

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.1361: Special Rule for Bank Required to Change from the Reserve Method of Accounting on Becoming an S Corporation

(Also: Sections 166, 446, 481(a), 581, and 585)

Rev. Proc. 2008-18

SECTION 1. PURPOSE

This revenue procedure explains how a bank that changes from the reserve method of accounting for bad debts under § 585 of the Internal Revenue Code for its first taxable year for which an election under § 1362(a) is in effect may elect under § 1361(g) to take into account the resulting § 481(a) adjustment in determining taxable income for the immediately preceding taxable year.

SECTION 2. BACKGROUND

.01 Section 1361(a) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year. Section 1361(b) provides that any corporation that is a financial institution which uses the reserve method of accounting for bad debts

described in § 585 is not eligible to be an S corporation.

.02 If a financial institution changes from the § 585 reserve method of accounting for bad debts to the § 166 specific charge-off method, the amount of the § 481(a) adjustment for the change generally is the amount of the institution's reserve for bad debts as of the close of the taxable year immediately before the year of change. This positive adjustment is generally taken into account over four taxable years beginning in the year of change.

.03 Rev. Proc. 2002-9, 2002-1 C.B. 327, (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified, clarified and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, and as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561) provides procedures by which a taxpayer may obtain the automatic consent of the Commissioner of Internal Revenue under § 446 for a change in method of accounting described in the APPENDIX of Rev. Proc. 2002-9. Section 11.01 of that APPENDIX provides rules for a bank changing its method of accounting for bad debts from the § 585 reserve method of accounting to the § 166 specific charge-off method of accounting. A taxpayer complying with all of the applicable provisions of Rev. Proc. 2002-9 has obtained the consent of the Commissioner to change its method of accounting.

.04 Section 8233(a) of the Small Business and Work Opportunity Act of 2007 (Public Law 110-28) added § 1361(g) to the Code. Section 1361(g) provides that, in the case of a bank which changes from the reserve method of accounting for bad debts described in § 585 for its first taxable year for which an election under § 1362(a) is in effect, the bank may elect to take into account any adjustments under § 481 by reason

of such change for the taxable year immediately preceding such first taxable year.

Section 1361(g) applies to taxable years beginning after December 31, 2006.

SECTION 3. SCOPE

.01 In general. Section 11.01 of the APPENDIX of Rev. Proc. 2002-9 provides rules for a bank (as defined in § 581, including a bank for which a qualified subchapter S subsidiary (QSub) election is filed) that wants to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method. Section 11.01 specifically references the requirement that a bank must change its method of accounting for bad debts from the § 585 reserve method in order to be eligible to elect subchapter S status.

.02 Election for § 481(a) adjustment. Section 4.01 of this revenue procedure describes the process by which a bank may elect under § 1361(g) to take into account the § 481(a) adjustment resulting from a change in method of accounting for bad debts in determining taxable income for the taxable year immediately preceding the year of change.

SECTION 4. APPLICATION

.01 Requirements for election to include § 481(a) adjustment in taxable year immediately preceding the year of change. For a taxable year beginning after December 31, 2006, a bank that changes its method of accounting for bad debts, under section 11.01 of the APPENDIX to Rev. Proc. 2002-9, from the § 585 reserve method to the § 166 specific charge-off method for the first taxable year for which the S corporation election is effective (year of change) may elect to take into account the amount of the resulting § 481(a) adjustment in determining taxable income for the

taxable year immediately preceding the year of change. To make this election, a bank must (1) file an original and copy of Form 3115 under section 6.02(3) of Rev. Proc. 2002-9 for the year of change, (2) file an additional copy of the Form 3115 with its original (or amended) federal income tax return for the taxable year immediately preceding the year of change filed no later than the date the original Form 3115 is properly filed under section 6.02(3) of Rev. Proc. 2002-9, and (3) include the amount of the § 481(a) adjustment in gross income for the taxable year immediately preceding the year of change. The original (and each copy of) Form 3115 must state at the top of the document, "Section 1361(g) Election Filed Pursuant to Rev. Proc. 2008-18."

.02 *Example.* X, a calendar year taxpayer, is a bank as defined in § 581 and is not a large bank as defined in § 585(c)(2). For taxable years before 2007, X accounted for its bad debts under the § 585 reserve method. By March 15, 2007, X properly filed a Form 2553 electing to be an S corporation effective January 1, 2007. Pursuant to section 11.01(3) of the APPENDIX to Rev. Proc. 2002-9, the filing of the Form 2553 constituted an agreement by X to change from the § 585 reserve method to the § 166 specific charge-off method in 2007 in accordance with all of the applicable provisions of Rev. Proc. 2002-9. Thus, for example, X must file a Form 3115 for this change in duplicate, in accordance with section 6.02(3) of Rev. Proc. 2002-9, by attaching the original Form 3115 to X's timely filed (including extensions) original federal income tax return for 2007 and filing a copy of the Form 3115 with the national office. The amount of X's § 481(a) adjustment for the change is the amount of X's bad debt reserve as of the close of December 31, 2006. X wishes to elect under § 1361(g) to include the § 481(a) adjustment in income in the tax year ending December 31, 2006, the taxable

year immediately preceding the year of change. To make this election, X must (1) file an original and copy of Form 3115 under section 6.02(3) of Rev. Proc. 2002-9 for 2007, (2) file an additional copy of the Form 3115 with its original (or amended) federal income tax return for 2006 filed no later than the date the original Form 3115 is properly filed under section 6.02(3) of Rev. Proc. 2002-9, and (3) include the amount of its § 481(a) adjustment in gross income in its return for 2006. The original (and each copy of) Form 3115 must state at the top of the document, "Section 1361(g) Election Filed Pursuant to Rev. Proc. 2008-18."

SECTION 5. SPECIAL RULE FOR CERTAIN 2006 TAXABLE YEARS.

A special rule is provided for a bank that, prior to the issuance of this revenue procedure, changed its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method under section 11.01 of the APPENDIX of Rev. Proc. 2002-9 for a year of change beginning after December 31, 2005, and ending before December 31, 2007 ("2006 taxable year"). This special rule only applies if the bank elected to be an S corporation for its first taxable year beginning after December 31, 2006. Under this special rule, the bank may elect to take the entire § 481(a) adjustment into account in determining taxable income for the 2006 taxable year by attaching a copy of its original Form 3115 with the following language written on the top of the document, "Special Election under Section 5 of Rev. Proc. 2008-18," to an amended return for the 2006 taxable year that reflects the entire § 481(a) adjustment. A copy of the original Form 3115 with the required language written at the top should also be provided to the National Office (see section 6.02(6) of Rev. Proc. 2002-9 for the address). This special rule only applies to an election made under this section 5 on an

amended return for the 2006 taxable year filed on or before September 15, 2008.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 2006, except as provided in Section 5 of this revenue procedure.

SECTION 7. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies Rev. Proc. 2002-9 by adding section 4.01(1) of this revenue procedure to section 11.01 of the APPENDIX of Rev. Proc. 2002-9. See section 11.01 of the APPENDIX of Rev. Proc. 2002-9 for the specific rules relating to a change in accounting method from the § 585 reserve method of accounting for bad debts to the § 166 specific charge-off method of accounting.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Laura C. Fields of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure contact Laura C. Fields at (202) 622-3050 (not a toll free call).