Example 1. The X Corporation and the Y Corporation are commercial banks both of which have a calendar year as a taxable year. Both X and Y adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable year 1970 through 1973, X and Y determined their reasonable additions to a reserve for losses on loans outstanding (§1.585–2(e)(1)) under the percentage method. On June 30, 1974, the X Bank is merged into the Y Bank; for its short taxable year ending on June 30, 1974, X determines its reasonable addition under the percentage method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), Y determines its reasonable addition to a reserve for losses under the percentage method, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of X’s and Y’s respective amounts at the close of the taxable year ending December 31, 1969 (the base year of both X and Y determined under §1.585–2(e)(1) as if the distribution or transfer had not taken place). If, instead of the above, Y adopts the experience method of determining its reasonable addition to a reserve for losses for the taxable year 1974, than at the close of the base year (1973) the reserve balances, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of X’s and Y’s respective amounts at the close of the short taxable year ending on June 30, 1974 (X’s last taxable year before its (Y’s) most recent adoption of the experience method) and of Y’s respective amounts at the close of its taxable year 1973 (Y’s last taxable year before its most recent adoption of the experience method).

Example 2. The M Corporation and the N Corporation are commercial banks. M has a fiscal year ending September 30, as its taxable year, and N has a calendar year as its taxable year. Both M and N adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable years ending in 1970, 1971, and 1972, M determined its reasonable addition to a reserve for losses under the percentage method; for the taxable year ending in 1973 M adopted the experience method. For the taxable years 1970 through 1973, N determined its reasonable addition under the experience method. If, for the taxable year ending on December 31, 1974 (the first taxable year after M’s most recent adoption of the percentage method), or (b) if M did not have a reserve deficiency, the taxable year ending on September 30, 1969, and N’s respective amounts at the close of its taxable year 1979. If, instead of the above, N adopts the experience method for the taxable year 1979, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of M’s respective amounts at the close of its taxable year ending on September 30, 1972 (the last taxable year before M’s most recent adoption of the experience method), and N’s respective amounts at the close of the taxable year 1979 (the last taxable year ending before N’s most recent adoption of the experience method).

§1.585–5 Denial of bad debt reserves for large banks.

(a) General rule. For taxable years beginning after December 31, 1986, a large bank (as defined in paragraph (b) of this section) may not deduct any amount under section 585 or any other section for an addition to a reserve for bad debts. However, for these years, except as provided in §1.585–7, a large bank may deduct amounts allowed under section 166(a) for specific debts that become worthless in whole or in part. Any large bank that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in paragraph (d)(1) of this section) must follow the rules prescribed by §1.585–6 or §1.585–7 for changing from the reserve method of accounting for bad debts that is allowed by section 585, to the specific charge-off method of accounting for bad debts, in its disqualification year. However, except as may be provided otherwise in regulations prescribed under section 593, the rules prescribed by §§1.585–6 and 1.585–7 do not apply to a large bank that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year.

(b) Large bank—(1) General definition. For purposes of this section, a large...
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Bank is any institution described in §1.585–1(b)(1) (i) or (ii) if, for the taxable year (or for any preceding taxable year beginning after December 31, 1986) —

(i) The average total assets of the institution (determined under paragraph (c) of this section) exceed $500,000,000; or

(ii) The institution is a member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) and the average total assets of the group exceed $500,000,000.

(2) Large bank resulting from transfer by large bank — (i) In general. If a corporation acquires the assets of a large bank (as defined in this paragraph (b)) in an acquisition to which paragraph (b)(2)(ii), (iii) or (iv) of this section applies, the acquiring corporation (the acquirer) is treated as a large bank for any taxable year ending after the date of the acquisition in which it is an institution described in §1.585–1(b)(1) (i) or (ii).

(ii) Transfer of significant portion of assets where control is retained. This paragraph (b)(2)(ii) applies to any direct or indirect acquisition of a significant portion of a large bank’s assets if, after the acquisition, the acquirer is considered owned by a transferor bank if the stock is owned by any member of a parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) of which the bank is a member, by any related party within the meaning of section 267(b) or 707(b), or by any person that received the stock in a transaction to which section 355 applies.

