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Taxation--Reserve for Bad Debt

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CASE COMMENTS

Taxation—Reserve for Bad Debt

Taxpayers were partners operating eight finance offices in Alabama. They used the accrual method of accounting to report income and the reserve method for bad debts as prescribed by section 166(c) of the 1954 Internal Revenue Code.[1] As of May 31, 1960, the partnership books showed accounts receivable in the sum of $486,853.69 and a reserve for bad debts in the amount of $73,028.05. On June 1, 1960, the partners incorporated within the terms of section 351[2] of the Internal Revenue Code of 1954 and transferred all assets, including the face amount of accounts receivable, to the corporation in exchange for stock in the corporation. However, in setting up the corporation books, the reserve for bad debts was deducted, reflecting the net amount of accounts receivable. The Commissioner determined that the reserve for bad debts should have been included as income in the partnership's final fiscal year.[3] The district court,[4] in a refund

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[30] 398 U.S. 333 (1970).

[31] "The two groups of registrants that obviously do fall within these exclusions from the exemption [for conscientious objectors] are those whose beliefs are not deeply held and those whose objection to war does not rest at all upon moral, ethical, or religious principle but instead rests solely upon considerations of policy, pragmatism, or expediency." *Id.* at 343. *But see* Macgill, *Selective Conscientious Objection: Divine Will and Legislative Grace,* 54 VA. L. REV. 1355, 1376 (1968). "Application of these requirements [for a 'just war'] to any particular war necessarily involves the weighing of political facts which the state itself has already considered. Therefore, it is not surprising that opposition to such a war derived from that application might be regarded as political rather than religious in character, and a threat to good order."

[32] *McFadden* has also been filed for appeal with the Supreme Court, 39 U.S.L.W. 3074 (U.S. Aug. 25, 1970), but it may be dismissed for lack of jurisdiction as was *Sisson.*

[1] Nash v. United States, 398 U.S. 1 (1970); for a discussion of the Fifth Circuit decision, *Nash v. United States,* 414 F.2d 627 (5th Cir. 1969), and an explanation of the accural method of accounting, reserve for bad debts, and accounts receivable see 72 W. VA. L. REV. 302 & n.1, 2, 4 (1970).

[2] § 351 (a) General Rule

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

[3] "Upon examination, the Commissioner determined that for the fiscal year ending January 31, 1961, the partnership should include as taxable in-

suit, allowed taxpayer a recovery and the court of appeals[5] reversed. The Supreme Court, reversing the decision of the Fifth Circuit[6] and resolving a conflict between the Fifth Circuit and the Ninth Circuit,[7] *held* that the partnership, upon incorporating within the terms of section 351, was not required to include in income the amount of the bad debt reserve. *Nash v. United States,* 398 U.S. 1 (1970).

Prior to Revenue Ruling 62-128,[8] there had apparently been little dispute over the treatment of a bad debt reserve upon an incorporation within the provisions of section 351. Yet a similar statute had been on the books since the Revenue Act of 1921.[9] Since the

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come Seventy-three Thousand Twenty-eight and 05/100 Dollars ($73,028.05), the bad debt reserve applicable to the accounts receivable transferred to the corporation." Nash v. United States, 68-2 U.S. Tax Cas. ¶ 9513 (N.D. Ala. 1968).

[4] Nash v. United States, 398 U.S. 1 (1970), *rev'g* 414 F.2d 627 (5th Cir. 1969), *aff'g* 68-2 U.S. Tax Cas. 9513 (N.D. Ala. 1968).

[5] Nash v. United States, 414 F.2d 627 (5th Cir. 1969), *rev'g,* 68-2 U.S. Tax Cas. ¶ 9513 (N.D. Ala. 1968).

[6] Nash v. United States, 398 U.S. 1 (1970), *rev'g,* 414 F.2d 627 (5th Cir. 1969).

