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CHAPTER 5

Bad Debts

THE TREATMENT OF BAD DEBTS IN ORDINARY BUSINESS ACCOUNTing differs from the corresponding tax treatment in several respects. In ordinary business usage the term 'bad debts' refers primarily to losses arising from transactions made on credit in the normal course of business, that is, to losses on trade accounts and notes receivable. For tax purposes, on the other hand, bad debts are defined much more broadly. The tax concept, for instance, during the period covered by Part Two, was especially broad, embracing such items as losses on bonds and other debt obligations held as investments as well as losses on loans to officers and employees.

For both tax and book purposes bad debts may be accounted for in two ways: (a) they may be deducted as direct charges against income at the time they have been definitely ascertained to be uncollectible or (b) a reserve for probable losses may be established, ordinarily at the close of the period for which the accounts are made up. The method adopted for book purposes will depend upon circumstances. Despite the general acceptance of similar rules for both purposes, important differences often arise on technicalities, in matters of detailed application, and because a company elects one method for tax purposes though it uses the other for book purposes.

A RATIONALE OF ACCOUNTING FOR BAD DEBTS

Before considering the consequences of these differences in scope and accounting treatment, the rationale of the customary

provisions for bad debts is briefly presented. In commercial enterprises, the most commonly used and ordinarily the most justifiable basis for determining charges or credits to income is the completed transaction. Income is generally deemed to arise when a sale is made. Except for accruals of items such as interest or rent, no credit is taken for profits except when and to the extent that they are received or at least reasonably assured.

Thus, sales are commonly recognized as producing income at the time of sale on the assumption that the receivables taken in exchange for goods or services are the equivalent of cash, collection of which will be made in due course. But an element of risk inheres in most sales on credit. The taking up of income at the moment of sale therefore constitutes a departure from the strict theory of recognizing profits only when realized. Such recognition will prove to have been in error to the extent that receivables are not collected. The provision for loss on bad debts is thus essentially a correction of income estimates previously or currently made. From the viewpoint of the balance sheet, it is intended to reduce the receivables due from customers to the net amount estimated to be realizable.

Rigid adherence to the completed transaction as the basis of income recognition might be considered to imply that no provision for failure to collect the proceeds of a sale should be made until the loss is definitively ascertained. When two accounting periods are involved, however, as may often be the case, to take up income in one period and to cancel it in another would hardly be satisfactory. It would obviously distort the comparability of results of operations as between the two periods. The 'charge-off' method doubtless has this effect in direct ratio to the rigidity of insistence upon the date of ascertainment as the time for taking the deduction. In contrast, the reserve method, by far the more common accounting practice, has the merit of allocating the approximate loss to the year in which the sale, the proceeds of which were never realized, was made.

The receivable arising from a sale of goods or services may

be regarded as containing two parts: that which represents a cost and that which represents a gain. A case could be made in principle, although probably not in practice, for treating these parts separately. As far as the cost element is concerned, the sale may be regarded as a conversion of an asset from one form to another. To the extent that the value of the asset created exceeds its cost, there is a present or prospective accretion to assets and a gain.

In the ordinary case of a corporation making its return of income on an accrual basis, a gain will be taken up unless there is a high degree of uncertainty concerning the collectibility of the debt arising from it. In accounting as well as in tax practice, the measure of the gain is the excess of the cash equivalent of the receivable over the cost of the goods or services sold. In measuring the cash equivalent it is necessary to consider the interest element arising from delay in payment, the cost of collection, and the credit risk.

The first two elements are in many cases deemed immaterial and hence are ignored, though in other cases they are carefully computed. The credit risk is, however, more generally recognized as significant and provision is made for it. In some cases it is covered by insurance and the premium is, of course, charged against income in the period in which the debt is created.

More commonly, the debt is reduced to its assumed cash equivalent by a bad debt reserve. It then becomes apparent that the provision is properly a charge against the period in which the receivable is created. From another viewpoint, the bad debt reserve may be regarded as a self-insurance premium, the amount of which should equal the premium necessary to cover the risk of loss.

B Definition

Tax Treatment

The Internal Revenue Code provides for the deduction of bad debts in Section 23 as follows:

"In computing net income there shall be allowed as deductions:
(k) *Bad Debts*

(1) *General rule*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable allowance to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. . . .

