OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
March 2, 2000

Number: **200024004**
Release Date: 6/16/2000
TL-N-581-96
UILC: 166.00-00
6511.03-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service Division)
CC:DOM:FS

SUBJECT: An attempt to eliminate bad debt deductions for partially worthless debt on an amended return

This Field Service Advice responds to your memorandum dated November 4, 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

X =

Country 1 =
Country 2 =
Country 3 =

r =
s =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =

Date 8	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=

ISSUES

In general, whether X is entitled to amend its federal income tax return for the Year 1 fiscal year to eliminate previously claimed bad debt deductions attributable to loans to Country 1, Country 2, and Country 3.

1) Whether X can eliminate a deduction for partially worthless debt in Year 1 in order to increase its loan basis in a subsequent taxable year.

2) Whether X can rely on the seven year statute of limitations provided in I.R.C. § 6511(d)(1) in order for its amended return for the Year 1 fiscal year to be deemed timely filed.

3) Whether X can revoke the elections made on its original return to deduct partially worthless debt for the Year 1 fiscal year.

4) Whether X has improperly attempted to change its method of accounting under I.R.C. § 446(e).

5) Whether X has properly employed the net operating loss carryback and carryover rules under I.R.C. § 172(b)(1)(D).

CONCLUSIONS

1) X may not change the year in which it deducted partially worthless debt in order to increase its loan basis in a subsequent year, because X already claimed a deduction on its original return for Year 1 pursuant to Treas. Reg. § 1.166-2(d)(2).

2) The seven year limitation period under I.R.C. § 6511(d)(1) cannot be applied to allow X to timely file an amended return for the Year 1 fiscal year to eliminate the bad debt deduction that X previously claimed for partially worthless debt for Country 1, Country 2, and Country 3, because I.R.C. § 6511(d)(1) is only applicable where a taxpayer's bad debt deduction is either increased or the bad debt is discovered after the filing of the original return.

3) X could also be prohibited from filing an amended return pursuant to the doctrine of election, because X had a choice between two or more alternatives and X communicated its choice to the Service when its original return was filed for the Year 1 fiscal year with the election to claim a deduction for partially worthless debt.

4) X has improperly changed its method of accounting under I.R.C. § 446(e).

5) X properly employed the net operating loss carryback and carryover rules under I.R.C. § 172(b)(1)(D) for the partially worthless debt at issue because the bad debt deductions were made pursuant to I.R.C. § 166(a), but only to the extent of allowable losses as explained herein.

FACTS

X is a foreign bank operating a branch office in the United States. During Year 1, X computed the amount of its bad debt deduction for partially worthless debt on the basis of allocated transfer risk reserve (ATRR) schedules established by United States federal bank regulators for domestic banks. Pursuant to ATRR schedules, X established and maintained ATRRs on its United States books in the amounts of r%, s%, and s% of the outstanding principal balances on loans to Country 3, Country 2 and Country 1, respectively. On Date 1, X filed its federal income tax return, Form 1120F, for Year 1 and claimed bad debt deductions for loans to Country 3, Country 1 and Country 2 in the amounts of $a, $b, and $c, respectively, for a total of $d.

In Date 2, X filed its federal income tax return for Year 3 fiscal year and reported a gain from the sale of the loan to Country 3. On Date 3, the Service began auditing X's returns for the Year 1 through Year 2 fiscal years and accepted X's bad debt deductions. The Service completed this audit on Date 4.

In Date 5, X filed its federal income tax return for the Year 4 fiscal year and reported a gain from a taxable restructuring of the loan to Country 1 and a loss from the sale of the loan to Country 2. X also claimed a bad debt deduction in the amount of $e on its return for the Year 4 fiscal year and elected in the return for Year 4 fiscal year to carryback a portion of the Year 4 bad debt loss to the Year 6 fiscal year.

On Date 6, the Service began auditing X's returns for the Year 3 through Year 5 fiscal years. X filed an amended return for the Year 1 fiscal year on Date 7, three days before the statute of limitation pursuant to I.R.C. § 6511(d)(1) expired on Date 8. In its amended return, X eliminated the bad debt deductions that it had previously claimed in the original return for partially worthless debt for the loans to Country 1, Country 2, and Country 3. The elimination of these bad debt deductions did not create an overpayment and additional taxes were not owed for the Year 1 fiscal year.

