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TAXATION-DEDUCTIONS FOR PARTIAL WORTHLESSNESS OF A DEBT

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TAXATION—DEDUCTIONS FOR PARTIAL WORTHLESSNESS OF A DEBT— Taxpayer was accustomed to loan money to a related corporation on open accounts. The debtor consistently lost money and became bankrupt in 1938. Thereupon taxpayer wrote off the whole debt using it as a deduction from 1938 income. The commissioner assessed a deficiency on the theory that the taxpayer, by a subordination agreement made with another creditor in 1931, had recognized the then balance to be worthless. Hence, he argued, advances made after that date were a separate debt; therefore taxpayer had lost the right to deduct the debt due in 1931 for failure to take it in the year in which it became worthless. Taxpayer argued that the account represented but one debt, so that he need not deduct the partial worthlessness occurring in 1931, but might await the year of complete worthlessness before seeking any deduction. *Held:* for the taxpayer. *The E. Richard Meinig Co. v. Commissioner*, 9 T.C. 976 (1947).

Absent statutory authority, the judicial doctrine that transactions take on tax significance only within the taxable period when they become "final and definite"[1] would preclude any deduction for partial worthlessness.[2] Present statutes provide that the Commissioner "may" allow a deduction for partial worthlessness when it occurs.[3] From this the courts have spelled out a further relaxation of the periodic annual accounting rule by interpreting the provision to give the taxpayer an option to deduct partial worthlessness of a debt as it occurs, or await the total worthlessness of the debt and deduct the total amount in the later period.[4] The right to partial deductions, however, has its limitations. If the debt is evidenced by corporate bonds, debentures, notes, or certificates, any worthlessness is treated as a capital loss.[5] And, unless the taxpayer is a corporation, only debts incurred in trade or business are subject to partial deductions.[6] Finally the right extends only to specific debts.[7] Implicit in this latter concept is the rule that the debt for which the creditor seeks a partial deduction must consist solely of one claim.[8] In determining this question the Tax Court has adopted a cause of action test. If the creditor could sue in one action for the entire amount of the debt, then, regardless of its form,[9] there is but one debt.[10] But if the creditor would be entitled to sue in separate actions, then each amount for which an action could be maintained is a separate debt.[11] Hence in the instant case had the Commissioner shown as a matter of fact that the parties had struck a balance in 1931, all loans to that date would have been merged in the balance as a single claim.[12] Advances made thereafter

[1] Burnet v. Sanford & Brooks, 282 U.S. 359, 51 S.Ct. 150 (1931).

[2] The Revenue Act of 1918 §§ 214 (a) (7), 234 (a) (5) allowed "debts ascertained to be worthless and charged off within the taxable year." Under this provision no partial deduction was possible since no final disposition of the debt was made within the taxable period for which the deduction was sought, Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 54 S.Ct. 644 (1934).

[3] I.R.C., § 23 (k) (1).

[4] Moock Electric Supply Co., 41 B.T.A. 1209 (1940); Atlantic Coast Line R.R. Co. v. Commissioner, 4 T.C. 140 (1944); Reed v. Commissioner, (C.C.A. 4th, 1942) 129 F. (2d) 908.

[5] Banks, however, are exempt from this limitation, I.R.C., §§ 23 (k) (1), (2), (3).

[6] Non-business debts becoming worthless are treated as a capital loss, I.R.C., §§ 23 (k) (1), 23 (k) (4). Whether a debt is incurred in a "trade or business" is a question of fact, U.S. TREAS. REG. 111, § 29.23 (k) (6).

[7] U.S. TREAS. REG. 111, § 29.23 (k) (1) (b).

[8] For instance, the taxpayer may not take an overall deduction of 50 per cent of all his outstanding debts, 3 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION, § 28.34 (1934).

[9] Blair v. Commissioner, (C.C.A. 2d, 1937) 91 F. (2d) 992, and Eljer Co. v. Commissioner, (C.C.A. 3d, 1943) 134 F. (2d) 251, on single debts.

[10] Note 9, supra.

[11] Instant case and cases therein cited.

[12] By the agreement in 1931 the taxpayer subordinated its claim for the amount then due it to that of another creditor for an almost equal amount. The commissioner likened this to an arrival by the parties at an "account stated." The

could then have been called a new debt, separate from the prior transactions, giving rise to another cause of action. Under this theory taxpayer would have lost the right to deduct the balance due in 1931, for such balance would have consisted of a separate debt which must be deducted in the year in which it became completely worthless or not at all.[13] Once shown that the account represented but one claim, however, the taxpayer was under no duty to deduct any partial worthlessness occurring in 1931, but was entitled to wait, if he so desired, until the claim became wholly worthless before seeking any deduction.[14] This statutory allowance of partial deductions in the year of occurrence is at odds with the "realization" doctrine whereby a transaction can be accorded tax significance only when it "is 'closed' for tax purposes." [15] And the taxpayer's option to carry forward allowable deductions seems out of step with the general notion that tax significant events may not be shuffled to and fro between taxable periods.[16] While the allowance seems to be in keeping with the growing tendency to cushion the impact of the "realization" doctrine,[17] the option seems somewhat anomalous.[18]

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court rejected this argument since the parties did not then, or at any later period, treat the account as inactive. Instant case 978.

[13] I.R.C., § 23 (k) (1).

[14] Note 4, supra.

[15] Surrey, "The Revenue Act of 1939," 49 YALE L.J. 1153 at 1165 (1940). Property losses are disallowed unless "realized in money by a sale," Weiss v. Weiner, 279 U.S. 333 at 335, 49 S.Ct. 337 (1929). In this respect the partial deduction allowance bears a certain analogy to a depreciation allowance, for it has been stated that, absent statute, the doctrine precludes any year by year deduction for depreciation calculated on the estimated future worthlessness of the property in question, Jefferson & Clearfield Coal & Iron Co. v. United States, (D.C. N.Y. 1936) 14 F. Supp. 918, 83 Ct. Cl. 491, cert. den., 299 U.S. 581, 57 S.Ct. 46 (1936).

[16] Normally to avoid tax juggling Congress has sought to make each tax year sui generis, hence "the net income shall be computed upon the basis of the taxpayer's annual accounting period," I.R.C., § 41. On postponing reporting of the receipt of income from one period to another, see Miller, Inc. v. Commissioner, (C.C.A. 3d, 1947) 164 F. (2d) 268; on shifting losses suffered on performing a contract see Burnet v. Sanford & Brooks, 282 U.S. 359, 51 S.Ct. 150 (1931).

[17] In addition to the allowance for partial deductions the realization doctrine is relaxed by allowances for depreciation, I.R.C., § 23 (l); and depletion, I.R.C., § 23 (m); permission to report, prior to receipt, income on certain building contracts covering more than one taxable year, U.S. TREAS. REG. 111, § 29.42-4; and permission to pro rate income to be subsequently received on maturity of a non interest bearing bond issued at a discount, I.R.C. § 42 (b).

[18] While normally a transaction has no tax significance until realized (note 15, supra) the reflection of realized events in the tax return is confined to one taxable period (note 16, supra). For instance, depreciation, while allowed, unlike partial worthlessness cannot "be accumulated and held for use in that year in which it will bring the taxpayer the most tax benefit," Virginia Hotel Co. v. Helvering, 319 U.S. 523 at 525, 63 S.Ct. 1260 (1942).