(2) *Securities becoming worthless*—If any securities . . . become worthless within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, . . . , be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets."

The statute covers all debts owned by the taxable unit. It is not limited to those arising from accounts receivable or investments; the debt need not even arise from a transaction connected with the trade or business. Irrespective of the nature of the transaction giving rise to the debt, a deduction for it can be taken only under the provisions of the bad debts section. There is no option to take a deduction for a bad debt under the loss provisions of the statute [Sec. 23 (e) and (f)]; the two sections are mutually exclusive.[1]

There are, however, restrictions on the types of item that can be deducted as bad debts. First, the item must involve a genuine debtor-creditor relationship. This relationship serves to distinguish losses arising out of bad debts from other losses. When the relationship does not exist, there is no debt, and the loss is deductible, if at all, only under the provisions relating to the deduction of losses. The distinction could be important, for the provisions of the Code controlling the deduction of losses and of bad debts were phrased differently in the period covered by Part Two: a loss was deductible in the year in which sustained, a bad debt only in the year in which its worthlessness was ascertained and in which it was charged off. In some situations the technical requirements of ascertainment and

[1] Spring City Foundry Company v. Commissioner, 292 U.S. 182 (1934).

charge-off might be more restrictive. The deduction, furthermore, is limited to the tax basis of the debt.

Since the 1938 Act,[2] the statutes have made a distinction in the treatment of bad debts evidenced by 'securities' as defined in Section 23 (k)(3) and other bad debts. When the securities are capital assets and have been ascertained to be worthless and charged off, the loss is not deducted as a bad debt, but is treated as a loss from the sale or exchange of capital assets on the last day of the taxable year. The requirements of ascertainment and charge-off applicable to other bad debts must be met; the only change made by the amendment is in the amount of loss that can be taken. Under the revised statute, the loss from securities is subject to the capital loss limitations whether the loss occurs because of a sale or an exchange. The provision that the loss shall be considered a loss from the sale or exchange of capital assets on the last day of the taxable year is an arbitrary rule which may or may not operate to the advantage of the taxpayer.

Accounting Treatment

The restriction of bad debt loss or expense in business accounting to losses on trade accounts and notes receivable is necessary to obtain adequate information about a company's operations. These receivables have presumably been passed on by the company's own credit department, or have come under the general or discretionary rules by which the sales department operates. The losses are, in a sense, part of the cost of doing business under the customary credit terms and with the class of customers actually dealt with. This bad debt loss is a significant operating figure, changes in which may indicate the relative desirability of modifying credit terms to different classes of customers. It is properly segregated as an internal

[2] In 1936, to which the statistics of Sample I pertain, no distinction was made in the law between debts evidenced by securities and other debts. In the statistical tabulation, therefore, losses from bad debts evidenced by securities are included in the bad debt item on the tax return, not in the capital loss item.

check on a company's operations, and to give comparable figures between companies in an industry or trade.

Losses from debts other than trade receivables arise from entirely different business situations and, if appreciable, must be handled separately to reveal the nature of the company's operations. Ordinarily they are not regular recurring charges. They arise irregularly, if at all, when investments or nontrade debts owing a company are liquidated. Since they often represent the realization of a loss that has been developing over a series of years, they are sometimes charged directly to surplus, on the ground that a charge to the income account would distort income in the year of realization.

The foregoing differences in the definition of bad debt loss for tax purposes and public reports may involve no more than different listings of the various loss items. But even though shown separately, two or more distinct loss items may be grouped together, and all included as part of 'general and administrative expenses'. One item, however, may be classified separately to indicate its peculiar nature, as when a loss on a debt arising from an investment is shown as an extraordinary charge in an income statement because it is held to be nonrecurring, and 'income before special loss' is deemed to be a significant intermediate figure. Likewise, losses on loans to officers and employees should be shown as charges distinct from general bad debt expense. The final net income figure for tax and business purposes would be the same if similar loss items were included in the same year regardless of their designation. This balancing within a single year will not always occur. Because of the differences in definition, certain losses on debts may be taken in different years for the two types of report or they may be treated differently when taken, as when a large nonrecurring loss is charged to surplus.

