Reasonable Additions to a Reserve for Bad Debts for Tax Purposes

Robert Lee Curry III
most cases as a result of judicial interpretation of the present code.\textsuperscript{46}

The second proposed change would eliminate the dismissal of appeals because of the failure of the appellant to pray for citation. It would also remove from the appellee the duty of determining for himself if an appeal has been taken. However, this proposal would not eliminate the delays caused by the oversight of clerks of court in failing to issue notice of appeal or in failing to have all necessary parties served. The great majority of appeals are taken by motion immediately after rendition of judgment (and very often in the presence of opposing counsel) so that citation or notice is neither necessary under the present procedural rules nor desirable from a practical standpoint. Under the proposal of the Louisiana State Law Institute requiring service of notice of every appeal, the burden on court officers of issuing and serving such notice would be vastly, and, it is submitted, needlessly, multiplied.

A revision of the pertinent Code of Practice article abolishing citation whenever appeal is taken by motion would, in the opinion of the writer, be the more practical method of eliminating the unsatisfactory rules relative to citation of appeal now present in the appellate procedure of this state.

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**Reasonable Additions to a Reserve for Bad Debts for Tax Purposes**

The Internal Revenue Code allows two alternative methods to be followed in deducting bad debt losses: (1) a deduction for debts which have actually become worthless during the taxable year and (2) a deduction for a reasonable addition to a reserve for bad debts.\textsuperscript{1} The Treasury Regulation pertaining to the calcu-

\textsuperscript{46} See cases cited in notes 10 and 11 supra.

\textsuperscript{1} In theory these two alternatives conform to the cash and accrual methods of accounting. (See note 6 \textit{infra}.) The Commissioner of Internal Revenue, however, has acquiesced in the Board of Tax Appeals' holding that the method of deducting bad debts will not be disturbed if it is consistent with the taxpayer's method of accounting so that income is clearly reflected. Estate of Maurice S. Saltstein, 48 B.T.A. 774 (1942). In this case a taxpayer employing the cash method of accounting was allowed to deduct a reserve against loss of capital. The Commissioner acquiesced in the decision. See also Frederick W. Gray, 8 CCH 1949 T.C.MEM. DEC. 710 (1949); First National
lation, for ordinary commercial enterprises, of a reasonable addition to a reserve for bad debts\(^2\) has gone little beyond prescribing very general criteria and has remained relatively unchanged for many years. In the field of banking, however, the mode of computing a reasonable addition to a reserve for bad debts has been specifically set forth in a Bureau Mimeograph,\(^3\) and to some extent one might say a method has also been prescribed in the Code and Regulations for mutual savings banks, domestic building and loan associations, and cooperative banks.\(^4\) The general

\(^1\) Bank of Omaha, 17 B.T.A. 1358 (1929); I.T. 2540, IX-2 CUM. BULL. 347 (1930), which modifies G.C.M. 938A, VI-2 CUM. BULL. 206, 209, question XII (1927).

\(^2\) Other than for worthless items which have been previously recognized as income or reported as taxable income. Charles A. Collin, 1 B.T.A. 305 (1925).

\(^3\) A taxpayer on the cash basis is allowed to deduct from gross income a worthless item which has not been previously treated as income or reported as taxable income. Charles A. Collin, 1 B.T.A. 305 (1925).

\(^4\) The blanket exemption formerly given to mutual savings banks, domestic building and loan associations, and cooperative banks by § 101(2) of the Internal Revenue Code was repealed by Revenue Act of 1951, § 313(a), 65 Stat. 490 (1951). There was great concern over this because these organizations are usually required by law to maintain a certain fixed surplus or reserve and it was therefore felt that the Internal Revenue Code should allow a reserve sufficient to meet such requirements to be created tax free. As a consequence § 23(k)(1) was amended to allow a “mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit” to accumulate a reserve totaling 12 percent of the “total deposits or withdrawable accounts of its depositors” tax free. This was done by allowing any of the above organizations whose reserve did not equal the stipulated 12 percent to deduct as a “reasonable addition” to a reserve for bad debts such amount as would bring the total reserve up to 12 percent or the net income of the taxable year computed without deduction for bad debts, whichever is less. However, it is further provided that in no case shall the addition to the reserve be less than “the amount determined by the taxpayer as the reasonable addition for such year.” Therefore, mutual savings banks, domestic building and loan associations, and cooperative banks become faced with the vexing problem of what is a “reasonable” addition to a reserve for bad debts when either (1) they feel that their bad debts will amount to more than the difference between their accumulated reserve and 12 percent of total deposits and withdrawable accounts, or (2) when their reserve already equals or exceeds the stipulated 12 percent.
commercial enterprise, however, must still rely on ad hoc estimates. The purpose of this comment is to set forth the criteria which have been developed in administrative and business practice for making this estimate and to set forth the consequences which follow error.

