

withdrawable accounts have the same meanings as are assigned to them in paragraph (f) of § 1.593.6.

[T.D. 549, 43 FR 21455, May 18, 1978, as amended by T.D. 7626, 44 FR 31177, May 31, 1979]

§ 1.593-7 Establishment and treatment of reserves for bad debts.

(a) *Establishment of reserves*—(1) *In general.* A taxpayer described in § 1.593-4 shall establish and maintain a reserve for losses on nonqualifying loans, a reserve for losses on qualifying real property loans, and, if required under paragraph (b)(4) or (c)(3)(i)(c) of this section, a supplemental reserve for losses on loans. For rules governing the crediting of additions to the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans, see paragraph (b) of § 1.593-5.

(2) *Accounting for reserves.* (i) The taxpayer shall establish and maintain as a permanent part of its regular books of account an account for each of the reserves established pursuant to subparagraph (1) of this paragraph. For purposes of the preceding sentence, a taxpayer may establish and maintain a permanent subsidiary ledger containing an account for each of such reserves. If a taxpayer maintains such a permanent subsidiary ledger, the total of the reserve accounts in such ledger and the total of the reserve accounts in any other ledger must be reconciled.

(ii) Any credit or charge to a reserve established pursuant to subparagraph (1) of this paragraph must be made to such reserve irrespective of whether the amount thereof is also credited or charged to any surplus, reserve, or other account which the taxpayer may be required or permitted to maintain pursuant to any Federal or State statute, regulation, or supervisory order. Minimum amounts credited in compliance with such Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissible under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by the taxpayer, may also be credited to the reserve for losses on nonqualifying loans or the re-

serve for losses on qualifying real property loans, provided that the total of the amounts so credited to the reserve for losses on nonqualifying loans, or to the reserve for losses on qualifying real property loans, for any taxable years does not exceed the amount described in subparagraph (1) or (2) of § 1.593-5(a) (whichever applies) as the addition to such reserve for such year year.

(b) *Allocation of pre-1963 reserves*—(1) *In general.* In the case of a taxpayer described in § 1.593-4, the pre-1963 reserves, if any, of such taxpayer shall be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and, if required under subparagraph (4) of this paragraph, the supplemental reserve for losses on loans. The term *pre-1963 reserves* means the net amount (determined as of the close of December 31, 1962) accumulated for taxable years beginning after December 31, 1951, in the taxpayer's reserve for bad debts pursuant to section 166(c) of the Internal Revenue Code of 1954 and section 23(k) (1) of the Internal Revenue Code of 1939 (including the amount of any bad debt reserves acquired from another taxpayer). For purposes of the preceding sentence in the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year occurring before January 1, 1963, shall be treated as a taxable year. Thus, the pre-1963 reserves of the taxpayer shall be an amount equal to:

(i) The sum of the amounts allowed as deductions for additions to a reserve for bad debts for taxable years beginning after December 31, 1951, and ending before January 1, 1963, plus

(ii) In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the amount (determined under § 1.593-1 or 1.593-2) which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts for the part of such year occurring before January 1, 1963, if such part year constituted a taxable year, minus

(iii) The total amount of bad debts charged against a reserve for bad debts during the period which begins with the opening of the first taxable year

beginning after December 31, 1951, and which ends at the close of December 31, 1962 plus

(iv) The total amount of recoveries during the period described in subdivision (iii) of this subparagraph, on bad debts charged against a reserve for bad debts in a taxable year beginning after December 31, 1951.

(2) *Allocation to opening balance of reserve for losses on nonqualifying loans.* (i) As of the close of December 31, 1962 the pre-1963 reserves shall first be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans in an amount equal to the lesser of (a) the amount of such pre-1963 reserves, or (b) the amount determined under subdivision (ii) of this subparagraph.

(ii) The amount referred to in subdivision (i)(b) of this subparagraph shall be the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans under § 1.166-4 for a period in which the taxpayer's nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(3) *Allocation to opening balance of reserve for losses on qualifying real property loans.* (i) Any portion of the pre-1963 reserves remaining after the allocation provided in subparagraph (2) of this paragraph shall, as of the close of December 31, 1962, be allocated to (and constitute the opening balance of) the reserve for losses on qualifying real property loans in an amount equal to the lesser of (a) the amount of such remaining portion, or (b) the amount determined under subdivision (ii) of this subparagraph. If the amount described in (a) of the preceding sentence is less than the amount described in (b) thereof, see § 1.593-8 for allocation of pre-1952 surplus, if any, to the opening balance of such reserve.