(iii) Transfer to which section 381 applies. This paragraph (b)(2)(iii) applies to any acquisition to which section 381(a) applies if, immediately after the acquisition, the acquirer’s principal method of accounting for bad debts (determined under §1.381(c)(4)–1(c)(2)) with respect to its banking business is the specific charge-off method. In applying §1.381(c)(4)–1(c)(2) for this purpose, the following rules apply: A transferor large bank is considered to use the specific charge-off method for all of its loans immediately before the acquisition; an acquirer is considered to use a reserve method for all of its loans immediately before the acquisition; and all banking businesses of the acquirer immediately after the acquisition are treated as one integrated business. See §§1.585–6(c)(3) and 1.585–7(d)(2) for rules on the treatment of assets acquired from large banks in section 381(a) transactions.

(iv) Transfer of substantially all assets to related party. This paragraph (b)(2)(iv) applies to any direct or indirect acquisition of substantially all of a large bank’s assets if the transferor and the acquirer are related parties before or after the acquisition and a principal purpose of the acquisition is to avoid treating the acquired assets as those of a large bank. A transferor bank and an acquirer are considered to be related parties for this purpose if they are members of the same parent-subsidiary controlled group (as defined in paragraph (d)(2) of this section) or related parties within the meaning of section 267(b) or 707(b).

(3) Examples. The following examples illustrate the principles of this paragraph (b):

Example 1. Bank M, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). For its taxable year beginning on January 1, 1987, M has average total assets of $600 million. Since M’s average total assets for 1987 exceed $500 million, M is a large bank for that year. Pursuant to §1.585–6(d)(1), 1987 is M’s disqualification year. If M maintained a bad debt reserve under section 585 for its immediately preceding taxable year (1986), M must change in 1987 to the specific charge-off method of accounting for bad debts, in accordance with §1.585–6 or §1.585–7.

Example 2. Assume the same facts as in Example 1. Also assume that in 1988 M disposes of a portion of its assets and, as a result, M’s average total assets for taxable year 1988 fall to $400 million. M remains a large bank for taxable year 1988 and succeeding taxable years, since its average total assets for a preceding taxable year (1987) beginning after December 31, 1986, exceeded $500 million.

Example 3. Bank P, a calendar year taxpayer, is an institution described in §1.585–1(b)(1)(i). P has average total assets of $300 million for its taxable year beginning on January 1, 1986. For the same year, P is a member of a parent-subsidiary controlled group (within the meaning of §1.585–5(d)(2)) that has average total assets of $300 million. In February 1988, the group sells its stock in P to several individual investors. P is a large
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In general. For purposes of paragraph (b)(1) of this section, the average total assets of an institution or group for any taxable year are determined by—

(1) Computing, for each report date (as defined in paragraph (c)(2) of this section) within the taxable year, the amount of total assets (as defined in paragraph (c)(3) of this section) held by the institution or group as of the close of business on the report date;

(ii) Adding these amounts; and

(iii) Dividing the sum of these amounts by the number of report dates within the taxable year.

(2) Report date—(A) In general. A report date for an institution generally is the last day of the regular period for which the institution must report to its primary Federal regulatory agency. However, an institution that is required to report to its primary Federal regulatory agency more frequently than quarterly may choose the last day of the calendar quarter as its report date, and an institution that is required to report to its primary Federal regulatory agency less frequently than quarterly must choose the last day of the calendar quarter as its report date. If an institution does not have a Federal regulatory agency, its primary State regulatory agency is considered its primary Federal regulatory agency for purposes of this paragraph (c)(2)(i)(A). In the case of a short taxable year that does not otherwise include a report date, the first or last day of the taxable year is the institution’s report date for the year.

