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Income Tax - Non-Business Bad Debt Deduction - Deduction for Partially Secured Bad Debt Deferable Until Liquidation of Collateral Regardless of Tax Avoidance Motive

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INCOME TAX—NON-BUSINESS BAD DEBT DEDUCTION—DEDUCTION FOR PARTIALLY SECURED BAD DEBT DEFERABLE UNTIL LIQUIDATION OF COLLATERAL REGARDLESS OF TAX AVOIDANCE MOTIVE—In 1944 the taxpayer liquidated security held for a non-business debt and deducted the balance of the debt as worthless. The creditor had been insolvent for some time. The commissioner disallowed the deduction on the grounds that the taxpayer had held the security after the debt was worthless in order to obtain a larger tax benefit from the deduction. The district court upheld the Commissioner. On appeal, *held,* reversed.[1] A partially secured debt is not worthless as long as security is available for its satisfaction. The taxpayer's intent is not a factor in determining worthlessness. *Loewi v. Ryan,* (2d Cir. 1956) 229 F. (2d) 627.

Prior to 1942 bad debts were deductible in the year when ascertained to be worthless and charged off by the taxpayer.[2] In 1942 an objective standard, "the fact of worthlessness," was substituted for the former subjective test.[3] In the same year the deduction for non-business bad debts was limited to those debts that were wholly worthless.[4] A business debt may be deducted when partially worthless[5] or it may be deferred until the debt is entirely worthless,[6] so the rule laid down in the principal case is applicable to business as well as non-business debts. The decision recognizes that a debt is not

1 Majority opinion by Judge Hand, Judge Frank dissenting.

2 Revenue Act of 1939, 53 Stat. 13, §23 (k) (1). Sabath v. Commissioner, (7th Cir. 1938) 100 F. (2d) 569; Reading Co. v. Commissioner, (3d Cir. 1942) 132 F. (2d) 306.

3 H. Rep. 2333, 77th Cong., 2d sess., p. 44 (1942); Revenue Act of 1942, 56 Stat. 820, §124 (a).

4 Revenue Act of 1942, 56 Stat. 821, §124 (a).

5 I.R.C., §166 (a).

6 Ross v. Commissioner, (7th Cir. 1934) 72 F. (2d) 122; Allie M. Turbeville v. Commissioner, 31 B.T.A. 283 (1934). See also G.C.M. 18417, 1937-1 Cum. Bul. 142.

entirely worthless so long as property with some value[7] is held as security.[8] The majority opinion specifically states that the court will not consider the intent underlying liquidation of the security in a particular year.[9] Only if the debt had been originally incurred for the sole purpose of creating a bad debt deduction would the intent of the taxpayer serve to disallow a deduction.[10] Congressional intent on this subject was indicated when Congress repealed the previous subjective test of worthlessness in 1942.[11] This case carries to its logical conclusion the realization doctrine whereby a transaction has tax significance only when it is finally closed.[12] The dissenting opinion, arguing for the acceptance of the lower court's test of intent, states that Congress intended to allow this deduction on the basis of economic fact rather than give the taxpayer an opportunity to take the deduction at will.[13] It is true that the majority opinion, taken at face value, would lead to absurd results, e.g., a huge bad debt deduction could be postponed indefinitely by holding a small amount of collateral property. In a subsequent revision of this code section it would not seem necessary, however, for Congress to accept the view taken by either the majority or minority opinion. If the taxpayer continued to hold his security after it was clear that the debtor would be unable to satisfy the debt, the taxpayer would really be holding a capital asset in the hope of a gain and the tax significance of the debtor-creditor relationship would be factually at an end. Any further loss or gain would be attributable not to a bad debt but to the change in value of a capital asset. A code provision requiring the recognition of bad debt deductions in the year in which the debt becomes worthless, without regard to collateral, to the extent that the debt exceeds the fair market value of the collateral at that time would seem a desirable solution which would raise no unique problems of proof. Fair market value would then be assigned as the basis of the security.[14] Such treatment would avoid the problems of proof involved in the examination of the taxpayer's sub-

[7] The taxpayer would have to prove that as of the first of the taxable year the security had some value and therefore the debt was not worthless. Judge Hand, in his opinion, speaks of what a "reasonable person in his place would have thought." (Principal case at 629.) Such a test would not seem defensible, however, in view of the objective statutory language.

[8] Old Colony Trust Associates v. Hassett, (1st Cir. 1945) 150 F. (2d) 179; Industrial Trust Co. v. Commissioner, (1st Cir. 1953) 206 F. (2d) 229; Kessler Oil and Gas Company v. Commissioner, 41 B.T.A. 31 (1940).

[9] The court refused to follow a contrary decision of the Tax Court in In re Leopold Spingarn. P-H T.C. Mem. Dec. §48,129 (1948).

[10] Gregory v. Helvering, 293 U.S. 465 (1935).

[11] Revenue Act of 1942, 56 Stat. 820, §124(a).

[12] See 46 MICH. L. REV. 854 (1948).

[13] See I.R.C., §461 (a).

[14] A "voluntary" conveyance of mortgaged property as final settlement of a debt is treated in precisely this way under present law. I.T. 3548, 1942-1 Cum. Bul. 74. See Commissioner v. Spreckels, (9th Cir. 1941) 120 F. (2d) 517.

jective intent in holding the security, and would deny to the taxpayer any opportunity to defer the recognition of bad debt deductions.[15]

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[15] The suggested treatment would, however, require the proof not only of the creditor's inability to pay but of the fair market value of the security.