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# Income Tax--Taxation of Reserve for Bad Debts When Transferred to Controlled Corporation

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### Income Tax — Taxation of Reserve for Bad Debts When Transferred to Controlled Corporation

Taxpayers used the accrual method<sup>1</sup> of accounting and the reserve method<sup>2</sup> for bad debts in operating various finance institutions as a partnership. On June 1, 1960, the taxpayers incorporated under section 351<sup>3</sup> of the 1954 Internal Revenue Code and transferred partnership assets to the corporation. The transferred assets included accounts receivable<sup>4</sup> of \$486,853.69, which represented

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<sup>1</sup>The accrual technique of accounting requires income to be reported during the period when the right to receipt occurs, and deductions to be reflected during the period when the obligation to the creditor arises. Comment, *Tax Impact of a Transfer of a Bad Debt Reserve to a Controlled Corporation: An Analysis of Schuster v. Commissioner*, 6 SAN DIEGO L. REV. 297, 299 (1969). This method is to be contrasted with the cash method which requires income to be reported only when cash or its equivalent is actually or constructively received and deductions to be reflected when a debt is paid. R. RICE, *FEDERAL INCOME TAXATION*, 85 (1967). The accrual method is normally associated with businesses and the cash method with individuals.

<sup>2</sup>Section 166 of the Internal Revenue Code of 1954 allows deductions for bad debts and the creation of a reserve for that purpose; the reserve is an estimate utilized by a taxpayer to offset uncollectable debts. Bonovitz, *RESTORATION TO INCOME OF BAD DEBTS RESERVES*, 44 TAXES 300, 300 (1966).

<sup>3</sup>§351 (a) General Rule

No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) 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.

<sup>4</sup>The concept of accounts receivable is used in conjunction with the accrual method of accounting. Accounts receivable are rights a creditor has against his debtor which will be settled at a later date. In normal business operations some debts will not be paid, therefore, accountants have developed the reserve for bad debts to show the difference between the amount which should be collected and the amount which will not be collected. Losses, in effect, are being anticipated. On the proprietorship or liability side of the accounts, a bad debt expense account is debited, and on the asset side reductions are shown by a credit to a bad debt reserve (or allowance, account. Under this system losses will be reflected during the accounting period to which they are related, and assets resulting from the sale will be equivalent to the amount of the estimated collectible amount, since the allowance for bad debts is subtracted from accounts receivable on the balance sheet. Later, when an amount of accounts receivable is known to be worthless, the allowance account is debited and a credit is made to the receivable account. Assets remain unchanged and expenses are not affected since an asset is credited and the reserve for bad debts is debited. This method of anticipating losses is approved for tax purposes if consistent and reasonable. Comment, *Tax Impact of a Transfer of a Bad Debt Reserve to a Controlled Corporation: An Analysis of Schuster v. Commissioner*, 6 SAN DIEGO L. REV. 297, 300 (1969).

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the face value of the accounts at the time of the transfer. However, the partnership books also carried a reserve account for bad debts applicable to the accounts receivable. The amount of this account, \$73,028.05, was deducted in setting up the corporation's books. The taxpayers contended that the resulting entry represented the net amount of the accounts receivable and was not taxable. The Commissioner decided that the sum of \$73,028.05 represented income to the partnership and should have been reported in the partnership's final tax return. The taxpayers brought a suit to recover the additional taxes. The district court held that the partners did not have to include the pro rata share of the reserve for bad debts as income. *Held*, reversed. A partnership which incorporates, and transfers accounts receivable to a controlled corporation must treat the amount of accumulated unused bad debt reserve as income in the final fiscal year of the partnership. *Nash v. United States*, 414 F. 2d 627 (5th Cir. 1969), *cert. granted*, 90 S. Ct. 556 (1970).

The primary purpose of section 351 is to enable persons to transfer property to a newly formed controlled corporation without suffering a heavy tax at the formation of the new corporation.<sup>5</sup> On the other hand, the reasoning behind taxing the reserve for bad debts is that:

In the year the reserve is no longer needed, what was formerly the estimate becomes the actual, reflecting, in the case of a credit balance in the reserve, that excessive bad debt deductions were taken in prior years. In order to adjust prior estimated bad debt deductions to reflect what has actually occurred, the balance in the reserve must be restored. . . .

The logic and fairness of requiring this restoration to income is readily apparent. The recovery by a taxpayer of an amount related to that which it has previously claimed as a bad debt deduction and in fact deducted from income, should be restored to income to remove the effect of a prior deduction and thus prevent a distortion. . . .<sup>6</sup>

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<sup>5</sup> *Tax Problems of Accounts Payable and Receivable Upon Incorporating a Cash Basis Taxpayer*, 6 SANTA CLARA LAWYER 216, 218 (1966).