Of the two the reserve method involves an attempt to estimate in the taxable year the total amount of current receivables\(^5\) reflected in income which will become worthless in both the present and future years. Although the accrual method\(^6\) of reporting income and expenses for federal tax purposes was recognized prior to 1921,\(^7\) the deduction for bad debts was allowed only for those debts determined to have become worthless during the taxable year. The taxpayer who reported his income on the accrual basis could not charge off bad debt losses in the year in which the debts came into existence even though it was then evident that losses would eventually materialize. The result was an overstatement of income from the accounting standpoint and therefore a larger tax liability than would have been incurred had the taxpayer been allowed to report only the collectible income.\(^8\) For this reason an amendment was adopted in 1921\(^9\) allowing a taxpayer to deduct a reasonable addition to a reserve for bad debts. This provision has been incorporated into the Internal Revenue Code to read as follows:

"In computing net income there shall be allowed as deductions:

". . .

"(k) . . . Debts which become worthless within the tax-

\(^5\) "... an addition to a bad debt reserve must be based on an actual debt owing. A reasonable addition to a reserve cannot be based on a contingent liability, nor is a reserve allowable for items which have not been reflected in income. . . . The reserve system may be employed in the case of losses on loans and notes and is not confined to trade accounts." MERTENS, THE LAW OF FEDERAL INCOME TAXATION 497 (1953).

\(^6\) "The accrual method, at bottom, consists simply in the effort to recognize in a given period all revenues which can fairly be said—on the basis of valid business and legal rules—to have arisen in the period, and to absorb as expenses all the costs attaching to such revenues." PATON, ACCOUNTANT'S HANDBOOK 113-114 (3d ed. 1949). This method of accounting is to be compared with the cash method, wherein only amounts which are actually received or expended are recognized in the taxable year.

\(^7\) Revenue Act of 1916, § 8(g), 39 STAT. 763 (1916).

\(^8\) The cash basis taxpayer never encountered this difficulty unless the bad debt loss arose out of a loan of capital, because he reported as income only the collected accounts receivable.

\(^9\) Revenue Act of 1921, § 214(a), 42 STAT. 239-40 (1921): "In computing net income there shall be allowed as deductions: . . . (7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the commissioner, a reasonable addition to a reserve for bad debts). . . ."
The principal problem raised by this amendment is the ascertainment of what the Commissioner will consider a "reasonable" addition. On creating the reserve, the taxpayer must rely at best on an informed estimate. The problem is aggravated by the fact that by the time an audit is made of the taxpayer's return the Commissioner usually has the benefit of several years of "hindsight," and can frequently ascertain exactly what debts have in fact become bad. The taxpayer must also reckon with the presumption of correctness which the statute, as interpreted by the courts, accords the Commissioner's determination of what was reasonable. In discussing the weight to be given the Commissioner's determination, the Board of Tax Appeals gave a very clear statement of the law, which is still in effect, in holding that unless the Commissioner's refusal to permit a deduction for an addition to a reserve for bad debts "is capricious or arbitrary, or otherwise an abuse of discretion . . . [we] should be slow to override it. Certainly . . . [the Board] may not merely substitute its judgment for that of the Commissioner as if the statute contained no such condition [of discretion] and the Board were simply to decide de novo whether the claimed addition to the reserve were reasonable." It is therefore apparent that the taxpayer must approach the computation of the addition to his reserve with caution. Once the amount of the addition is disallowed by the Commissioner, the taxpayer must prove not only the reasonableness of his own contentions, but also the unreasonableness of the Commissioner's contentions.

The Commissioner's interpretation of the statute with regard to what constitutes a reasonable addition to a reserve for bad debts is set forth as follows in the Income Tax Regulations:

"What constitutes a reasonable addition to a reserve for
bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.\textsuperscript{16}

This statement is too broad to be of much help to the taxpayer attempting to compute his “reasonable addition.” Although it is impossible to set forth a fixed formula for determining a “reasonable addition,” the following analysis of accounting procedures and judicial decisions may be of some guidance, particularly to the concern that has been in operation for some substantial length of time.