The elimination of the bad debt deductions for Year 1, however, increased X's bases in the loans and resulted in substantial losses from the sale and restructuring of the loans to Country 1 and Country 2. This gave X a net operating loss for the Year 4 fiscal year in the amount of $f, rather then $g, as originally reported. X's potential bad debt carryback of $e from Year 4 to Year 6 was initially limited to a net operating loss of $g. However, because of the amended return for Year 1, the net operating loss for Year 4 was increased to $f thereby allowing X to carryback the entire bad debt of $e to the Year 6 fiscal year.

X's original Year 1 potential net operating loss carryforward of $h was due to expire in the Year 5 fiscal year. Pursuant to the amended return for Year 1, however, a net operating loss of only $i would be due to expire in the Year 5 fiscal year.

X used the specific charge off method for debts in the Year 1 through Year 4 fiscal years. X carried its net operating losses for the partially worthless debt back and forward using the calculation set forth in I.R.C. § 172(b)(1)(D).

LAW AND ANALYSIS

Bad Debt Deduction:

I.R.C. § 166(a)(2) provides that when satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. Treas. Reg. § 1.166-2(a) provides that in determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

For a United States bank, under Rev. Rul. 84-94, 1984-1 C.B. 34, the portion of international loans that are subject to an ATRR are conclusively presumed to be worthless under Treas. Reg. § 1.166-2(d)(1). Rev. Rul. 84-94 was published prior to Treas. Reg. § 1.166-2(d)(3), which provides the same conclusive presumption for banks making a conformity election. Rev. Rul. 92-14, 1992-1 C.B. 93, superceded Rev. Rul. 84-94 by holding that the portion of international loans held by a bank that are subject to an ATRR (because banks would be directed by their supervisory authority to charge this portion to an ATRR if the banks did not charge against the bank's allowance for possible loan losses) are treated as debt charge offs in obedience to a specific order of the bank's supervisory authority for purposes of the conclusive presumptions under Treas. Reg. § 1.166-2(d)(1) and § 1.166-2(d)(3).

In general, a foreign bank is not subject to an ATRR requirement of United States bank regulators because it is not a “banking institution” for purposes of the International Lending Supervision Act of 1983, Pub. L. 98-181, 97 Stat. 1153 and implementing regulations. Therefore, X’s bad debt deductions for partially worthless debt were not eligible for the conclusive presumption of worthlessness under Treas. Reg. § 1.166-2(d)(1). Accordingly, Rev. Rul. 92-14, 1992-1 C.B. 93, and Rev. Rul. 84-94, 1984-1 C.B. 34, which deal with ATRRs, are inapplicable to X. However, if, from all the facts and circumstances, the district director is satisfied that (1) a debt is partially worthless under Treas. Reg. § 1.166-2(a) and (b), and (2) the debt has been properly charged off under Treas Reg. § 1.166-3(a), then, the deductions for partially worthless debt may be appropriate.

The district director may consider an ATRR schedule as evidence of partially worthless debt. Other information may be considered as well, such as the treatment of the debt by the regulators of the foreign home office. The district director may also consider X’s established and maintained ATRR as a specific reserve to the extent it satisfies the charge off requirements. See Brandtjen & Kluge v. Commissioner, 34 T.C. 416 at 444 (1960), acq. 1960-2 C.B. 4, a case in which the court concluded that a proper charge off was made when (1) the book entries were limited to specific debts (a specific reserve) and (2) the entries were intended to accomplish a charge off and were described in terms indicating a sustained loss, rather than an anticipated loss, in the one specific account. If the district director is satisfied that X has properly charged off its bad debts for purposes of I.R.C. § 166, X must likewise treat the bad debts as charged off for all purposes under Treas. Reg. § 1.882-5. Note, the requirements of I.R.C. § 166 necessarily require consistent treatment of the debt by the United States branch and the foreign home office.