[7] In *Estate of Schmidt v. Commissioner,* 355 F.2d 111 (9th Cir. 1966), the Ninth Circuit had disagreed with the Commissioner's reasoning and held that the bad debt reserve when transferred under a section 351 exchange was not to be taxed as income.

[8] A taxpayer, engaged in a business as a sole proprietor, transferred all of the assets of his business, subject to its liabilities, to a corporation controlled by the transferor in a nontaxable exchange under the provisions of section 351 of the Internal Revenue Code of 1954. Prior to the transfer the business had, on its books of account, a reserve for bad debts which had been accumulated by additions for which the taxpayer had derived full tax benefits in prior taxable years. *Held,* under these circumstances the reserve for bad debts is not transferable to any other entity. Accordingly, the reserve for bad debts represents ordinary income to the taxpayer for the taxable year during which the transfer of the accounts receivable was made, since during such time his need for the reserve ceased.

Under similar circumstances, a partnership must likewise include such reserve for bad debts in its final return as ordinary income. However, to the extent that the additions to the reserve for bad debts in prior years may not have resulted in tax benefits, they need not be included in the transferor's gross income.

1962-2 CUM BULL. 139 [citations omitted].

[9] REVENUE ACT OF 1921, ch. 136, § 202(c) (3), 42 Stat 230. In *Estate of Schmidt v. Commissioner,* 355 F.2d 111, 112-13 (9th Cir. 1966), the court observed that, prior to Revenue Ruling 62-128, there had never been a reported case in which the Commissioner had taken the position that a bad debt reserve should be restored to income upon incorporation.

issuance of the ruling, much litigation[10] and confusion had preceded the *Nash* decision. The dispute in prior cases over the disposition of the reserve for bad debts seems to have stemmed from a difference in opinion as to what the reserve represents. The Internal Revenue Service viewed the reserve as representing untaxed income, while the taxpayer saw it as an allowance for bad debts which represented a decrease in value recognized for tax purposes, a loss inherent in the total of the receivables.[11]

The tax benefit rule,[12] that is, a recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery, formed the basis of the Commissioner's contention[13] that the reserve should be restored to income. The Commissioner felt that the unused amount of the bad debt reserve had to be restored when the "need" for the reserve ended with the termination of the proprietorship or partnership. The concept that income should be recognized when the "need" for maintaining the reserve ceased was not novel. The Commissioner had often treated the end of "need" as a taxable event.[14]

The Court in *Nash* stated that Congress, if it desired to make the end of "need" synonomous with "recovery", could make the tax benefit rule read: "[A] bad debt reserve that has produced an income tax benefit in a prior year is to be added to income in the year when it was recovered or when its need is ended."[15] In that context the

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[10] *See, e.g.,* Robert P. Hutton, 53 T.C. 37 (1969); Bird Management, Inc., 48 T.C. 586 (1967); J. E. Hawes Corp., 44 T.C. 705 (1965). For a detailed history of the litigation preceding the Supreme Court decision in *Nash* see 72 W. VA. L. REV. 302, 304-06 (1970).

[11] Stoffel, *Treatment of Reserve Accounts on Incorporation and Liquidation,* N.Y.U. 26TH INST. ON FED. TAX. 773, 773 (1968).

[12] *Cf.* INT. REV. CODE OF 1954, § 111 (a): General Rule.—

> Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

[13] *See, e.g.,* Max Schuster, 50 T.C. 98 (1968); West Seattle Nat'l Bank of Seattle v. Commissioner, 33 T.C. 341 (1959), *aff'd,* 288 F.2d 47 (9th Cir. 1961).

[14] *See, e.g.,* Argus, Inc., 45 T.C. 63 (1965); Geyer, Cornell & Newell, Inc., 6 T.C. 96 (1946).

[15] Nash v. United States, 398 U.S. 1, 4 (1970).