(ii) The amount referred to in subdivision (i)(b) of this subparagraph shall be an amount equal to the greater of:

(a) 3 percent of the taxpayer's qualifying real property loans outstanding at the close of December 31, 1962, or

(b) The amount which would constitute a reasonable addition to the reserve for losses on such loans under

§ 1.166-4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(4) *Allocation to supplemental reserve for losses on loans.* Any portion of the pre-1963 reserves remaining after the allocations provided in subparagraphs (2) and (3) of this paragraph shall be allocated in its entirety to the supplemental reserve for losses on loans. (5) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) *Facts.* X Corporation, a domestic building and loan association organized on April 1, 1954, makes its returns on the basis of a taxable year ending March 31 and the reserve method of accounting for bad debts. For its taxable years ending March 31, 1955, through March 31, 1962, X was allowed a total of \$750,000 as deductible additions to its reserve for bad debts under section 166(c). For its taxable year ending March 31, 1963, X was allowed a deduction under section 166(c) for an addition to a reserve for bad debts. Of such deduction \$46,000 was determined under § 1.593-1 (relating to additions to reserve for bad debts) by reference to § 1.593-9 (relating to taxable income for taxable years beginning in 1962 and ending in 1963) as the amount which would be allowable for the period April 1 through December 31, 1962, if such period constituted a taxable year. During the taxable years ending March 31, 1955, through March 31, 1963, X charged bad debts of \$55,000 against its reserve for bad debts and made recoveries on such debts of \$10,000. Of such bad debt charges and recoveries, \$50,000 was charged off and \$9,000 was recovered prior to January 1, 1963. At the close of December 31, 1962, X had outstanding nonqualifying loans of \$500,000 and outstanding qualifying real property loans of \$10 million. It is assumed that, under § 1.166-4, \$2,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to \$500,000 and \$20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to \$10 million.

(ii) *Pre-1963 reserves determined.* X's pre-1963 reserves are \$755,000, computed as follows:

Deductible additions to reserve for bad debts:	
Years ending March 31, 1955 through March 31, 1962	\$750,000
Period April 1 through December 31, 1962	46,000
	\$796,000

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Less:

Net bad debt losses for period		
April 1, 1954 through De-		
cember 31, 1962:		
Bad debts	50,000	
Recoveries	(9,000)	41,000
		755,000

(iii) *Allocation to opening balance of reserve for losses on nonqualifying loans.* The portion of the \$755,000 of pre-1963 reserves to be allocated to the reserve for losses on nonqualifying loans as the opening balance thereof is \$2,000 since such amount would constitute a reasonable addition to the reserve for losses on nonqualifying loans under § 1.166-4 for a period in which the amount of such loans increased from zero to \$500,000.

(iv) *Allocation to opening balance of reserve for losses on qualifying real property loans.* Of the \$753,000 (\$755,000 minus \$2,000) of pre-1963 reserves remaining after the allocation described in subdivision (iii) of this example, \$300,000 (3 percent of \$10 million, the total amount of qualifying real property loans outstanding at the close of December 31, 1962) is allocated to the opening balance of the reserve for losses on qualifying real property loans, since such amount is greater than \$20,000, the amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166-4 for a period in which the amount of such loans increased from zero to \$10 million.

(v) *Allocation to supplemental reserve for losses on loans.* The balance of the pre-1963 reserves, or \$453,000 (\$755,000 minus the sum of \$2,000 and \$300,000), is allocated in its entirety to the supplemental reserve for losses on loans.

Example 2. Assume the same facts as in example 1, except that X was organized in 1936, and on December 31, 1962, had pre-1963 reserves of only \$15,000 (rather than \$755,000). In such case, \$2,000 of such pre-1963 reserves would be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and \$13,000 (\$15,000 minus \$2,000) would be allocated to and constitute part of the opening balance of the reserve for losses on qualifying real property loans. However, since such \$13,000 is less than \$300,000 (3 percent of \$10 million), the opening balance of the reserve for losses on qualifying real property loans must be increased by so much of the taxpayer's pre-1952 surplus as is necessary to increase such opening balance to \$300,000. For rules on the allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans, see § 1.593-8.

(c) *Treatment of reserves—(1) In general.* Except as provided in paragraph (d) of § 1.593-8 (relating to the allocation of pre-1952 surplus), each of the reserves established pursuant to para-

graph (a) of this section shall be treated, for purposes of subtitle A of the Code, as a reserve for bad debts, except that no deduction shall be allowed under section 166 for any addition to the supplemental reserve for losses on loans. Accordingly, if in any taxable year the taxpayer charges any of the reserves established pursuant to paragraph (a) of this section for an item other than a bad debt, gross income for such year shall be increased by the amount of such charge. For special rules in case of certain nondeductible distributions to shareholders by a domestic building and loan association, see § 1.593-10.