Bad debt expenses may fluctuate with the quantum of sales, but, assuming stable business conditions, their ratio to sales will remain fairly constant. For this reason a percentage based on past experience may be computed which can reasonably be expected to portray the future bad debts of the taxpayer. If such an effort is made to project past experience, care must be taken in the computation to assure that the correct components are employed due to the fact that the calculation may be made by comparing various relations, that is, by comparing bad debts to accounts receivable outstanding,\textsuperscript{17} total sales,\textsuperscript{18} or to total credit sales. Generally speaking, the most accurate method would be to compute the relation of bad debts to total credit sales, because it is only these sales which may eventually become uncollectible.\textsuperscript{19}

After determining the percentage, it is applied to the current

\textsuperscript{17} P\!AT\!ON, ACCOUNTANT’S HANDBOOK 404 (3d ed. 1949), points out the disadvantages of this ratio as follows: “If accounts representing the sales of previous periods are present among the outstanding accounts . . . the bad debts contained therein have presumably already been provided for. It follows that the account balances of previous periods should be deducted from the outstanding balances before computing the current bad-debts charge on this basis. Moreover, the outstanding balances representing sales arising during the current period are likely to fluctuate from year to year in terms of factors other than credit sales, and hence the application of an average rate to the amount outstanding is likely to provide a charge which does not correspond closely, period by period, to actual experience.”
\textsuperscript{18} This ratio would be acceptable if total sales and total credit sales varied in the same manner from year to year, or if cash sales accounted for only an insignificant portion of total sales.
\textsuperscript{19} P\!AT\!ON, ACCOUNTANT’S HANDBOOK 404 (3d ed. 1949).
total credit sales, the result being an estimate of debts to become worthless in the future.\textsuperscript{20}

This percentage will naturally vary among different types of businesses;\textsuperscript{21} however, were it not for the constant changes in the business trend, and changes in credit policies and collection personnel, a percentage, once determined, would remain reasonably accurate for a particular concern.\textsuperscript{22} Changes in business conditions, cycles of depression and expansion, require the taxpayer to attempt to look into the future and either add to or subtract from what he considers to be the normal percentage. In attaining this "normal" percentage it can readily be seen that more than one year must be taken into consideration because the current taxable period may be completely abnormal. Here again the nature of the particular business must be considered: the normal period for one concern may be abnormal for another. No flat statement may be made as to how many years should be included; however, the span covered should receive careful attention, because if it is too long, the general business policies might have varied (such as collection procedures and the like); whereas, if the span is too short, adequate coverage is not given to the possible business trends.\textsuperscript{23}

A new business does not, of course, have the benefit of past experience in collecting accounts on which to base its calculations. Such a concern, setting up its reserve for the first time, must necessarily use a more or less arbitrary estimate.\textsuperscript{24} If there are similar concerns within the business area, information from them can be sought, and the taxpayer can to some extent base his reserve on the past experiences of other comparable business firms. Such an estimate can be supplemented by "aging" the accounts receivable, i.e., an individual analysis of each account, a tedious but helpful process. An analysis of the credit status of each account may also be resorted to. Similar problems can arise

\textsuperscript{20} The taxpayer may feel that it is desirable to supplement this computation by evaluating each account. This is done by determining the number of days the various accounts are outstanding, and then by classifying them as good, doubtful, or bad, according to the length of time they have remained on the books.


\textsuperscript{23} PATON, ACCOUNTANT'S HANDBOOK 404 (3d ed. 1949).

\textsuperscript{24} Id. at 405.
for established concerns when there is a change in the class of customers served or a change in the type of business, because in such cases the past experience of the business will not provide a reliable basis on which to compute the reserve.\footnote{Stewart & Bennett, Inc., 20 B.T.A. 850 (1930).}

No matter how reasonable the addition to the reserve is with respect to the volume of credit sales, the nature of the business, and economic conditions of the current year, consideration must be given to the reserve carried over from previous years, since the total reserve, and not only the yearly addition, must be reasonable and may not exceed the expectation of loss.\footnote{C. P. Ford & Co., 28 B.T.A. 156 (1933). I.T. 1341, I-1 CUM. BULL. 160 (1922).} If it becomes apparent that additions made in previous years were either excessive or deficient, this must be taken into account, and the addition reduced or increased as the case warrants.\footnote{I.T. 1442, I-2 CUM. BULL. 119 (1922).} The whole reserve will be considered in determining whether or not an addition in a particular year is excessive.\footnote{Rogers Peet Co., 21 B.T.A. 577 (1930).}