C THE RESERVE METHOD

Tax Treatment

Until 1921 the tax law did not permit the deduction of a bad debt loss until the loss had been definitely ascertained. The Act of 1921, by sanctioning the reserve method for tax purposes, authorized a well-established trade practice. It thereby took a step towards implementing the general principle laid down in the Act of 1918 that net income should be computed in accordance with the method of accounting regularly employed by the taxpayer. Under the amendment it became permissible, at the discretion of the Commissioner, to take as a deduction a reasonable addition to a reserve for bad debts.

The reserve alternative had been recommended by the Ways and Means Committee as "a method of providing for bad debts much less subject to abuse" than that available under the existing statute.[3] As T. S. Adams pointed out to the Senate Finance Committee, the reserve method affords the authorities far better control over bad debt deductions than does the direct charge method. "You cannot," Mr. Adams maintained, "go through a taxpayer's debts and actually check off each one and make up your mind whether it is a good or a bad debt. Business is usually so well established that the normal debt loss is pretty well known. . . . If the taxpayer charges off more than the ordinary percentage, the situation is flagged. But when the taxpayer writes off a lot of bad notes (or accounts), we have no positive check." [4]

The use of the reserve method for tax purposes is subject to the following conditions: the taxpayer must choose either the specific debt or the reserve method and stick to his choice except as the Commissioner permits him to change it. Furthermore, he may employ only one method: he cannot use the reserve method for part of his accounts and the specific debt

[3] Cf. House Report 350, 67th Cong., 1st Sess. (1921), p. 11.

[4] Cf. Senate Finance Committee, *Hearings on Revenue Bill of 1921,* 67th Cong., 1st Sess., p. 53.

method for other debts. Not all taxpayers are allowed the option; for example, a taxpayer reporting sales on the installment basis may not use the reserve method. This is merely an illustration of the basic rule that a bad debt deduction cannot be taken unless the amount represented by the debt has entered gross income.

The essential criterion from the tax viewpoint is that the addition to the reserve is reasonable. The fact that the addition to the reserve is computed as a percentage of either gross sales or of bad debts outstanding does not necessarily mean that it is 'reasonable'. When additions over a period of years computed as a percentage of gross sales have made the balance in the reserve unnecessarily large, an addition for the current year, computed in the same manner, has been disallowed.

According to Regulations 111, Section 29.23(k)-5, what constitutes a reasonable addition depends "primarily upon the total amount of debts outstanding as of the close of the taxable year". Nevertheless, other factors, such as the volume of sales during the year, the amount of the reserve at the beginning of the year, and the amount of debts charged against the reserve during the year, are taken into account in determining whether the reserve is reasonable. While an attempt is made to limit the addition to an amount that bears a close relation to the period for which it is deducted, the addition is necessarily affected by circumstances of preceding years. Just as a current addition may be cut down or entirely disallowed because of an unnecessarily large balance in the reserve, so too, the taxpayer may increase his addition in one year when unusually large bad debt losses of preceding years have depleted the reserve.[5]

Accounting Treatment

As already pointed out, the reserve method of handling bad debts has important business advantages, particularly as it facilitates the allocation of losses to the periods in which the sales

[5] I.T. 1442, Cumulative Bulletin, I-2, p. 119 (1922); Regulations 111, Sec. 29.23(k)-5.

giving rise to income are made. The same objective could, of course, be achieved by anticipatory write-downs of individual receivables, but a reserve is especially useful when a company holds a large number of receivables. The aggregate of bad debt losses can be estimated much more precisely than the specific receivables that will not be paid. Experience gives a reasonably accurate basis for an estimate of the total amount that will be uncollectible, while a detailed appraisal of the prospects of payment from each individual account would be both costly and unsatisfactory. Also, if specific accounts were written down in anticipation of loss, inevitable unexpected losses and unexpected payments or recoveries would have to be accounted for. An over-all account, reserve for bad debts, makes such adjustments unnecessary because the anticipated loss is conceived of as applying against the aggregate of receivables, not against individual receivables to varying degrees.