(B) Alternative report date. In lieu of the report date prescribed by paragraph (c)(2)(i)(A) of this section, for any taxable year an institution may choose as its report date the last day of any regular interval in the taxable year that is more frequent than quarterly (such as bi-monthly, monthly, weekly, or daily).

(ii) Groups. If all members of a parent-subsidiary controlled group have
the same taxable year, a report date for the group is the report date, determined under paragraph (c)(2)(i) of this section, for any one member of the group that is an institution described in §1.585–1(b)(1)(i) or (ii). The same report date must be used in applying paragraph (b)(1)(ii) of this section to all members of the group for a taxable year. If all members of a parent-subsidiary controlled group do not have the same taxable year, a report date for the group must be determined under similar principles.

(iii) Member of group for only part of taxable year. If an institution is a member of a parent-subsidiary controlled group for only part of a taxable year, paragraph (b)(1)(ii) of this section is applied to the institution for that year on the basis of the group’s average total assets for the portion of the year that the institution is a member of the group. Thus, only the group’s report dates (as determined under paragraph (c)(2)(ii) of this section) that are included in that portion of the year are taken into account in determining the group’s average total assets for purposes of applying paragraph (b)(1)(ii) of this section to the institution. If no report date of the group is included in that portion of the year, the first or last day of that portion of the year must be treated as the group’s report date for purposes of this paragraph (c)(2)(iii).

(3) Total assets—(i) All corporations. The amount of total assets held by an institution or group is the amount of cash, plus the sum of the adjusted bases of all other assets, held by the institution or group. For this purpose, the adjusted basis of an asset generally is its basis for Federal income tax purposes, determined under sections 1012, 1016 and other applicable sections of the Internal Revenue Code. In determining the amount of total assets held by a group, any asset of a member of the group that is an interest in another member of the group is not to be counted.

(ii) Foreign corporations. In determining the amount of total assets held by a foreign corporation, all of the corporation’s assets are taken into account, including those that are not effectively connected with the conduct of

a banking business within the United States. In the case of a foreign corporation that is not engaged in a trade or business in the United States, the adjusted basis of an asset must be determined substantially in accordance with United States tax principles as provided in regulations under section 964. In the case of a foreign corporation that is engaged in a trade or business in the United States, the amount of its average total assets for a taxable year (within the meaning of paragraph (c)(1) of this section) is the amount of the corporation’s average worldwide assets used for purposes of computing the interest expense deduction allowable under section 862 and §1.882–5 for the taxable year.

(4) Estimated adjusted tax bases—(i) In general. The amount of the adjusted Federal income tax bases (tax bases) of assets held on a report date may be estimated, for purposes of applying paragraph (c)(3) of this section. This estimate must be based on the adjusted bases of the assets on that date as determined by reference to the asset holder’s books and records maintained for financial reporting purposes (book bases). The estimate must reflect any change in the ratio between the asset holder’s tax and book bases of assets that occurs during the taxable year, and the estimate must assume that this change occurs ratably. If an institution or group member estimates the tax bases of assets held on any report date during a taxable year, it must do so for all assets (other than cash) held on that report date, and it must do so for all other report dates during the year. However, the tax bases of assets may not be estimated for any report date that is the first or last day of the taxable year or that is determined under paragraph (c)(2)(i)(B) of this section.

(ii) Formulas. The estimated amount of the tax bases of assets held on any report date during a taxable year is based on the following variables: The total book bases of the assets on the report date (B); the asset holder’s tax/book ratio as of the close of the preceding taxable year (R); and the result (whether positive or negative) obtained when R is subtracted from the asset holder’s tax/book ratio as of the close of
the current taxable year (Y). For purposes of determining R and Y, an asset holder’s tax/book ratio is the ratio of the total tax bases of all of the holder’s assets (other than cash), to the total book bases of those assets. If an asset holder’s taxable year is the calendar year and its report date is the last day of the calendar quarter, its estimated tax bases of assets held on the first three report dates of the year are determined under the following formulas:

