken into account by the acquiring corporation. Id. In other words, a transferor should prepare its final return using its old method of accounting. The transferor would then compute a hypothetical tax based on the assumption that it had changed its accounting method for its final year. The acquiring corporation would then take into account directly the increase or decrease in tax which would be imposed on (a) the income that would have been reported by the transferor under the new method, plus (b) the section 481(a) adjustment that would have resulted had the change actually been made by the transferor. See, California Federal Savings & Loan Association, GCM 39,436, I-279-84 (Nov. 1, 1985).

In this case, prior to the reorganizations, Target Subsidiaries 1 and 2 maintained bad debt reserves in accordance with section 593. Acquiring Subsidiary was a large commercial bank that was required to use the section 166 specific charge-off method of accounting for bad debts. The mergers of Target Subsidiaries 1 and 2 into Acquiring Subsidiary were reorganizations described in section 368(a)(1) and subject to section 381(c)(4). Because Acquiring Subsidiary was not permitted to use the section 593 bad debt reserve method, a change in method of accounting was required pursuant to Reg. § 1.381(c)(4)-1(c).

Target Subsidiaries 1 and 2 were required to recapture amounts equal to their entire bad debt reserve balances and compute their section 481(a) adjustments subject to the rules provided in Reg. § 1.381(c)(4)-1(c). The regulations under section 381 do not distinguish bad debt reserve balances by reference to the years such amounts are charged to the reserve. For example, Reg. § 1.381(c)(4)-1(a)(1)(ii) does not treat bad debt reserve balances prior to Year 1 differently from amounts charged to reserves in Year 1 and subsequent years. For the year in issue, the regulations make clear that bad debt reserve balances are aggregated and recaptured in the year of transfer. Accordingly, in this case, Target Subsidiaries 1 and 2 should have recaptured $c and $f, respectively, for purposes of computing their section 481(a) adjustments.

2. Acquiring Parent Was Required to Take Any Tax Increase Resulting From the Method Change and the Entire Section 481(a) Adjustments into Account in Year 3

As discussed above, Reg. § 1.381(c)(4)-1(c)(1) provides that when an acquiring corporation must use a different method of accounting for an acquired business than its transferor did, the adjustments necessary to reflect such change and any resulting increase or decrease in tax are determined as if the transferor had initiated a change in method of accounting on the date of transfer. The increase or decrease in tax shall be taken into account by the acquiring corporation. In this case the resulting tax increase attributable to the method changes and to the section 481(a) adjustments should have been taken into account by Acquiring Parent on its Year 3 consolidated return.

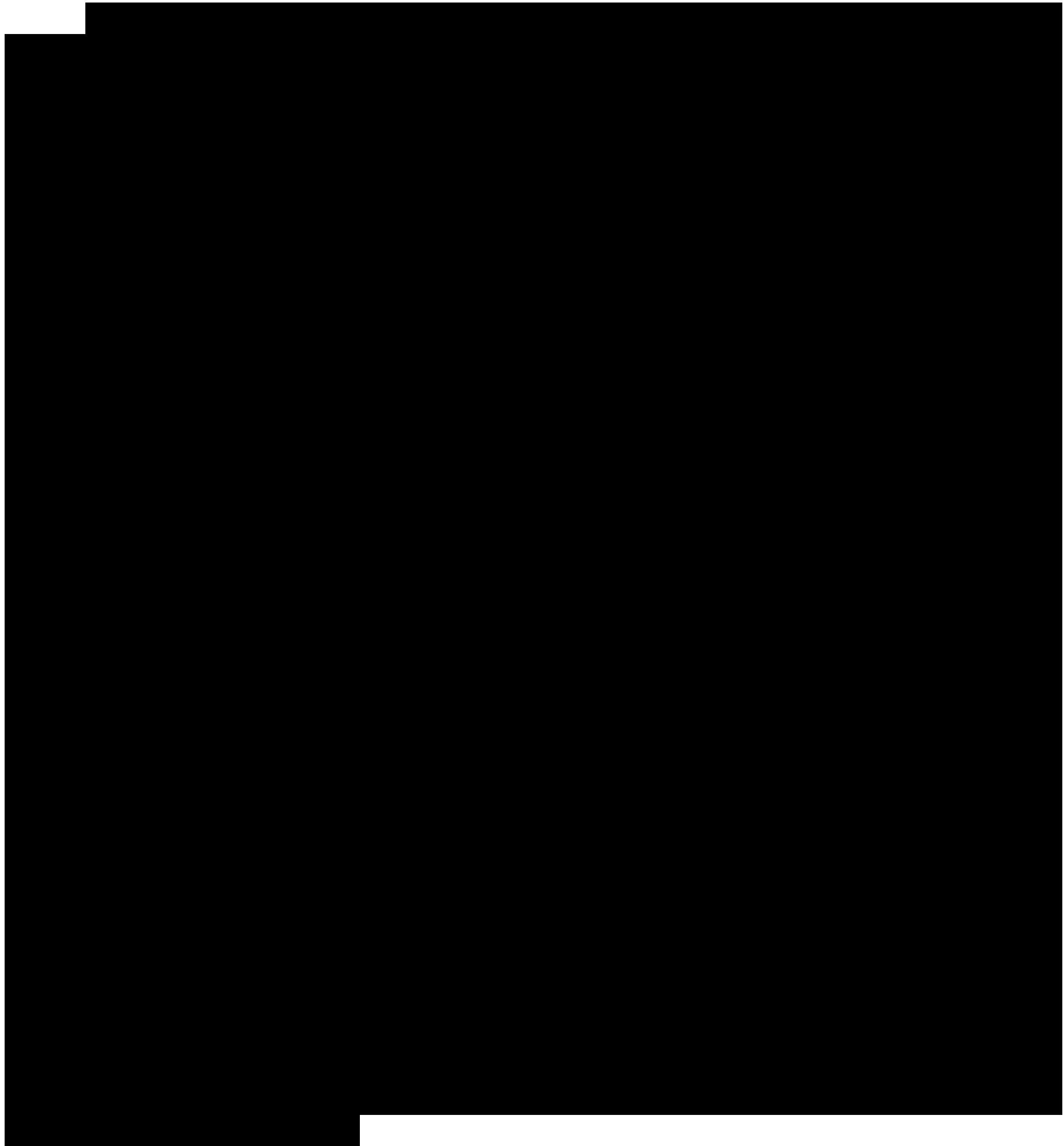
3. Section 593(g) Is Not Effective for the Years in Issue

Section 593(g) applies to taxable years beginning after December 31, 1995, and thus is not effective for the tax years in issue in this case. See section 593(f). If section 593(g) did apply in this case, Target Subsidiaries 1 and 2 would have been required to recapture only its "applicable excess reserves" (as defined in section 593(g)(2)). Under section 593(g)(1)(C) such reserves would have been taken into account ratably over the 6-taxable year period beginning with the first taxable year beginning after December 31, 1995.

However, as the facts indicate, Target Subsidiary 1 was merged on Date 3 and had a Date 4 fiscal year. Similarly, Target Subsidiary 2 was merged on Date 5 and had a Date 6 fiscal year. In each case, the target subsidiaries were merged into Acquiring Subsidiary prior to the end of their fiscal years that began in Year 2. Because Target Subsidiaries 1 and 2 were merged prior to their first taxable years

beginning after December 31, 1995, section 593(g) clearly is not applicable in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please call if you have any further questions.

By: ______________________________
JOEL E. HELKE
Chief, Financial Institutions
& Products Branch
(Field Service)

William A. Goss
CC:SER