

Council). The balance in a reserve for bad debts is not treated as equity.

(4) *Estimated tax payments of financially troubled banks.* For purposes of applying section 6655(e)(2)(A)(i) with respect to any installment of estimated tax, a bank that is financially troubled as of the due date of the installment is treated as if no amount will be included in income under paragraphs (a) and (b) of this section for the taxable year. For this purpose, a bank is considered financially troubled as of the due date of an installment of estimated tax only if its nonperforming loan percentage (computed under paragraph (d)(3) of this section) would exceed 75 percent for a short taxable year ending on that date. For purposes of computing this nonperforming loan percentage, the ending of such a short taxable year would not cause the last day of that year to be treated as the last day of a quarter of the taxable year.

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

Example 1. Bank R is a bank to which this § 1.585-6 applies. R's disqualification year is its taxable year beginning on January 1, 1987. R is not financially troubled (within the meaning of § 1.585-6(d)(3)) for taxable year 1987 or for any taxable year after 1989, but it is financially troubled for taxable years 1988 and 1989. Since R is not financially troubled for its disqualification year, R must include an amount in income under § 1.585-6 (a) and (b) for that year (taxable year 1987). R may make the election allowed by § 1.585-6(b)(2) for that year. Since R is financially troubled for taxable years 1988 and 1989, pursuant to § 1.585-6(d)(1) R does not include any amount in income under § 1.585-6 (a) and (b) for these years, and it treats taxable years 1990, 1991 and 1992 as the first, second and third taxable years after its disqualification year for purposes of applying § 1.585-6 (a) and (b).

Example 2. Assume the same facts as in Example 1, except that R is financially troubled for taxable year 1987 (its disqualification year). R may make the election allowed by § 1.585-6(d)(2) for 1987 (the disqualification year), for 1990 (the first year after the disqualification year in which R is not financially troubled), or for 1988 or 1989 (the intervening years). R elects to include 60 percent of its net section 481(a) adjustment in income in 1987. Thus, the remainder of the adjustment, for purposes of applying the rules of § 1.585-6(b)(2), is 40 percent. R must include in income 2/9 of the remainder in 1990, 1/3 of the remainder in 1991, and 4/9 of the remainder in 1992.

Example 3. Bank S, which is not a member of a parent-subsiidiary controlled group, is a bank to which this § 1.585-6 applies. S's disqualification year is its taxable year beginning on January 1, 1987. S determines its nonperforming loan percentage under § 1.585-6(d)(3) on a quarterly basis. S is not financially troubled for taxable year 1987 and includes 10 percent of its net section 481(a) adjustment in income in that year. S's outstanding balance of nonperforming loans (as defined in § 1.585-6(d)(3)(iii)) is \$80 million on March 31, 1988; \$68 million on June 30, 1988; and \$59 million on September 30, 1988. The amount of S's equity (as defined in § 1.585-6(d)(3)(iv)) is \$100 million on each of these threedates. Thus, S's nonperforming loan percentage, computed under § 1.585-6(d)(3), would be 80 percent (80/100) for a short taxable year ending on April 15 or June 15, 74 percent $[(80+68) \div 200]$ for a short taxable year ending on September 15, and 69 percent $[(80+68+59) \div 300]$ for a short taxable year ending on December 15. Since S's nonperforming loan percentage for a short taxable year ending on April 15 or June 15 would exceed 75 percent, pursuant to § 1.585-6(d)(4) S is considered financially troubled as of these dates. Thus, S is treated as if no amount will be included in income under § 1.585-6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on April 15, 1988, and June 15, 1988. However, since S's nonperforming loan percentage for a short taxable year ending on September 15 or December 15 would not exceed 75 percent, S is not considered financially troubled as of these dates. Thus, S is treated as if 20 percent of its net section 481(a) adjustment will be included in income under § 1.585-6 (a) and (b) for the year for purposes of applying section 6655(e)(2)(A)(i) with respect to the installments of estimated tax that are due on September 15, 1988, and December 15, 1988.