Section 351 had its origin in the Revenue Act of 1921. The concept was in 1921 and has been since, that a transfer to a controlled corporation is to be treated as a mere change in the form of ownership, thus eliminating tax impediments to the incorporation of businesses.

Hickman, *Incorporation and Capitalization*, 40 TAXES 974, 979 (1962).

<sup>6</sup> Bonovitz, *Restoration to Income of Bad Debt Reserves*, 44 TAXES 300, 301-02 (1966).

Thus, when a section 351 transfer also involves a transfer of a bad debt reserve, a conflict of tax policies occurs. Apparently contrary to the intent of section 351, the Commissioner has repeatedly taxed transfers of reserves for bad debts which are otherwise tax free transactions under sections 351 and 337<sup>7</sup> of the Internal Revenue Code of 1954. The Commissioner has relied primarily on Revenue Ruling 62-128,<sup>8</sup> which holds that a transfer of a business by a sole proprietor or partnership to a controlled corporation makes the existing reserve for bad debts taxable as ordinary income, with the exception of prior additions to the reserve for bad debts which did not result in a tax benefit to the taxpayer.

The *Nash* case clearly shows the Commissioner's view on taxing the transfer of a reserve for bad debts when incorporating using section 351. The Fifth Circuit recognized that the Ninth Circuit had previously held<sup>9</sup> that the reserve for bad debts when transferred under section 351 was not to be taxed as income, but despite the resulting divergence of opinion, the Fifth Circuit disagreed with the Ninth Circuit and affirmed the Commissioner's view.<sup>10</sup>

In cases not dealing with section 351, the Commissioner has generally prevailed over the taxpayer when the litigation involves

<sup>7</sup> §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.

<sup>8</sup> 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 deprived 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 estate income.

1962-2 CUM BULL. 139 (citations omitted).

<sup>9</sup> Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966).

<sup>10</sup> *Nash v. United States*, 414 F.2d 627, 629 (5th Cir. 1969), cert. granted, 90 S. Ct. 556 (1970).

the taxation of a reserve for bad debts which was not converted to income in the year the need for th reserve ceased. In a 1965 case<sup>11</sup> involving section 337, it was held that a reserve for bad debts became ordinary income when no longer needed by the taxpayer. In another section 337 case, *Bird Management, Inc. v. Commissioner*,<sup>12</sup> it was held that when a balance remained in the reserve for bad debts and there was no need for the reserve, the reserve was to be restored to income.

The Commissioner has also had success in section 351 cases. In *Schuster v. Commissioner*,<sup>13</sup> which involved a transfer under section 351 of a sole proprietorship including accounts receivable, the Tax Court held that a balance in a reserve for bad debts had to be restored to income in the year of the transfer. Other cases have likewise held that the reserve for bad debts is taxable income.<sup>14</sup>

A view contrary to the Commissioner's was taken by the Ninth Circuit in *Estate of Schmidt v. Commissioner*.<sup>15</sup> This court held that a taxpayer who operated a business as a sole proprietorship and transferred accounts receivable to a controlled corporation under section 351, with an offset for a reserve for bad debts, did not realize taxable income on the reserve for bad debts which he no longer needed. The Ninth Circuit stated:<sup>16</sup>

where accounts receivable are sold for cash for less than face value, the difference being the amount of the reserve, the taxpayer does not then 'realize' a loss. He 'realized' the loss, for tax purposes, when he set up the reserve, and cannot have it twice. The price received merely demonstrates that the estimate of loss was correct. And there is no gain merely because the reserve is no longer 'needed;' rather, the correctness of the reserve as an estimate of loss is confirmed."

The court in *Schmidt* felt that the Commissioner and the Tax Court had ignored "the economic realities of the situation."<sup>17</sup> The

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<sup>11</sup> *J. E. Hawes Corp.* 44 T. C. 705 (1965).

<sup>12</sup> 48 T. C. 536 (1967).

<sup>13</sup> 50 T. C. 98 (1968).

<sup>14</sup> *Handleman v. Commissioner*, 36 T. C. 560 (1961) (liquidation); *West Seattle Nat'l Bank of Seattle v. Commissioner*, 33 T. C. 341 (1959), *aff'd* 288 F.2d 47 (9th Cir. 1961) (liquidation); *Geyer, Cornell & Newell, Inc. v. Commissioner*, 6 T.C. 96 (1946) (liquidation).

<sup>15</sup> *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966).

