

# IRS Issues Additional Guidance on Nonperforming Loan Interest

By Monica J. Schmidt, CPA, and Tiffany A. Barker, CPA

The Internal Revenue Service (IRS) recently released new audit guidance to its revenue agents on what they should be looking for during an audit related to the proper tax treatment of interest on nonperforming loans. Due to the current economic environment, most financial institutions are carrying significantly more nonperforming loans, and many institutions face potential IRS exam issues if they fail to distinguish between the proper regulatory and tax treatments for these loans. Banks do, however, have two elections available to minimize IRS scrutiny of their treatment of the nonperforming loans and related nonaccrual interest.

In March 2010, the IRS issued a Large- and Mid-size Business (LMSB) directive (LMSB 4-0110-003) on nonperforming loans. The LMSB directive provides administrative guidance to IRS examiners. While this directive reinforces the difference between regulatory and tax treatment of interest on nonperforming loans, it also outlines two options – the bad-debt conformity election and the safe harbor method of accounting – that banks may elect to obtain greater certainty should they be audited.

## Regulatory Versus Tax Treatment

For regulatory purposes, a bank must place a loan on nonaccrual status and stop accruing interest income on the loan once it is 90 days in arrears and a bank will reverse any accrued but

unpaid interest. For tax purposes, an accrual-basis bank must continue to accrue interest and report it as taxable income until it is determined that the underlying loan is worthless or the related interest is uncollectible. Interest is deemed uncollectible when a bank has no reasonable expectation of future payments. The IRS's presumption of a reasonable expectancy of payment can be rebutted only through a detailed and burdensome loan-by-loan analysis that establishes that collection is in doubt. The mere passage of time or late payment of interest, which suffices for regulatory purposes, will not satisfy the IRS.

Banks must also distinguish between regulatory and tax treatment of subsequent payments received after a loan is placed on nonaccrual status. For tax purposes, if a bank receives



subsequent payments on the loan, it must first apply the payments to any outstanding interest, with any residual balance applied to loan principal. This differs from the regulatory treatment, which allows subsequent payments to be applied entirely to loan principal. Ultimately, income recognized for tax purposes and not for book will result in a tax deduction when the loan is either charged off or no longer on nonaccrual status for regulatory purposes.

## The Bad-Debt Conformity Election

Banks can potentially avoid IRS scrutiny of their treatment of interest on nonperforming loans by making the bad-debt conforming election. Based on a 2007 IRS revenue ruling (Rev. Rul. 2007-32), the LMSB directive states that banks

making this election may stop accruing interest on loans placed in nonaccrual status for regulatory purposes and claim a bad-debt deduction for previously accrued but unpaid interest when that interest is reversed for regulatory purposes. Such treatment of accrued but unpaid interest applies to loans placed in nonaccrual status for regulatory purposes even if the underlying loan cannot be charged off as a bad debt for tax purposes at that time.

Note, however, that a potential book-to-tax timing difference may remain after the election is in place, depending on how the bank applies receipts from loans on nonaccrual status for regulatory purposes. If the bank applies subsequent payments first to unpaid interest and then to principal for regulatory purposes, no book-to-tax difference will arise, as this coincides with the proper tax treatment of the subsequent payments. However, a book-to-tax difference will result if the bank applies subsequent payments first to principal and then to unpaid interest.

## The Safe Harbor Method

Alternatively, a bank can elect a safe harbor method of accounting (Rev. Proc. 2007-33). The safe harbor method permits banks to limit the amount of unpaid interest on nonperforming loans that they must accrue for tax purposes based on a “recovery percentage.” Automatic IRS consent is granted for this accounting method change.

The recovery percentage is calculated by dividing the total payments received by a bank on loans (including principal and interest) during the five taxable years immediately preceding the taxable year by the total amounts that were due and payable to the bank on loans during the same five taxable years. The amount of uncollected interest for which a bank is considered to have a reasonable expectancy of payment is determined annually by multiplying the total accrued but unpaid interest for the year by the bank’s recovery percentage for that year. The bank is not considered to have a reasonable expectancy of recovery in excess of the calculated amount – the amount in excess is excluded from income.

Consider the following example. During the five immediately preceding taxable years, Bank X received \$73.5 million in payments on all of its loans. During the same five-year period, \$75 million was due and payable on the loans. If, for the current year, Bank X’s accrued but unpaid interest is \$50,000, the amount that Bank X must include in income is \$49,000 ( $(73.5 \text{ million} / 75 \text{ million}) \times \$50,000$ ). The remaining \$1,000 is excluded from income.

## Minimizing the Headaches

The IRS guidance makes clear the areas where the IRS will direct its attention upon audit. By making one of the elections described above, banks can reduce the burden of tracking nonperforming loans separately for tax purposes as well as mitigate audit issues.

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