1st Report Date = B \times (R + \frac{1}{4}Y)
2nd Report Date = B \times (R + \frac{3}{4}Y)
3rd Report Date = B \times (R + \frac{3}{4}Y)

(5) Examples. The following examples illustrate the principles of this paragraph (c):

Example 1. Bank U is a fiscal year taxpayer, and its fiscal year ends on January 31. U reports to its primary Federal regulatory agency as of the last day of the calendar quarter. U does not choose under §1.585-5(c)(2)(i)(B) a report date more frequent than quarterly. Thus, U’s report dates under §1.585-5(c)(2)(ii)(A) are March 31, June 30, September 30, and December 31. For its taxable year beginning on February 1, 1987, U has total assets (within the meaning of §1.585-5(c)(3)) of $480 million on March 31, $490 million on June 30, $510 million on September 30, and $540 million on December 31. Thus, pursuant to §1.585-5(c)(1), U’s average total assets for its taxable year beginning on February 1, 1987, are $505 million.

Example 2. Bank W is a calendar year taxpayer, and its report date (within the meaning of §1.585-5(c)(2)(i)(A)) is the last day of the calendar quarter. Pursuant to §1.585-5(c)(4), W chooses to estimate the tax bases of its assets for 1990. Therefore, W must estimate the tax bases of all of its assets (other than cash) for its first three report dates in 1990. Since W’s fourth report date (December 31) is the last day of its taxable year, the tax bases of its assets may not be estimated for this date. The adjusted tax bases of all of W’s assets (other than cash) are $450z on December 31, 1989, and $480z on December 31, 1990. The book bases of those assets are $500z on December 31, 1989; $520z on March 31, 1990; $540z on June 30, 1990; $560z on September 30, 1990; and $590z on December 31, 1990. Applying the formulas provided in §1.585-5(c)(4)(i), W’s tax/book ratio as of the close of 1989 (R), is 0.9 (450z/500z). W’s tax/book ratio as of the close of 1990 is 0.8 (480z/600z). Thus, Y = 0.1. The estimated adjusted tax bases of all of W’s assets (other than cash) on the first three report dates of 1990 are as follows:

1st = B \times (R + 1\frac{1}{4}Y) = 0.9 \times 0.8 \times (450z + 1\frac{1}{4} \times 0.1 \times 0.9 \times 0.8 \times 450z) = $455z
2nd = B \times (R + 1\frac{3}{4}Y) = 0.9 \times 0.8 \times (450z + 1\frac{3}{4} \times 0.1 \times 0.9 \times 0.8 \times 450z) = $459z
3rd = B \times (R + 1\frac{3}{4}Y) = 0.9 \times 0.8 \times (450z + 1\frac{3}{4} \times 0.1 \times 0.9 \times 0.8 \times 450z) = $462z

(d) Definitions. The following definitions apply for purposes of this section and §§1.585-6, 1.585-7 and 1.585-8:

(1) Disqualification year. A bank’s disqualification year is its first taxable year beginning after December 31, 1986, for which the bank is a large bank within the meaning of paragraph (b) of this section.

(2) Parent-subsidiary controlled group. A parent-subsidiary controlled group includes all of the members of a controlled group of corporations described in section 1563(a)(1). The members of such a group are determined without regard to whether any member is an excluded member described in section 1563(b)(2), a foreign entity, or a commercial bank.

(3) Example. The following example illustrates the principles of this paragraph (d):

Example. Bank X is a large bank within the meaning of §1.585-6(b)(1)(i). Bank Y is not a large bank under §1.585-5(b), and it maintains a bad debt reserve under section 585. In 1988, X purchases all of the stock of Y. If the acquisition causes Y to become a member of a parent-subsidiary controlled group described in §1.585-5(b)(1)(i), Y is a large bank beginning in its first taxable year that ends after the date of the acquisition. Pursuant to §1.585-5(d)(1), this year is Y’s disqualification year. Y must change in this year to the specific charge-off method of accounting for bad debts, in accordance with §1.585-6 or §1.585-7.