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§ 1.585-7 Elective cut-off method of changing from the reserve method of section 585.

(a) *General rule.* Any large bank (as defined in § 1.585-5(b)) that maintained a reserve for bad debts under section 585 for the taxable year immediately preceding its disqualification year (as defined in § 1.585-5(d)(1)) may elect to use the cut-off method set forth in this section. Any such election must be made at the time and in the manner prescribed by § 1.585-8. If a bank makes this election, the bank must maintain its bad debt reserve for its pre-disqualification loans, as prescribed in

paragraph (b) of this section, and the bank must include in income any excess balance in this reserve, as required by paragraph (c) of this section. The bank may not deduct, for its disqualification year or any subsequent taxable year, any amount allowed under section 166(a) for pre-disqualification loans (as defined in paragraph (b)(2) of this section) that become worthless in whole or in part, except as allowed by paragraph (b)(1) of this section. However, except as provided in paragraph (d)(3) of this section, the bank may deduct, for its disqualification year or any subsequent taxable year, amounts allowed under section 166(a) for loans that the bank originates or acquires on or after the first day of its disqualification year and that become worthless in whole or in part. If a bank makes the election allowed by this paragraph (a), its change to the specific charge-off method of accounting for bad debts in its disqualification year does not give rise to a section 481(a) adjustment.

(b) *Maintaining reserve for pre-disqualification loans*—(1) *In general.* A bank that makes the election allowed by paragraph (a) of this section must maintain its bad debt reserve for its pre-disqualification loans (as defined in paragraph (b)(2) of this section). Except as provided in paragraph (d)(3) of this section, the bank must charge against the reserve the amount of any losses resulting from these loans (including losses resulting from the sale or other disposition of these loans), and the bank must add to the reserve the amount of recoveries with respect to these loans. In general, the reserve must be maintained in the manner provided by former section 166(c) of the Internal Revenue Code and the regulations thereunder. However, after the balance in the reserve is reduced to zero, the bank is to account for any losses and recoveries with respect to outstanding pre-disqualification loans under the specific charge-off method of accounting for bad debts, as if the bank always had accounted for these loans under this method.

(2) *Definition of pre-disqualification loans.* For purposes of this section, a pre-disqualification loan of a bank is any loan that the bank held on the last

day of its taxable year immediately preceding its disqualification year (as defined in §1.585-5(d)(1)). If the amount of a pre-disqualification loan is increased during or after the disqualification year, the amount of the increase is not treated as a pre-disqualification loan.

(c) *Amount to be included in income when reserve balance exceeds loan balance.* If, as of the close of any taxable year, the balance in a bank's reserve that is maintained under paragraph (b) of this section exceeds the balance of the bank's outstanding pre-disqualification loans, the bank must include in income the amount of the excess for the taxable year. The balance in the reserve is then reduced by the amount of this excess. See paragraph (d) of this section for rules on the application of this paragraph (c) when a bank disposes of loans.

(d) *Effect of disposing of loans*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, if a bank that makes the election allowed by paragraph (a) of this section sells or otherwise disposes of any of its outstanding pre-disqualification loans, the bank is to reduce the balance of its outstanding pre-disqualification loans by the amount of the loans disposed of, for purposes of applying paragraph (c) of this section.

(2) *Section 381 transactions.* If a bank that makes the election allowed by paragraph (a) of this section transfers outstanding pre-disqualification loans to another corporation in a transaction to which section 381(a) applies, the acquiring corporation (the acquiror) must follow the rules of paragraph (d)(2)(i) or (ii) of this section.