Court said the Commissioner's ruling would be honored, but it did not feel free to state the tax benefit rule in those terms.[16] Rather, the Court turned to section 351 (a) of the Code, which states that no gain or loss shall be recognized upon transfer of property to a corporation in exchange for stock if immediately after the exchange the transferrors of property are in control of the corporation.[17]

The Commissioner's position on the treatment of a bad debt reserve was an attempt to give a section 351 transfer an entirely new effect, specifically from a tax free transaction into a semi-taxable event.[18] Following the reasoning of the Ninth Circuit,[19] the Supreme Court felt the deduction of the reserve from receivables upon incorporation conformed to the "reality of the transaction."[20] Taxpayers received stock equal in value to the net worth of the accounts transferred, that is, the face amount of receivables less the total of the bad debt reserve.[21] Since it was conceded that the reserve was reasonable and the stock received was equal to the net value of receivables, the Court felt there was no "recovery".[22]

The Court reasoned that a tax benefit was received by the partnership when the bad debt reserve was initially taken as a deduction and a double benefit would have occurred had the stock been issued for the gross amount of receivables, but stated: "We do not, however, understand how there can be a 'recovery' of the benefit of the bad debt reserve when the receivables are transferred less the reserve."[23] Accordingly, the Court agreed with the position of the Ninth Circuit[24] that although the "need" for the bad debt had ceased, it did not mark a "recovery" within the meaning of the tax benefit rule.[25]

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[16] *Id.*

[17] INT. REV. CODE OF 1954, § 351.

[18] Hickman, *Incorporation and Capitalization,* 40 TAXES 974, 977 (1962). In the author's critical comment, he stated that the Commissioner's position "flies directly in the teeth of the purpose of that section [section 351] to promote incorporation."

[19] Estate of Schmidt v. Commissioner, 355 F.2d 111, 113 (9th Cir. 1966). The Ninth Circuit felt that the Tax Court's and the Commissioner's position disregarded the "economic realities" of the situation. *Schmidt* was also followed in *Rowe v. United States,* 69-1 U.S. Tax Cas. ¶ 9162 (W.D. Ky. 1969), where the court, with a similar factual situation, stated the reasoning of the Ninth Circuit was "controlling".

[20] Nash v. United States, 398 U.S. 1, 4 (1970).

[21] *Id.*

[22] *Id.*

[23] *Id.* at 5.

[24] Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966).

[25] Nash v. United States, 398 U.S. 1, 5 (1970).

The Supreme Court decision in *Nash* hopefully resolves the controversy over disposition of a bad debt reserve upon the transfer of assets in a section 351 exchange. However, the opinion does not go so far as to say that a bad debt reserve may never be restored to income in a section 351 transfer. The decision was based on an exchange of assets for stock equal to the *net value* of accounts receivable. Therefore, where it can be determined that the value of stock issued to the transferor represents the face value of accounts receivable and disregards the bad debt reserve, there would be a "recovery" within the meaning of the tax benefit rule, and the recovery would be considered a taxable event. Whether or not the *Nash* decision will be applied to a section 337[26] liquidation with a similar factual situation is left unanswered; however, in light of the economic realities test applied in *Schmidt* and the apparent adoption of that principle by the Supreme Court in *Nash,* it seems likely that a section 337 liquidation would not be considered a taxable event.

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Constitutional Law—Freedom of Religion—
Tax Exempt Status of Church Property

The plaintiff, an owner of real property, brought suit in the New York courts seeking to enjoin the New York City Tax Commission from granting property tax exemptions to religious organizations on properties used solely for religious purposes. These exemptions were authorized by state constitutional[1] and statutory

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[26] INT. REV. CODE OF 1954, § 337 (a) General Rule.— If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

[1] N. Y. CONST. art. XVI, § 1:

Exemptions from taxation may be granted only by general laws. Exemptions may be altered or repealed except those exempting real or personal property used exclusively for religious, educational or charitable purposes as defined by law and owned by any corporation or association organized or conducted exclusively for one or more of such purposes and not operating for profit.