<sup>16</sup> *Id.* at 114.

<sup>17</sup> *Id.* at 113.

*Schmidt* case was followed in *Rowe v. United States*<sup>18</sup> when the court held that a partnership which in a section 351 transaction, transferred its notes, accounts receivable and bad debt reserve to a controlled corporation did not take the bad debt reserve as taxable income.

Although the Ninth Circuit rejected the Commissioner's attempt to tax a reserve for bad debts in the *Schmidt* case, neither the Tax Court nor the Commissioner has adopted its reasoning. In *Bird Management, Inc. v. Commissioner*,<sup>19</sup> the Tax Court felt that the court of appeals in *Schmidt* had misconceived the theory calling for the inclusion of the bad debt reserve into income. In a more recent case, *Hutton v. Commissioner*,<sup>20</sup> the taxpayer transferred the assets of a sole proprietorship to a controlled corporation. The court held that the balance in the reserve for bad debts had to be restored to income because the need for the reserve had ceased.

While there is no standard uniformly applied among the circuits and the Tax Court in taxing the reserve for bad debts, there are methods by which the taxpayer may avoid restoring a reserve for bad debts to income when the need for the reserve ceases. The taxpayer, in a liquidation or dissolution, might write off all the bad debts possible before liquidating or dissolving.<sup>21</sup> The taxpayer may also write off bad debts before incorporating under section 351 or even go to the extent of not transferring the accounts receivable to the new corporation.<sup>22</sup> It was implied in *Cardinal Finance Co.*,<sup>23</sup> that if the taxpayer, while he owned the receivables, justifiably wrote off the bad debt reserve, there would have been no tax on the reserve. In view of past court treatment of reserves for bad debts, it may be wise to bear in mind possible methods to avoid the tax on the reserve for bad debts under section 337 or section 351. It is readily apparent that a definite conflict exists on the taxation of

<sup>18</sup> 69-1 U.S. TAX CAS. ¶ 9162 (D. Ky. Jan. 3 1969).

<sup>19</sup> 48 T.C. 586 (1967). In finding for the Commissioner the court stated: It is not that the creditor has 'received' something or has 'realized' income in the usual sense. Rather, it is an accounting concept that one who has taken a deduction for bad debts in earlier years by reason of his method of accounting, must, in accordance with that method of accounting, restore that deduction to income in a later year when it becomes clear that no bad debt loss will occur *Id.* at 597.

<sup>20</sup> 53 T. C. 37 (1969).

<sup>21</sup> Tovey, "Retired" Reserve Can Bring Unexpected Taxable Income Where Business Changes, J. TAXATION 198, 200 (Apr. 1964).

<sup>22</sup> *Id.*

<sup>23</sup> CCH TAX CT, MEM. 90 (1963).

a reserve for bad debts when there is a transfer under section 351 or a liquidation under section 337 of the Internal Revenue Code of 1954. The Supreme Court has granted certiorari in the *Nash* case. Until there is a final decision, however, any taxpayer contemplating a transfer or liquidation must exercise caution in transferring a reserve for bad debts.

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### **Juvenile Courts — Insanity Defense No Bar To Adjudication of Delinquency**

The bodies of two young girls were found in a wooded area where they had been beaten to death with blunt objects. The next day, H. C., a fifteen-year-old juvenile, was apprehended and charged with delinquency for the killing of the two girls. The factual evidence taken at the original hearing, including an admission by H. C., made it clear that H. C. had killed the girls in the woods, returned home, and acted so naturally throughout the evening that his parents noticed nothing unusual. Testimony at the hearing from three psychiatrists, one called by the prosecutor and two by the defense, established that H. C. suffered from schizophrenia, and the unanimous conclusion was that he was neither capable of controlling his actions nor of appreciating the consequences. After an additional ninety-day psychiatric observation which yielded the same conclusions and brought a recommendation of psychiatric care, the hearing continued on the matter of delinquency in the Juvenile and Domestic Relations Court, Morris County, New Jersey. *Held, inter alia*, that proof of the defense of insanity under the *M'Naghten* rule did not bar an adjudication of delinquency with respect to a minor, even though he suffered from such disease of the mind as would be a complete defense to criminal charges against an adult. The juvenile was adjudicated delinquent and sent to a state mental hospital, with the court expressly retaining jurisdiction on the matter of discharge. *In re State In Interest of H. C.*, 106 N.J. Super. 583, 256 A.2d 322 (Juv. & D.R. Ct. 1969).

The basic issue before the court was whether there could and should be an adjudication of delinquency in view of the psychiatric testimony and evaluation which concluded that the juvenile, H. C.,