(2) *Bad debt losses.* Any bad debt in respect of a nonqualifying loan shall be charged against the reserve for losses on nonqualifying loans, and any bad debt in respect of a qualifying real property loan shall be charged against the reserve for losses on qualifying real property loans. At the option of the taxpayer, however, any bad debt in respect of either class of loans may be charged in whole or in part against the supplemental reserve for losses on loans.

(3) *Recoveries of bad debts.* Any amount recovered after December 31, 1962, in respect of a bad debt shall be credited to the reserves established pursuant to paragraph (a) of this section in the following manner:

(i) If the recovery is in respect of a bad debt which was charged prior to January 1, 1963, against a reserve for bad debts established pursuant to section 166(c) of the Internal Revenue Code of 1954, or section 23(k)(1) of the Internal Revenue Code of 1939, then the amount recovered shall be credited:

(a) First, to the reserve for losses on nonqualifying loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(2) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(2)).

(b) Second, to the reserve for losses on qualifying real property loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(3) of

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this section exceeds the opening balance of such reserve (determined under such paragraph (b)(3)), and

(c) Finally, to the supplemental reserve for losses on loans

For purposes of determining the amounts of the credits under (a) and (b) of this subdivision, the opening balances of the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans shall be deemed to include the sum of the amounts of any prior credits made to such reserves pursuant to this subdivision.

(ii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against only one of the reserves established pursuant to paragraph (a) of this section, the entire amount recovered shall be credited to the reserve so charged.

(iii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against more than one of the reserves established pursuant to paragraph (a) of this section, then the amount recovered shall be credited to each of the reserves so charged in the ratio which the amount of the bad debt charged against such reserve bears to the total amount of such bad debt charged against both such reserves.

(iv) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. In 1962, the taxpayer sustained a bad debt of \$10,000, which was charged against a reserve for bad debts established pursuant to section 166(c). As of the close of December 31, 1962, the balance of the taxpayer's reserve for losses on nonqualifying loans was \$2,000, the amount determined under paragraph (b)(2)(ii) of this section. As of the same time, the balance of the taxpayer's reserve for losses on qualifying real property loans was \$100,000, but the amount determined under paragraph (b)(3)(ii) of this section was \$106,000. In 1963, the taxpayer recovers \$8,000 of the \$10,000 charged off in 1962. Of the \$8,000 recovered in 1963, \$6,000 (\$106,000 minus \$100,000) is credited to the reserve for losses on qualifying real property loans, and the balance of \$2,000 is credited to the supplemental reserve for losses on loans.

[T.D. 6728, 29 FR 5859, May 5, 1964, as amended by T.D. 549, 43 FR 21457, May 18, 1978]

§ 1.593-8 Allocation of pre-1952 surplus to opening balance of reserve for losses on qualifying real property loans.

(a) *General rule.* In the case of a taxpayer described in § 1.593-4, if the amount of pre-1963 reserves allocated (under paragraph (b)(3)(i) of § 1.593-7) to the opening balance of the reserve for losses on qualifying real property loans is less than an amount equal to the greater of:

(1) The total amount of qualifying real property loans outstanding at the close of December 31, 1962, multiplied by 3 percent, or

(2) The amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166-4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962

then such opening balance shall be increased by an amount equal to so much of the *pre-1952 surplus* of the taxpayer as is necessary to increase such opening balance to the greater of the amounts described in subparagraph (1) or (2) of this paragraph. The amount of such increase shall be deemed to be included in such opening balance solely for the limited purpose described in paragraph (d) of this section.

(b) *Pre-1952 surplus defined*—(1) *In general.* For purposes of this section and § 1.593-7, the term *pre-1952 surplus* means an amount equal to:

(i) The sum of the taxpayer's surplus, undivided profits, and reserves determined (under the principles of paragraph (d)(2) of § 1.593-1) as of the close of the taxpayer's last taxable year beginning before January 1, 1952 (including any amount acquired from another taxpayer), minus

(ii) The amount of any impairments of such sum (as determined under paragraph (c) of this section).

(2) *Reduction for certain excludable interest.* (i) The amount otherwise determined under subparagraph (1) of this paragraph may, at the option of the taxpayer, be reduced by the portion, if any, of such amount which is attributable to interest which would have been excludable from gross income of such taxpayer under section 22(b)(4) of