A taxpayer operating on the accrual basis may not take a deduction for actual worthless debts in addition to a deduction for a reasonable addition to the reserve, since to do so would result in a double deduction.\footnote{New York Water Service Corp., 12 T.C. 780 (1949); Abraham Sultan, 22 B.T.A. 889 (1931); Harry Kahn, 17 B.T.A. 499 (1929); Rhode Island Hospital T. Co. v. Commissioner, 29 F.2d 339 (1st Cir. 1928); Transatlantic Clock and Watch Co., 3 B.T.A. 1064 (1926); G.C.M. 938A, VI-2 CUM. BULL. 206, 208 (1927); 5 MERTENS, THE LAW OF FEDERAL INCOME TAXATION 498 (1953).} However, if a particular account becomes worthless during the taxable year and the facts show that this loss was not provided for by the current reasonable addition as heretofore established, the taxpayer may adjust his addition so that it will cover this particular loss as well as others.\footnote{W. H. Langley and Co., 23 B.T.A. 1297 (1931); C. P. Ford & Co., 28 B.T.A. 156 (1933); Mill Factors Corp., 14 T.C. 1366 (1950); 2 CCH FED. TAX REP. § 213.099 (1954).}

The purpose of Section 23 (k) of the Internal Revenue Code is to allow a reasonable addition to a reserve for bad debts in light of the facts as they exist at the time of determination.\footnote{W. H. Langley and Co., 23 B.T.A. 1297 (1931); C. P. Ford & Co., 28 B.T.A. 156 (1933); Mill Factors Corp., 14 T.C. 1366 (1950); 2 CCH FED. TAX REP. § 213.099 (1954).} For this reason the Commissioner is not bound by additions.
allowed in prior years, nor is he allowed to charge the taxpayer with a deficiency if the actual worthless debts are not as large as previously anticipated, so long as the addition is reasonable in the light of the facts existing at the time it was made. However, when the taxpayer discovers that a prior addition was excessive, he must adjust his present addition to bring the total reserve back within reason. Thus, “an unused balance in a reserve built up by deductions which offset income, is properly to be restored to income of the year during which the reason or necessity for the reserve ceased to exist.” The converse of this is also true, that is, if the taxpayer discovers that his reserve as established in prior years is insufficient, he is not allowed to deduct this insufficiency as such, but must correct it when calculating his reasonable addition for the current year.

The calculation of a reasonable addition to a reserve for bad debts for income tax purposes is not an insurmountable task even though procedures are not precisely prescribed. To the contrary, the degree of proof required to prove an addition reasonable is much less exacting than that required to prove a particular debt worthless. On the other hand, it might well be that a method could be prescribed by the Commissioner for the general commercial enterprise similar to the procedures now available to banks. While it is true that the “moving average” method available for banking businesses may not be completely accurate in a particular taxable year for a given concern, it is submitted that over a period of years full allowance for bad debts can be achieved by such a method. This method would eliminate or at least materially reduce the uncertainties which present practices of estimation entail.

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32. H. W. Porter & Co., 14 T.C. 307 (1950), rev’d on other grounds, 187 F.2d 939 (3d Cir. 1951); Black Motor Co., 41 B.T.A. 300 (1940), aff’d on other grounds, 125 F.2d 977 (6th Cir. 1942); Art Metal Const. Co. v. United States, 17 F. Supp. 854 (Ct. Cl. 1937); C. P. Ford & Co., 28 B.T.A. 156 (1933).
33. G.C.M. 938A, VI-2 CUM. BULL. 206 (1927); MONTGOMERY, FEDERAL INCOME TAX HANDBOOK 505 (1938); SPEISMAN & CONNELLY, ALEXANDER FEDERAL TAX HANDBOOK 340 (1951). It is only when the addition taken is unreasonable that the Commissioner will be allowed to collect a deficiency assessment.
35. M. & E. Corporation, 7 T.C. 1276, 1278 (1946).
37. See note 3 supra.
38. For a discussion of the improvements in bad debt procedures in the field of banking see Vernon, Bad Debt Reserves for Banks, 4 TAX L. REV. 53, 71 (1948).