I.R.C. § 166 does not permit a taxpayer to arbitrarily chose the year in which to deduct a worthless debt. See Winter v. Hirsch, 571 F.2d 11 (Ct. Cl. 1978). The regulations permit, under limited circumstances, a taxpayer to elect to defer claiming a deduction for a debt currently charged off on its books and records when the charge off is in obedience to a specific order or the regulator confirms in writing that the charge off would have been subject to a specific order. A subsequent deduction is permitted only to the extent a debt actually becomes wholly or partially worthless in the subsequent year in which the deduction is claimed. Treas. Reg. § 1.166-2(d)(2).[1]

In this case, X could not meet the requirements in Treas. Reg. § 1.166-2(d)(2) for a deduction of partially worthless debt in a year subsequent to Year 1 because X previously charged off the debt and claimed a deduction for the partial worthlessness in its original return for Year 1. We have no information that the debt became wholly or partially worthless in a year subsequent to the charge offs. In addition, the charge off was made neither in obedience to a specific order nor pursuant to a regulator's written confirmation that the charge off would have been subject to a specific order. Based on I.R.C. § 166 and the regulations, X may neither deduct the partially worthless debt attributable to the Year 1 fiscal year in

[1] Under Treas. Reg. § 1.166-2(d)(2), if a bank or other corporation subject to Treas. Reg. § 1.166-2(d)(1) does not claim a deduction for the partially or totally worthless debt in its return for the taxable year in which the charge off takes place, but claims the deduction for a later taxable year, then the charge off in the prior taxable year shall be deemed to have been involuntary and the deduction under I.R.C. § 166 shall be allowed for the taxable year for which claimed, provided that the taxpayer produces sufficient evidence to show that:

(i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge off, as the case may be; and,

(ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year.

the Year 4 fiscal year, nor may it restore its basis in the debt for any year subsequent to the Year 1 fiscal year.

Statute of Limitations Pursuant to I.R.C. § 6511(d)(1):

Generally, a taxpayer may file a claim for refund within three years after the return was filed or two years after the tax was paid, whichever is later. I.R.C. § 6511(a). Several provisions in I.R.C. § 6511 create special limitation periods that are applicable to federal income tax. X alleges that I.R.C. § 6511(d)(1) allows a taxpayer to amend its return and change taxable income relating to bad debt deductions within seven years of the timely filed federal income tax return. I.R.C. § 6511(d)(1) states:

> If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of-
>
> (A) The deductibility by the taxpayer, under section 166 or section 832(c), of a debt as a debt which became worthless, or, under section 165(g), of a loss from worthlessness of a security, or
>
> (B) The effect that the deductibility of a debt or loss described in subparagraph (A) has on the application to the taxpayer of a carryover.
>
> In lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 7 years from the date prescribed by law for filing the return for the year with respect to which the claim is made. If the claim for credit or refund relates to an overpayment on account of the effect that the deductibility of such a debt or loss has on the application to the taxpayer of a carryback, the period shall be either 7 years from the date prescribed by law for filing the return for the year of the net operating loss which results in such carryback or the period prescribed in paragraph (2) of this subsection, whichever expires the later...

In the case Indiana National Corporation, et al v. United States, 980 F.2d 1098 (7^{th} Cir. 1992), the taxpayer and its subsidiaries timely filed its 1973 consolidated return, reporting bad debts and a net operating loss. The taxpayer in Indiana National Corp. later filed an amended return that reduced the bad debt deduction and increased the net operating loss. In 1974, Indiana Corp. applied for a tentative refund for 1973, stating that it had carried back to 1970 and 1971 its net operating loss and unused investment credit relating to 1973. Indiana Corp. filed a second tentative refund claim for 1970, stating that it had carried back to 1967 an unused investment credit, freed up by the net operating loss carryback from 1973 to 1970.

Indiana Corp, however, did not submit the amended returns for 1967 and 1970 until 1977. It then filed an amended 1973 return showing a slightly lower net operating loss than reported on its original return.