The amounts to be credited or charged to reserves for bad debts may be estimated by two methods, each of which has several adaptations. The required balance in the reserve may be computed at the end of each accounting period, on the basis of experience. Accounts receivable are classified by age, and a percentage of probable loss is applied to each age group. The required reserve thus estimated is compared with the existing reserve after allowing for all necessary charge-offs of specific accounts that have been determined to be uncollectible. The difference, which constitutes the bad debt expense of the period, is then set up on the books. Such a reserve will presumably be appropriate for balance sheet purposes in the sense that it will indicate net receivables or the amount that will actually prove collectible. The bad debt expense figure may, of course, vary greatly from period to period, and will be determined by the age classification of receivables, bad debts actually charged off, and recoveries, if they are credited to the reserve. If primary emphasis is on the age rather than the amount of receivables, the bad debt expense charge will lag behind the period of expanding sales but precede the period of actual charge-offs.

Under another method, the bad debt expense is taken as a certain percentage of sales in each period. This amount is added to the reserve which is decreased by actual write-offs. Bad debt expense in this way is related to the probable loss on the outstanding receivables at any one date. Bad debt expense as a percentage of sales may be so set as to cover total estimated losses over a considerable period, averaging out the variations in different phases of the business cycle, or it may be computed as a different percentage of sales in each period to approximate either the probable losses on sales of the period or on receivables outstanding at the end of the period. Perhaps the most common method is a percentage of sales for interim reports, with an adjustment at the end of the accounting period to bring the bad debt reserve in line with probable losses on the then outstanding receivables.

To summarize, bad debt expense is a correction of income estimates based on the expectation of uncollectibility of a certain percentage of receivables as indicated by experience. But under many accounting systems it is the aging of the receivables rather than the making of the sale that determines the bad debt charge. Even under the reserve method there may be a time lag between the original recognition and the correction of the estimate by an adequate bad debt charge.

D THE DIRECT CHARGE-OFF METHOD

Tax Treatment

When the deduction for bad debts is taken on the basis of specific debts charged off within the taxable year rather than upon the reserve basis, two major requirements were imposed by the statute during the period covered by Part Two: the debt must be ascertained to be worthless and it must be charged off the books in the taxable year.

This provision was changed in the Revenue Act of 1942. Section 23(k)(1), applying retroactively to years beginning January 1, 1939, now reads simply:

[There shall be allowed as deductions:—]

Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts. . . .

The earlier requirement that the deduction had to be taken in the year in which the debt was ascertained to be worthless and had been charged off had led to a great deal of controversy and litigation over the meaning of 'ascertainment' and 'charge-off'. Insistence upon strict interpretations of both terms not infrequently led to situations in which the deduction was denied altogether. The 1942 Act further provided a special seven-year period for refunds and credits in case of controversy over the year in which worthlessness occurred.[6] These two provisions should remove most of the ground for controversy and a great deal of the divergence on bad debt deductions. The usual period for adjustments was extended because by the time it was known that a deduction had been denied, the earlier year to which it might have been properly attributable was barred by the general three-year statute of limitations in the Internal Revenue Code. The change in 1942 was along the lines of Section 3801 of the Code, discussed briefly above, to assure inclusion of all income items and the allowance of all deductions, without double inclusion or double deductions arising from technicalities.

The more complicated rules existing during the period covered by Part Two and influencing the figures may be described briefly. The taxpayer had to take the deduction in the year in which he ascertained the worthlessness of the debt. This did not necessarily mean that the debt may not have been actually worthless in an earlier year. As long as the taxpayer acted in good faith and with reasonable prudence, the deduction was allowable in the year in which he ascertained worthlessness. The condition that he must ascertain worthlessness in accordance with the standards of a reasonably prudent person was obviously necessary to prevent tax avoidance. The taxpayer was

[6] Revenue Act of 1942, Sec. 169; Internal Revenue Code, Sec. 322(b)(5).

not allowed to defer intentionally his 'ascertainment' of worthlessness in order to take the deduction in some later year when its effectiveness in reducing taxable income might be greater.

The charge-off requirement was intended to prevent the deduction, for tax purposes, of a debt that remained on the books, for other purposes, as an asset. The literal requirement of the statute that the debt must be charged off during the taxable year was, of course, almost impossible of fulfillment. The courts, recognizing that the books of a firm were ordinarily not—indeed, cannot be—closed until the early months of the following year, softened the statutory requirement by allowing a bookkeeping charge-off made in the early months of the following year, before the books were closed, to constitute a compliance with the statute.[7]

A further merciful relaxation occurred in a case in which the taxpayer had charged off the debt in an earlier year when he was not allowed the deduction; in a later year when the deduction was allowed, a second charge-off was unnecessary. The fact that the debt was in a state of being charged off and was therefore eliminated from the assets was a sufficient compliance with the statute.

