

(4) *Requirements.* A bank changing its method of accounting under the automatic revocation rules of this paragraph (d)(3)(iv)(C) must attach a completed Form 3115 to its income tax return for the year of revocation prescribed by paragraph (d)(3)(iv)(C)(2) of this section. The words "REVOCATION OF § 1.166-2(d)(3) ELECTION" must be typed or legibly printed at the top of page 1 of the Form 3115. If the year of revocation is a year for which the bank has already filed its income tax return, the bank must file an amended return for that year reflecting its change in method of accounting and must attach the completed Form 3115 to that amended return. The bank also must file amended returns reflecting the new method of accounting for all subsequent taxable years for which returns have been filed and tax may be assessed.

(D) *Revocation by Commissioner.* An election under this paragraph (d)(3) may be revoked by the Commissioner as of the beginning of any taxable year for which a bank fails to follow the method of accounting prescribed by this paragraph. In addition, the Commissioner may revoke an election as of the beginning of any taxable year for which the Commissioner determines that a bank has taken charge-offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority as defined in paragraph (d)(3)(III)(D) of this section.

(E) *Voluntary revocation.* A bank may apply for revocation of its election made under this paragraph (d)(3) by timely filing a completed Form 3115 for the appropriate year and obtaining the consent of the Commissioner in accordance with section 446(e) and § 1.446-1(e) (including any applicable administrative procedures prescribed thereunder). The words "REVOCATION OF § 1.166-2(d)(3) ELECTION" must be typed or legibly printed at the top of page 1 of the Form 3115. If any bank has had its election automatically revoked pursuant to paragraph (d)(3)(iv)(C) of this section and has not changed its method of accounting in accordance with the

requirements of that paragraph, the Commissioner will require that any voluntary change in method of accounting under this paragraph (d)(3)(iv)(E) be implemented retroactively pursuant to the same amended return terms and conditions as are prescribed by paragraph (d)(3)(iv)(C) of this section.

(4) *Definitions.* For purposes of this paragraph (d)—

(i) *Bank.* The term *bank* has the meaning assigned to it by section 581. The term *bank* also includes any corporation that would be a bank within the meaning of section 581 except for the fact that it is a foreign corporation, but this paragraph (d) applies only with respect to loans the interest on which is effectively connected with the conduct of a banking business within the United States. In addition, the term *bank* includes a Farm Credit System institution that is subject to supervision by the Farm Credit Administration.

(ii) *Charge-off.* For banks regulated by the Office of Thrift Supervision, the term *charge-off* includes the establishment of specific allowances for loan losses in the amount of 100 percent of the portion of the debt classified as loss.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7254, 38 FR 2418, Jan. 26, 1973; T.D. 8396, 57 FR 6294, Feb. 24, 1992; T.D. 8441, 57 FR 45569, Oct. 2, 1992; T.D. 8492, 58 FR 53658, Oct. 18, 1993]

**§ 1.166-3 Partial or total worthlessness.**

(a) *Partial worthlessness—(1) Applicable to specific debts only.* A deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

(2) *Charge-off required.* (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) but only to the extent charged off during the taxable year.

(ii) If a taxpayer claims a deduction for a part of a debt for the taxable year within which that part of the debt is

charged off and the deduction is disallowed for that taxable year, then, in a case where the debt becomes partially worthless after the close of that taxable year, a deduction under section 166(a)(2) shall be allowed for a subsequent taxable year but not in excess of the amount charged off in the prior taxable year plus any amount charged off in the subsequent taxable year. In such instance, the charge-off in the prior taxable year shall, if consistently maintained as such, be sufficient to that extent to meet the charge-off requirement of section 166(a)(2) with respect to the subsequent taxable year.

(iii) Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

(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.

(b) *Total worthlessness.* If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction from gross income for any prior taxable year shall be allowed as a deduction for the current taxable year.

[T.D. 6500, 25 FR 11402, Nov. 29, 1960, as amended by T.D. 8763, 63 FR 4396, Jan. 29, 1998]

#### § 1.166-4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items. This paragraph applies both to bad debts owed to the taxpayer and to bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations. If a reserve is maintained for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations, then a separate reserve must also be maintained for all other debt obligations of the taxpayer in the same trade or business, if any. A taxpayer may not maintain a reserve for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations if with respect to direct debt obligations in the same trade or business the taxpayer takes deductions when the debts become worthless in whole or in part rather than maintaining a reserve for such obligations. See § 1.166-10 for rules concerning section 166(f)(1)(A) guaranteed debt obligations.

(b) *Reasonableness of addition to reserve—(1) Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of