The Government argued in Indiana National Corp. that the refund claims relating to 1967 and 1970 were time barred under I.R.C. § 6511(d)(2)(A) and (4)(A) instead of the seven year limitation period of I.R.C. § 6511(d)(1) because the taxpayers' bad debt deductions decreased since the filing of their original return, and the effect of the decreased deductions on the taxpayers' application of the carryback did not cause an overpayment for which they are entitled to a refund. The court agreed with the Government, holding that unless a taxpayers' bad debt deduction is newly discovered or increased after the original filing, the effect of the deduction on the application of a carryback cannot account for an overpayment and the limitation period under I.R.C. § 6511(d)(1) does not apply. Id.

This interpretation is further supported by the legislative history of I.R.C. § 6511(d)(1) and Rev. Rul. 55-523, 1955-2 C.B. 497. The House Report of the session that enacted I.R.C. § 322(b)(5), the forerunner of I.R.C. § 6511(d)(1), explained the need for the statute in order to protect a taxpayer for whom "later evidence" discloses a miscalculation about the year in which a debt becomes worthless. H.R. Rep. No. 2333, 77th Cong., 1st Sess., reprinted in 1942-2 C.B. 372, 408. "The 7-year period was designed to prevent possible prejudice to those taxpayers whose otherwise legitimate deduction might be placed in jeopardy by the general 3-year period. No such risk extends to a taxpayer whose bad debt deduction is taken on the original return for the year." Armstrong v. United States, 681 F.2d 774, 776 (Cl. Ct. 1982). Rev. Rul. 55-523 also expressly limits the applicability of I.R.C. § 6511(d)(1) to situations in which the bad debt deduction is newly discovered or increased. Indiana National Corp. at 1102.

In the case at issue, X took bad debt deductions for the loans to Country 1, Country 2, and Country 3 in the original return for the Year 1 fiscal year, which was filed with the Service on Date 1. In X's amended return for Year 1, X is eliminating or reducing the bad debt deduction for Year 1. Thus, X is not attempting to deduct newly discovered or increased bad debts in addition to those bad debts deducted in the original return for Year 1. Therefore, the effect of X's elimination or reduction of the bad debt deduction cannot account for an overpayment and the limitation period under I.R.C. § 6511(d)(1) does not apply.

Doctrine of Elections

The doctrine of election was first developed in the case Pacific National Co. v. Welch, 304 U.S. 191 (1938). In Pacific National Co., the taxpayer had the option to treat certain income under either the deferred payment or the installment method. It reported the income using one method and later sought a refund based on a computation under the other method. The Supreme Court held that "change from one method to the other... would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws....There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to the other method." Id. at 194.

Under the doctrine of election, the general rule is that a taxpayer who elects a proper method of reporting may not later revoke or change that election and substitute another (albeit correct) method. A taxpayer who makes a conscious election may not, without the consent of the Commissioner, revoke or amend the election merely because events do not unfold as planned. Hodel v. Commissioner, T.C. Memo. 1996-348. Stated another way, "once the taxpayer makes an elective choice, he is stuck with it." Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982). This is particularly true where an election is affirmatively made in a timely filed return and where the benefits of the election are reflected on the return as prepared and filed by the taxpayer. Goldstone v. Commissioner, 65 T.C. 113 (1975). The doctrine of election also applies in cases where the taxpayer attempts to eliminate an election rather then substitute an election with an alternative election.

> The taxpayer, having elected to avail himself of the provision of the statute which he had a right to do, could not thereafter withdraw the election without the permission of the Commissioner. We are not dealing with a situation where the taxpayer desires to correct errors or miscalculations in his original return. Here it is sought to change the basis upon which taxes for different years will be computed. It is a case where the election made by a taxpayer later results in a disadvantage to him. He cannot at this later date disavow that election.

Keeler v. Commissioner, 180 F.2d 707, 710 (10th Cir. 1950).

The doctrine of election is an equitable doctrine predicated upon the policy concerns that allowing the taxpayer to make a new election on an amended return 1) places an undue administrative burden upon the Commissioner's enforcement of the tax law, particularly when the new method chosen requires a recalculation of tax liability for several taxable years or for other taxpayers; 2) often has the effect of enlarging the time for filing a return to include the period of limitation for refund claims; 3) prejudices the government's revenue interests by permitting the taxpayer to have the benefit of hindsight in choosing the most advantageous method of reporting; and 4) may undercut the equity and fairness of the tax system by treating similarly situated taxpayers differently. See J.E. Riley Investment Co. v. Commissioner, 311 U.S. 55, 59 (1940); Pacific National Co. v. Welch, 304 U.S. 191, 194 (1938); Mamula v. Commissioner, 346 F.2d 1016, 1018-1019 (9th Cir. 1965). The doctrine of election consists of the following elements: 1) There must be a free choice between two or more alternatives, and 2) there must be an overt act by the taxpayer communicating the choice to the Commissioner. Grynberg v. Commissioner, 83 T.C. 255 (1984).

