

Section 166.—Bad Debts

26 CFR 1.166-3T: Partial or total worthlessness (temporary).

T.D. 8676

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Modifications of Bad Debts and Dealer Assignments of Notional Principal Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the allowance of a deduction for a partially worthless debt when the terms of a debt instrument have been modified. The temporary regulations provide guidance to certain taxpayers that modify the terms of a debt instrument after deducting an amount for partial worthlessness. This document also contains temporary regulations relating to certain assignments of notional principal contracts by dealers in those contracts. The temporary regulations provide guidance to taxpayers relating to consequences of these assignments. The text of these temporary regulations also serves as the text of the proposed regulations set forth in FI-59-94 on page 23 in this issue of the Bulletin.

DATES: These regulations are effective September 23, 1996.

FOR FURTHER INFORMATION CONTACT: Concerning the modifications of bad debts, Craig R. Wojay, Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3920 (not a toll-free number), and concerning dealer assignments of notional principal contracts, Thomas J. Kelly, Office of the Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1992, the IRS published in the **Federal Register** (57 FR

57034 [FI-31-92, 1992-2 C.B. 683]) a notice of proposed rulemaking that set forth proposed income tax regulations (26 CFR part 1) under section 1001 of the Internal Revenue Code (Code). Under § 1.1001-3(a) of the proposed regulations, a significant modification of a debt instrument is deemed to result in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. This rule is retained in the final regulations under § 1.1001-3, published in TD 8675, 1996-29 I.R.B. 50. Thus, when a debt is significantly modified, a taxpayer (holder) is required to recognize gain or loss based on the difference between the issue price of the significantly modified debt and the taxpayer's adjusted issue price in the original instrument.

Prior to finalizing the § 1.1001-3 regulations, the IRS and Treasury received comments that gain recognized as the result of a significant modification of a debt instrument often is attributable to the fact that the taxpayer previously claimed a deduction for partial worthlessness with respect to the debt. According to the commentators, the modification does not alter the fact that a portion of the debt remains uncollectible. Thus, the commentators suggested that, in this situation, a taxpayer should be permitted to offset the gain with a corresponding bad debt deduction.

The IRS and Treasury also received comments that the assignment by a dealer in notional principal contracts of its position in a contract to another dealer should not result in a deemed exchange under section 1001. Although the dealer will recognize gain or loss on the disposition of its position, treating the transaction as a deemed exchange would force the counterparty to realize the gain or loss on the contract even though the counterparty is maintaining its position. The commentators argued that dealer-to-dealer assignments are a common business practice and that these assignments have relatively little significance to the dealers' counterparties.

Explanation of Provisions

Section 166(a)(2) and § 1.166-3(a) provide that a deduction for a partially worthless debt is allowed only to the

extent the debt is charged off in the taxable year. The charge-off requirement is also contained in § 1.166-2(d)(1) and (3), which provides for a conclusive presumption of worthlessness under certain circumstances.

In general, the amount of a deduction on account of partial worthlessness is the amount by which the adjusted basis of a debt (as determined under section 1011) exceeds the amount recoverable on the debt. The amount of the deduction, however, may not exceed the amount charged off during the taxable year. The charge-off requirement is satisfied for a debt when a portion of the debt is removed from a taxpayer's books and records. This generally is accomplished by reducing the debt's book basis. Thus, when an amount has been deducted for partial worthlessness, there is generally a reduction of both the book basis and tax basis of a debt.

When a taxpayer is required to recognize gain under section 1001 because of a modification of a debt instrument, the taxpayer's tax basis in the debt is increased by the amount of gain recognized. Commentators on the proposed § 1.1001-3 regulations have indicated, however, that regulatory and general accounting principles generally would not permit a corresponding increase in the book basis of the debt. Because the prior charge-off is not restored (that is, the book basis of the debt is not increased), there is no opportunity for the taxpayer to take a new charge-off for pre-existing worthlessness. Thus, the charge-off requirement of section 166(a)(2) can never be satisfied with respect to the amount by which the debt's tax basis exceeds its book basis as a result of the modification, and the excess would not be allowed as a deduction until the debt becomes totally worthless.

