

# Section 166.—Bad Debts

*26 CFR 1.166-3: Partial or total worthlessness.*

T.D. 8763

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: Final and temporary regulations.

SUMMARY: This document contains regulations that deem a charge-off and allow a deduction for a partially worthless debt when the terms of a debt instrument

have been modified. The regulations provide guidance to certain taxpayers that have claimed a deduction for a partially worthless debt and then modified the terms of the debt instrument. This document also contains regulations relating to certain assignments of notional principal contracts by dealers in those contracts. The regulations provide guidance to taxpayers relating to the consequences of these assignments.

**DATES:** *Effective date:* These regulations are effective January 29, 1998.

*Applicability date:* These 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.

**FOR FURTHER INFORMATION CONTACT:** Concerning the modifications of bad debts, Craig Wojay, (202) 622-3920, and concerning dealer assignments of notional principal contracts, Thomas M. Preston, (202) 622-3940 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

*Background*

On June 25, 1996, temporary regulations (T.D. 8676 [1996-2 C.B. 9]) relating to modifications of bad debts and dealer assignments of notional principal contracts under sections 166 and 1001 of the Internal Revenue Code (Code) were published in the **Federal Register** (61 F.R. 32653). A notice of proposed rulemaking (REG-209743-94, formerly FI-59-94 [1996-2 C.B. 442]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (61 F.R. 32728). No public hearing was requested or held.

Written comments responding to the notice were received. After consideration of the comments, the regulations proposed by REG-209743-94 are adopted by this Treasury decision, and the corresponding temporary regulations are removed.

*Explanation of Provisions*

The preamble to the temporary regulations sets forth limited circumstances under which a taxpayer will be permitted

to deduct an amount on account of a partially worthless debt even though an amount has not been charged off within the taxable year.

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 satisfied when a portion of the debt is removed from the 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 the tax basis of a debt.

When a taxpayer is required to recognize gain under §1.1001-1 because of a modification of a debt instrument, the taxpayer's tax basis in the debt is increased by the amount of gain recognized. However, 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.

The purpose of the temporary regulations is to preserve a portion of a taxpayer's bad debt deduction with respect to a partially worthless debt. The portion preserved 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, if all the conditions of the temporary regulations 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 deemed 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. The temporary regulations also address debt that constitutes transferred basis property under section 7701(a)(43).

In addition, the temporary regulations provide a limited rule dealing with a dealer's assignment of its position in an interest rate swap, commodity swap, or other notional principal contract to another dealer. If the assignment is permit-

ted by the terms of the contract, the assignment is not 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.

Three comments were received on the §1.166-3T regulations. The first comment requests a deemed charge-off for a taxpayer that purchased at a discount debt for which a previous deduction for partial worthlessness was claimed, and then significantly modified the debt under §1.1001-3 and recognized gain on the modification. Whenever debt is purchased for less than the stated redemption price, recognized gain from a significant modification is attributable to market discount as defined in section 1278(a)(2)(A) and not to a previously claimed deduction for partial worthlessness. In addition, the temporary regulations refer to §1.166-3(a)(1) and (2) for guidance relating to prior charge-offs and deductions for partial worthlessness. Extending the temporary regulations to cover a discount purchase would significantly expand the regulations beyond their intended scope and create a situation that would be extremely difficult to administer. The regulations do not adopt the request to extend the regulations to cover such a purchase.

The second comment requests a deemed charge-off for a member of a consolidated group that purchased debt, for which a previous deduction for partial worthlessness was claimed, from another member of the group, then significantly modified the debt under §1.1001-3 and recognized gain on the modification. Whenever debt is purchased for less than the stated redemption price, subsequently recognized gain from a significant modification is attributable to market discount as defined in section 1278(a)(2)(A) and not to a previously claimed deduction for partial worthlessness. Extending the temporary regulations to cover a purchase from another member of the consolidated group would significantly expand the regulations beyond their intended scope. The regulations do not adopt the request to extend the regulations to cover an intercompany transaction.

The third comment requests expanding the temporary regulations to include other

situations in which a taxpayer has tax basis in a debt but no corresponding book basis. The first situation involves the accrual of interest income on loans that have been placed on non-accrual status for book purposes. The second situation involves the requirement to accrue interest on original issue discount obligations even if the loan has become uncollectible. This comment deals with situations other than the modification of a debt instrument and is beyond the scope of this regulation project.

#### 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) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

#### Drafting Information

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

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#### 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. In §1.166–3, paragraph (a)(3) is added to read as follows:

#### §1.166–3 Partial or total worthlessness.

(a) \* \* \*

(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) applies to significant modifications of debt instruments occurring on or after September 23, 1996.

\* \* \* \* \*

#### §1.166–3T [Removed]

Par. 3. Section 1.166–3T is removed.

Par. 4. Section 1.1001–4 is added to read as follows:

#### §1.1001–4 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 applies to assignments of interest rate swaps, commodity swaps, and other notional principal contracts occurring on or after September 23, 1996.

#### §1.1001–4T [Removed]

Par. 5. Section 1.1001–4T is removed.

Michael P. Dolan,  
Deputy Commissioner of  
Internal Revenue.

Approved January 14, 1998.

Donald C. Lubick,  
Assistant Secretary of  
the Treasury.

(Filed by the Office of the Federal Register on January 28, 1998, 8:45 a.m., and published in the issue of the Federal Register for January 29, 1998, 63 F.R. 4396)

#### Section 471.—General Rule for Inventories

26 CFR 1.471–2: Valuation of inventories.

Guidance, including a “retail safe harbor method,” is provided for a taxpayer that wants to change to a method of accounting for estimating inventory “shrinkage” in computing ending inventory. See Rev. Proc. 98–29, page 22.

#### Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

**LIFO; price indexes; department stores.** The February 1998 Bureau of Labor Statistics price indexes are accepted for use by department stores em-

ploying the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 1998.

## Rev. Rul. 98-20

The following Department Store Inventory Price Indexes for February 1998 were issued by the Bureau of Labor Sta-