Courts, however, have recognized a limited number of exceptions to the doctrine of election. Grynberg v. Commissioner, 83 T.C. 255 (1984). A material mistake of fact may be an exception to the doctrine of election. Id. Situations in which a material mistake of fact may allow a taxpayer to revoke an election are: 1) the amended return was filed prior to the date prescribed for filing a return; 2) the treatment of the contested items in the amended return was not inconsistent with his treatment of the item in his original return; or 3) the treatment of the item on the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return. Goldstone v. Commissioner, 65 T.C. 113, 116 (1975). However, mere "oversight, poor judgment, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences of making an election, miscalculation, and unexpected subsequent events have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the Code." Estate of Stamos v. Commissioner, 55 T.C. 468, 474 (1970).

The principles of the doctrine of election have a long and consistent application to the deductions for bad debts under I.R.C. § 166. For example, in Security-First National Bank of Los Angeles v. Commissioner, 1942 B.T.A.(P-H) Dec. ¶ 42407, the court stated there is no authority to rescind a deduction for a voluntary partial charge off in order to permit a deduction in a subsequent year. See also First National Bank of Montoursville, Pa. v. Commissioner, 1 T.C.M. (CCH) 602 (1943).

In the case at issue, X meets both of the necessary elements for the doctrine of election. First, X had a choice between two or more alternatives. X could have taken a bad debt deduction for partially worthless debt on the Year 1 return, or X could have waited to take the bad debt deduction once the debt had become totally worthless in a subsequent year or had become recoverable in part subsequent to the year of the charge off. Second, there was an overt act manifesting X's choice to the Commissioner. On X's return for Year 1, X claimed deductions for the bad debts for the loans to Country 1, Country 2, and Country 3.

In the case at issue, X would not qualify for one of the limited exceptions to the doctrine of election. It appears that X's reason for changing its election is that X now sees with hindsight that it is more advantageous for X to not claim bad debt deductions because X can get a large refund if the bases of the loans are increased instead. This is precisely one of the policy reasons behind the doctrine of elections. Therefore, X may not revoke X's election to claim the bad debt deductions without the approval of the Commissioner.

It is in the Service's discretion as to whether the Service will approve or accept an amended return. There is no statutory authorization for the filing of an amended return, although the Service has, "as a matter of internal administration", accepted amended returns under certain circumstances. Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977). A refusal by the Service to accept an amended return will be upset only upon a showing that the refusal amounted to an abuse of discretion. Lion Associates v. United States, 515 F. Supp. 550 (E.D. PA. 1981). This treatment of amended returns recognizes that it would be disruptive to the administration of the tax laws if a taxpayer could disregard his return and automatically change an assessment based thereon by making an amended return in his favor long after the expiration of the time for filing the original return. Miskovsky v. United States, 414 F.2d 954, 956 (3d Cir. 1969). The Service would not abuse its discretion by not accepting or approving X's amended return for fiscal year Year 1 because the limitation period has run and X is attempting to revoke an election made on X's original return because X now believes it is more advantageous to make a different election.

Change in Accounting Method

I.R.C. § 446(e) requires a taxpayer to obtain permission from the Secretary of the Treasury before changing a method of accounting. Consent is generally obtained by filing a Form 3115, Application for Change in Accounting Method, with the Commissioner. Treas. Reg. § 1.446-1(e)(3)(i). See Treas. Reg. § 1.446-1(e)(2)(i).