The temporary regulations contained in this document set forth limited circumstances under which a taxpayer will be permitted to deduct an amount on account of a partially worthless debt even though no amount has been charged off within the taxable year. The purpose of these temporary regulations is to preserve the portion of a taxpayer's bad debt deduction with respect to a partially worthless debt that corresponds to the amount the taxpayer would have been entitled to deduct for partial worthlessness with respect to the modified

debt if the book basis of the modified debt were increased to the same extent as the tax basis of that debt. Thus, these temporary regulations apply only if all of the following conditions are satisfied. First, a significant modification of a debt instrument (within the meaning of § 1.1001-3) must result in a taxpayer's recognition of gain under § 1.1001-1(a). In addition, the debt must have been previously charged off and deducted by the taxpayer, and the prior charge-off and deduction must have satisfied the requirements of § 1.166-3(a)(1) and (2). If these conditions are satisfied, then a modified debt is deemed to have been charged off in the year in which gain is recognized. The amount of the charge-off, however, is limited to the difference between the tax basis of the debt and the greater of the book basis or the fair market value of the debt.

Both the proposed and the final regulations under § 1.1001-3 deal only with modifications of debt instruments. In response to comments on the proposed regulations, however, the temporary regulations contained in this document provide a limited rule dealing with a dealer's assignment of its position in an interest rate or commodity swap, or other notional principal contract to another dealer. If the assignment is permitted by the terms of the contract, the assignment will not be treated as a deemed exchange by the nonassigning party of the original contract for a new contract that differs materially either in kind or in extent. Thus, an assignment to which the rule applies does not trigger gain or loss to the dealer's counterparty. No inference is intended with respect to whether an assignment of rights by one party to other types of bilateral contracts results in an exchange or other disposition under section 1001 by the nonassigning party.

Effective Dates

The temporary regulations apply to significant modifications of debt instruments and assignments of interest rate swaps, commodity swaps, and other notional principal contracts occurring on or after September 23, 1996.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined

that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of the regulations concerning the modification of bad debts is Craig R. Wojay, Office of the Assistant Chief Counsel (Financial Institutions and Products), IRS. The principal author of the regulations concerning the dealer assignments of certain notional principal contracts is Thomas J. Kelly, Office of the Assistant Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805

Par. 2. Section 1.166-3T is added to read as follows:

§ 1.166-3T Partial or total worthlessness (temporary).

(a)(1) and (2) [Reserved]. For guidance, see § 1.166-3(a)(1) and (2).

(3) *Significantly modified debt—(i) Deemed charge-off.* If a significant modification of a debt instrument (within the meaning of § 1.1001-3) during a taxable year results in the recognition of gain by a taxpayer under § 1.1001-1(a), and if the requirements of paragraph (a)(3)(ii) of this section are met, there is a deemed charge-off of the debt during that taxable year in the amount specified in paragraph (a)(3)(iii) of this section.

(ii) *Requirements for deemed charge-off.* A debt is deemed to have been charged off only if—

(A) The taxpayer (or, in the case of a debt that constitutes transferred basis

property within the meaning of section 7701(a)(43), a transferor taxpayer) has claimed a deduction for partial worthlessness of the debt in any prior taxable year; and

(B) Each prior charge-off and deduction for partial worthlessness satisfied the requirements of paragraphs (a)(1) and (2) of this section.

(iii) *Amount of deemed charge-off.* The amount of the deemed charge-off, if any, is the amount by which the tax basis of the debt exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses. The amount of the deemed charge-off, however, may not exceed the amount of recognized gain described in paragraph (a)(3)(i) of this section.

(iv) *Effective date.* This paragraph (a)(3) is effective September 23, 1996.

(b) [Reserved]. For further guidance, see § 1.166-3(b).

Par. 3. Section 1.1001-4T is added to read as follows:

§ 1.1001-4T Modifications of certain notional principal contracts.

(a) *Dealer assignments.* For purposes of § 1.1001-1(a), the substitution of a new party on an interest rate or commodity swap, or other notional principal contract (as defined in § 1.446-3(c)(1)) is not treated as a deemed exchange by the nonassigning party of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) The party assigning its rights and obligations under the contract and the party to which the rights and obligations are assigned are both dealers in notional principal contracts, as defined in § 1.446-3(c)(4)(iii); and

(2) The terms of the contract permit the substitution.

(b) *Effective date.* This section is effective September 23, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved May 31, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 24, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 25, 1996, 61 F.R. 32653)