(i) *Acquiror completes cut-off method of change.* Except as provided in paragraph (d)(2)(ii) of this section, the acquiror steps into the shoes of the transferor in the section 381(a) transaction with respect to using the cut-off method of change. Thus, the transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, and the acquiror must complete the cut-off method begun by the transferor. For purposes of completing the transferor's cut-off method, the acquiror's balance of outstanding pre-disqualification

loans immediately after the section 381(a) transaction is the balance of these loans that it receives in the transaction, and the acquiror assumes all of the transferor's rights and obligations under this section.

(ii) *Acquiror uses reserve method.* If the acquiror is not a large bank (within the meaning of § 1.585-5(b)) immediately after the section 381(a) transaction and uses a reserve method of accounting for bad debts attributable to the pre-disqualification loans (and any other loans) received in the transaction, the acquiror does not step into the shoes of the transferor with respect to using the cut-off method of change. The transferor's bad debt reserve immediately before the section 381(a) transaction carries over to the acquiror, but the acquiror does not continue the cut-off method begun by the transferor. If the six-year moving average amount (as defined in § 1.585-2(c)(1)(ii)) for all of the loans received in the transaction exceeds the balance of the reserve that carries over to the acquiror, the acquiror increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

(3) *Dispositions intended to change the status of pre-disqualification loans.* This paragraph (d)(3) applies if a bank that makes the election allowed by paragraph (a) of this section sells, exchanges, or otherwise disposes of a significant amount of its pre-disqualification loans (as defined in paragraph (b)(2) of this section) and a principal purpose of the transaction is to avoid the provisions of this section by increasing the amount of loans for which deductions are allowable under the specific charge-off method. If this paragraph (d)(3) applies, the District Director may disregard the disposition for purposes of paragraphs (b)(1) and (d)(1) of this section or treat the replacement loans as pre-disqualification loans. If loans are so treated as pre-disqualification loans, no deductions are allowable under the specific charge-off method for the loans, except as provided in paragraph (b)(1) of this section, and the disposition that causes the loans to be so treated may be disregarded for pur-

poses of paragraphs (b)(1) and (d)(1) of this section. If a bank sells pre-disqualification loans and uses the proceeds of the sale to originate new loans, this paragraph (d)(3) does not apply to the transaction.

(e) *Examples.* The following examples illustrate the principles of this section:

Example 1. Bank M is a bank that properly elects to use the cut-off method set forth in this § 1.585-7. M's disqualification year is its taxable year beginning on January 1, 1987. On December 31, 1986, M had outstanding loans of \$700 million (pre-disqualification loans), and the balance in its bad debt reserve was \$10 million. M must maintain its reserve for its pre-disqualification loans in accordance with § 1.585-7(b), and it may not deduct any addition to this reserve for taxable year 1987 or any later year. For these years, M may deduct amounts allowed under section 166(a) for loans that it originates or acquires after December 31, 1986, and that become worthless in whole or in part.

Example 2. Assume the same facts as in Example 1. Also assume that in 1987 M collects \$150 million of its pre-disqualification loans, M determines that \$2 million of its pre-disqualification loans are worthless, and M recovers \$1 million of pre-disqualification loans that it had previously charged against the reserve as worthless. On December 31, 1987, the balance in M's bad debt reserve is \$9 million (\$10 million - \$2 million + \$1 million), and the balance of its outstanding pre-disqualification loans is \$548 million (\$700 million - \$150 million - \$2 million).

Example 3. Assume the same facts as in Examples 1 and 2. Also assume that on December 31, 1990, the balance in M's bad debt reserve is \$5 million and the balance of its outstanding pre-disqualification loans is \$25 million. In 1991 M collects \$21 million of its outstanding pre-disqualification loans and determines that \$1 million of its outstanding pre-disqualification loans are worthless. Thus, on December 31, 1991, the balance in M's bad debt reserve is \$4 million (\$5 million - \$1 million), and the balance of its outstanding pre-disqualification loans is \$3 million (\$25 million - \$21 million - \$1 million). Accordingly, M must include \$1 million (\$4 million - \$3 million) in income in taxable year 1991, pursuant to § 1.585-7(c). On January 1, 1992, the balance in M's reserve is \$3 million (\$4 million - \$1 million).