Under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a change in the method of accounting includes not only a change in the overall plan of accounting, but the treatment of any material item used in the overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

The Service position on the requirements for consistent treatment of a method are found in Rev. Proc. 90-38, 1990-1 C.B. 57. See Sec. 2.01(2) of Rev. Proc. 97-27, 1997-1 C.B. 679, 681-82. If a taxpayer treats an item properly in the first return that reflects the item, it is not necessary for the taxpayer to treat the item consistently in two or more taxable years before it has adopted a method. Rev. Rul. 90-38, 1990-1 C.B. at 58. This Service position is supported by Pacific National Co. v. Welch, 304 U.S. 191 (1938), where the Supreme Court held that when the taxpayer elects a proper method, it may not be changed without permission after the time for filing the return has passed, at least where it is not shown that the method chosen does not clearly reflect income. Further, a taxpayer may not change a method by amending its return in a subsequent year. Diebold, Inc. v. United States, 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990), citing Southern Pacific Transportation Co., 75 T.C. 497, 682 (1980); Rev. Rul. 90-38, 1990-1 C.B. at 58.

The deduction of the partially worthless debt is a material item within the meaning of the regulations because it involves the proper time for the taking of a deduction. X's treatment of the partially worthless debt appears to have been consistent with Treas. Reg. § 1.166-2(d)(2) and, if so, would be a proper method of accounting. Assuming that X properly adopted this method, X would need permission to change it after using it in the Year 1 fiscal year and could not change the method through the use of amended returns.[2]

Net Operating Loss Deduction

Under I.R.C. § 172(b)(1)(D), for any taxable year beginning after December 31, 1986, and before January 1, 1994, a bank (as defined in I.R.C. § 585(a)(2)), was entitled to a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss and a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss, but only for that portion of the net operating loss that is attributable to a deduction under I.R.C. § 166.

I.R.C. § 585 and the regulations thereunder provide rules permitting a deduction for a reasonable addition to a reserve for bad debts in the case of losses on the loans of certain banks in lieu of any deduction under I.R.C. § 166(a).

Rev. Rul. 93-69, 1993-2 C.B. 75, held that a commercial bank could not use the special 10-year net operating loss carryback provision of I.R.C. § 172(b)(1)(D) for the portion of its net operating loss that is attributable to a deduction for an addition to its bad debt reserve. The rationale for this position is that the reserves are deductible under I.R.C. § 585(a)(1) which allows reserves "in lieu of" any deduction under I.R.C. § 166(a) and not actually under I.R.C. § 166(a). The same conclusion

[2] We do not have complete information regarding how X treated partially worthless debt in other tax years. It appears X properly adopted the method in prior years and consistently used it for several years.

regarding reserve deductions under I.R.C. § 585(a)(1) was reached in First Alex Bancshares, Inc. v. United States, 830 F. Supp. 581 (W.D. Okla. 1993).

X employed the specific charge off method in the taxable years Year 1 through Year 4. Therefore, X may use the carryback and carryover provisions of I.R.C. § 172(b)(1)(D), because its bad debts deductions are allowed under I.R.C. § 166(a), rather than I.R.C. § 585(a)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In order for X to prevail on the issue of the correctness of its amended return, X must establish that the bad debt deduction for partially worthless debts was erroneous because its specific reserves under the ATRR schedules were for anticipated losses and not intended to reflect current losses, or, that the debts otherwise were not properly charged off in Year 1 because it didn't maintain ATRR equivalents. Taxpayer's argument would try to establish that the two part test in Brandtjen & Kluge v. Commissioner, 34 T.C. 416 (1960), acq. 1960-2 C.B. 4, was not met. The information you provided appears to the contrary. X claims to have established and maintained ATRR equivalents in respect to its foreign loans. However, if the facts are different and a specific reserve was not established and maintained, or the specific reserve is determined to be anticipatory contrary to the ATRR schedules, the hazards of litigation increase substantially. See Capital National Bank of Sacramento v. Commissioner, 16 T.C. 1202 (1951), acq. in part and nonacq. in part, 1952-1 C.B. 1, which involved a bank that took bad debt deductions for partially worthless debt without making a proper charge off, the bank was not estopped, in subsequent years, from asserting that the deduction was improper. On the other hand, if this were X's position, any other ATRR related deduction is suspect and should be disallowed in all open years.

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Please call if you have any further questions.