To be deductible, a debt need not be entirely worthless; the statute provides for a deduction for the partial worthlessness of specific debts. When part of a debt is clearly worthless and has been charged off the books, it may be taken as a deduction for tax purposes, subject to the important limitation that no deduction for partial worthlessness may be taken because of a mere fluctuation in the market value of collateral securing the debt.[8] There is, however, no compulsion upon the taxpayer to take a deduction for partial worthlessness in the year in which it is ascertained.[9] He may, in his discretion, take the deduction

[7] See Hamlen v. Welch, 116 F(2d) 413 (C.C.A.—1st, 1940), for a review of authorities on the nature of the charge-off required and on the circumstances that give rise to a debtor-creditor relationship.

[8] See Regulations 111, Sec. 29.23(k)-4.

[9] G.C.M. 18525, Cumulative Bulletin 1937-1, p. 80.

or defer it, taking a deduction for partial worthlessness in a greater amount or for total worthlessness in a later year.

Accounting Treatment

The tax treatment, arising as it does from the accounting treatment for business purposes, has indicated both the general objectives and methods of bad debt accounting. One problem of timing in the business applications of the direct charge-off method may be noted briefly. Accounting policies with respect to the timing of write-offs of bad debts may vary with the purpose for which the financial reports are prepared. If the primary objective is to prepare a balance sheet for creditors, receivables may be more stringently written down at each balance sheet date. The emphasis in this case is on a proper balance sheet figure; what is sought is a measure of the cash-yielding and debt-paying capacity of certain current assets. However, a loss figure derived in the process of valuing assets for this particular purpose may not be the most suitable to include in computing income.

Extreme conservatism in preparing balance sheets calls for an anticipation of all losses likely to be realized. Bad debt expense would thus tend to be high in years of declining business. When losses are actually realized, the prior anticipation makes bad debt expense less than it would otherwise have been. The greater the conservatism for balance sheet purposes, the bigger may be the fluctuation in reported income. And the greater the conservatism in stating income in depression, the larger will be the income and the degree of recovery shown in the subsequent period. If financial reports are prepared primarily for stockholders and management, it may be both proper and wise to avoid unreasonable accentuations in the fluctuation of income by tempering the extreme policies of anticipating all possible losses on receivables.

A policy of writing down receivables to give a conservative balance sheet figure is clearly likely to conflict with a tax policy that permits the write-off of debts ascertained to be worthless

and charged off. In many instances, write-downs will be made on the possibility or probability of loss before a debt is actually ascertained to be worthless. Even so, a situation might develop in which the total bad debt loss would be approximately the same over a period or even year by year for tax and for balance sheet purposes, but the specific debts written off in each year would differ; for example, if the loss that led to write-downs for the balance sheet was actually realized in later years. Tax allowances would then follow with a time lag the losses taken on the company's own books.

E RECOVERY OF BAD DEBTS PREVIOUSLY CHARGED OFF

After a debt has been charged off wholly or in part and deducted under a specific debt method, part or all may be recovered. Because the income tax rests on the concept of the taxable year as a distinct unit, the return for the earlier year when the deduction was taken remains unchanged in the case of such recoveries. If a direct charge-off has been made, the amount subsequently recovered must be included in gross income for the year in which received.[10] Under the reserve method, subsequent recoveries of debts that have been charged against the reserve do not directly enter gross income but are credited to the reserve.[11] Income for the year of recovery is, of course, indirectly affected since the crediting of the recovery to the reserve influences the determination of what is a reasonable addition to the reserve for that year.

Section 22(b)(12) provides that the subsequent recovery of a debt is not to be included in income if the previous deduction did not benefit the taxpayer because of a lack of income to be offset. The theory expressed in court cases before the present provision was adopted was that the previous deduction represented a loss of capital that must be recovered before income could be realized. For tax purposes the capital was considered to be recovered if the bad debt deduction offset income. If

[10] Regulations 111, Sec. 29.23(k)-1.

[11] I.T. 1825, Cumulative Bulletin II-2, p. 144 (1923).

there was insufficient income to be offset by the deduction, the capital represented by the bad debt had not been recovered. Therefore, the present collection on the debt loss previously deducted was a return of capital and could not be income.