Example 4. Assume the same facts as in Examples 1 through 3. Also assume that in 1992 M transfers substantially all of its assets to another corporation (N) in a transaction to which section 381(a) applies, and N is treated as a large bank under § 1.585-5(b)(2) for taxable years ending after the date of the transaction. Pursuant to § 1.585-7(d)(2)(i), N steps into M's shoes with respect to using the cut-

off method. M's bad debt reserve immediately before the section 381(a) transaction carries over to N, and N must complete the cut-off procedure begun by M. For this purpose, N's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives from M.

Example 5. Assume the same facts as in Examples 1 through 4, except that N is not treated as a large bank after the section 381(a) transaction. Also assume that N uses the reserve method of section 585 and plans to use this method for all of the loans it acquires from M (including loans that were not pre-disqualification loans). Pursuant to §1.585-7(d)(2)(ii), M's bad debt reserve immediately before the section 381(a) transaction carries over to N in the transaction; however, N does not continue the cut-off procedure begun by M and does not treat any loan as a pre-disqualification loan. If the six-year moving average amount (as defined in §1.585-2(c)(1)(ii)) for all of N's newly acquired loans exceeds the balance of the reserve that carries over to N, N increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

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§ 1.585-8 Rules for making and revoking elections under §§ 1.585-6 and 1.585-7.

(a) *Time of making elections*—(1) *In general.* Any election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) must be made on or before the later of—

- (i) February 28, 1994; or
- (ii) The due date (taking extensions into account) of the electing bank's original tax return for its disqualification year (as defined in §1.585-5(d)(1)) or, for elections under §1.585-6(d)(2), the year for which the election is made.

(2) *No extension of time for payment.* Payments of tax due must be made in accordance with chapter 62 of the Internal Revenue Code. However, if an election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) is made or revoked on or before February 28, 1994 and the making or revoking of the election results in an underpayment of estimated tax (within the meaning of section 6655(a)) with respect to an installment of estimated tax due on or before the date the election was so made or revoked, no addition to tax will be im-

posed under section 6655(a) with respect to the amount of the underpayment attributable to the making or revoking of the election.

(b) *Manner of making elections*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, an electing bank must make any election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) by attaching a statement to its tax return (or amended return) for its disqualification year or, for elections under §1.585-6(d)(2), the year for which the election is made. This statement must contain the following information:

- (i) The name, address and taxpayer identification number of the electing bank;
- (ii) The nature of the election being made (i.e., whether the election is to include in income more than 10 percent of the bank's net section 481(a) adjustment under §1.585-6 (b)(2) or (d)(2) or to use the cut-off method under §1.585-7); and
- (iii) If the election is under §1.585-6(b)(2) or (d)(2), the percentage being elected.

(2) *Certain tax returns filed before December 29, 1993.* A bank is deemed to have made an election under §1.585-6(b)(2) or (d)(2) if the bank evidences its intent to make an election under section 585(c)(3)(A)(iii)(I) or section 585(c)(3)(B)(ii) for its disqualification year (or, for elections under §1.585-6(d)(2), the election year), by designating a specific recapture amount on its tax return or amended return for that year (or attaching a statement in accordance with §301.9100-7T(a)(3)(i) of this chapter), and the return is filed before December 29, 1993. A bank is deemed to have made an election under §1.585-7(a) if the bank evidences its intent to make an election under section 585(c)(4) for its disqualification year by attaching a statement in accordance with §301.9100-7T(a)(3)(i) of this chapter to its tax return or amended return for that year, and the return is filed before December 29, 1993.

(c) *Revocation of elections*—(1) *On or before final date for making election.* An election under §1.585-6(b)(2), §1.585-6(d)(2) or §1.585-7(a) may be revoked