This line of reasoning, now embodied in the law, had earlier been rejected by the Board of Tax Appeals which held that recoveries of bad debts were income, irrespective of the benefit to the taxpayer of the previous deduction.[12] Later, the Treasury accepted the benefit theory, ruling in 1937 and 1939 that subsequent recoveries did not constitute income unless the prior deduction accomplished a reduction of tax liability.[13] But in 1940 the Treasury, revoking these rulings, returned to the earlier concept that subsequent recoveries are income, irrespective of the benefit of the deduction to the taxpayer, on the theory that bad debts are considered as operating expenses of the business, not as losses of capital that must be recovered before income can be derived.[14]

In the Revenue Act of 1942, Section 116, the present provision was established, retroactive to years beginning after December 31, 1938, under the Internal Revenue Code, and also retroactive under any prior revenue Act. Thus, any taxpayer who by litigation or otherwise had kept open the returns of earlier years stood to benefit by the final enactment into law of the tax benefit rule. The shifts in rulings and established procedure on this subject have been reviewed to give a striking though extreme example of the varying circumstances under which taxable income is computed.

In accounting practice, when a reserve for bad debt is set up, recoveries are typically added to the reserve, as is required for tax purposes. The reserve, therefore, over a period has to be maintained by charges to income to cover net bad debt write-offs. If the reserve is adjusted at the end of each year on the

12 Lake View Trust and Savings Bank v. Commissioner, 27 B.T.A. 290 (1932).

13 G.C.M. 18525, Cumulative Bulletin 1937-1, p. 80; G.C.M. 20854, Cumulative Bulletin 1939-1, Part 1, p. 102.

14 G.C.M. 22163, Cumulative Bulletin 1940-2, p. 76.

basis of the amount and age distribution of receivables, the bad debt expense for a period will be reduced by the amount of the recoveries. The effect on net income is accordingly the same as it would be if the recoveries were considered and shown as a separate item of receipts or credited directly to some expense. If the bad debt expense is computed as a certain percentage of sales, recoveries added to the reserve will influence the standard percentage charged to cover bad debt losses in the long run, but individual years will not be affected by unusually large or small recoveries.

If a reserve for bad debts is not set up, recoveries of bad debts previously charged off may be handled in three ways, each of which may be justified on logical grounds. They may be shown as income in the year when recovered or as offsets to the bad debt expense of the year. Both alternatives increase net income in the year of recovery, and the choice of accounting procedure will not make taxable income diverge from reported business income. The third alternative, somewhat less acceptable in practice, is to credit recoveries directly to surplus on the theory that they represent corrections of errors made in prior years when the debts were written off. This method leads to a divergence between taxable and business income in the year of recovery that is not balanced out in prior or subsequent periods.

F Summary

As is apparent from the foregoing discussion, the differences in the accounting and tax definitions and treatment of bad debts are likely to give rise to differences in the amount entered as bad debt expense on a financial statement and the amount deducted for bad debts on the tax return. This difference may, in turn, yield dissimilar net income figures. Some of the differences between taxable and business income may cancel each other in any one year while others will appear on an annual comparison but will in time wash out. Others are not dependent upon annual periods and more basically differentiate taxable and business income.

Certain differences that appear in the bad debt figures for the year are canceled so immediately that they do not cause differences in net income; e.g., differences in nomenclature or classification. A loss that is deducted as a bad debt on the tax return but charged to some special loss account on the financial statement will give a difference in the bad debt figures but not in the net income for the year, if all types of loss concerned are treated as expenses.

More significant differences are those which cause a discrepancy in the annual income figures but which cancel out over a period. The tax deduction for bad debts may be of the same amount as that charged off on the books, but it may be allowed for tax purposes in a different year from that in which it is taken for business purposes. This type of discrepancy can occur when the charge-off is made on the books in one year but the deduction is not allowed for tax purposes until a later year.

A debt may be written down on the books because of a diminution in value of either the debt or collateral; such a diminution would not be sufficient evidence of partial worthlessness to allow a partial bad debt deduction for tax purposes. Conversely, even when a tax deduction for partial worthlessness could be taken, a taxpayer might postpone taking it until a later year when total worthlessness could be claimed. In all these instances, although the books may show a charge-off of the same amount as is eventually allowed as a bad debt deduction, there will be discrepancies in the annual income figures.

Finally, some differences in the accounting and tax treatment of bad debts do yield differences in net income that will not ordinarily cancel out over time. For instance, when securities that represent debts become worthless, the entire loss may not be deductible for tax purposes because of the limitations of the capital loss provisions. As the full loss will be written off the books, the difference between taxable and business income will never be washed out.

Under a reserve method, the addition to the reserve approved by the Commissioner for tax purposes and the addition

actually made to the reserve on the books will not always be equal.

Under the specific debt method, the taxpayer might entirely lose the benefit of the deduction through failure to prove the facts of ascertainment and charge-off when they were required. To obtain the deduction his proof had to be sufficient to overcome the presumptive effect of the Commissioner's findings to the contrary.[15] The deduction for tax purposes may be entirely lost also when deductions claimed and disallowed in one year might properly have been taken in an earlier year. Whether the taxpayer failed to claim the deduction in the early year or had his claim disallowed, he will entirely lose the benefit of the deduction if the statute of limitations has run against the earlier year. Before the 1938 Act, the converse situation could occur: the taxpayer might obtain a double deduction of the bad debt loss, though this was rare. The deduction might be allowed in one year and claimed again in a later year. If the later year was determined to be the correct year and the statute had run against a deficiency assessment for the earlier year, the taxpayer obtained a double benefit from the deduction. This situation was partly corrected by the enactment in 1938 of Section 3801 of the Internal Revenue Code which with certain qualifications permits the assessment of a deficiency for the earlier year when the deduction is allowed for the later year.

Section 3801 does not constitute a remedy for the case in which the deduction is disallowed for the later year and the statute of limitations bars a claim for refund for the earlier year in which the deduction might have been taken. Nevertheless, the Section should tend to mitigate the difficulties inherent in the time of the deduction. Since it permits a deficiency assessment after the running of the statute of limitations against an early year when it is determined that the

[15] In circumstances in which the taxpayer was unable to prove his ascertainment and charge-off for any other year, his failure of proof for the year in which he claimed the deduction would entirely preclude his obtaining the benefit of the deduction.

deduction should properly be taken in a later year, administrative officials are likely to be more liberal in their allowance of deductions in the year claimed by the taxpayer. There is no longer a danger to the revenue from such liberality. The provision in 1942 for a special seven-year statute of limitations on bad debts, Section 322(b) (5), as stated above, should remove most of the difficulties about timing.

Another reason for differences between tax and book figures of bad debt expense is the not uncommon business practice of carrying large or unusual charges or credits directly to surplus instead of through the income account, though this practice is now discouraged by many accountants. When unusual losses are charged directly to surplus, total reported income for the company will escape the burden of this charge and will exceed total taxable income. If charges were not made to surplus, the loss or expense items would have to be charged against the income of one or more years. Surplus charges thus lead to an overstatement of aggregate income over a long period in the sense that total reported earnings are significantly modified by the surplus charges. Surplus charges, when made, are justified on the ground that the specific loss item is unusual and nonrecurring and would seriously distort the reported income of any one year or that, even though a normal recurring expense, it is properly attributable to prior years and should not be considered a burden on current activities. Unusual and nonrecurring charges might be illustrated by the complete loss of receivables in foreign countries following the outbreak of a war or the imposition of exchange control. A charge that might be claimed to be attributable to prior years would be necessary if it was discovered that failure to write off worthless accounts over a period of years had led to insufficient annual bad debt expense charges and an inadequate reserve. In both these situations, a charge to the income of the year of occurrence or discovery would give a distorted picture of the company's operations.

No thoroughly satisfactory solution exists for the dilemma

of distorting the income of a single year or incorrectly stating the aggregate income of a longer period. Correct average earnings over a long period are especially important for some purposes but the best possible estimate of current income is needed for other purposes. The problem is best handled by full explanations of any large unusual charges and by surplus reconciliation statements in conjunction with income statements.

The situation in which gains are credited directly to surplus has been noted with the remark that recoveries are sometimes credited directly to surplus on the theory that they represent the correction of errors of prior years and are not of significance in the year the recovery takes place. In such cases, taxable income will exceed business income and reported bad debt expense will be a gross rather than a net expense.