Michigan Law Review

Volume 55 | Issue 5

1957

Taxation - Income Tax - Accurabilty of Dealer Reserves Withheld by Finance Company

A. Duncan Whitaker S.Ed.
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Banking and Finance Law Commons, Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation
A. D. Whitaker S.Ed., *Taxation - Income Tax - Accurabilty of Dealer Reserves Withheld by Finance Company*, 55 MICH. L. REV. 733 (1957).
Available at: https://repository.law.umich.edu/mlr/vol55/iss5/16

This Recent Important Decisions is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

TAXATION—INCOME TAX—ACCRUABILITY OF DEALER RESERVES WITHHELD BY FINANCE COMPANY—Petitioner, a dealer in new and used trailers, had agreements with several finance companies whereby they agreed to buy promissory notes he received on installment sales. The agreements permitted the finance company to withhold a portion of the unpaid balance on each note and credit such amount to the petitioner's "dealer reserve" account. The petitioner was liable for all notes in default and the finance company could charge the reserve with any unpaid balance. The reserve could also be charged with any debts of the petitioner to the company. Periodically, the dealer was to receive portions of the reserve in excess of a certain percent of the total balance outstanding. The ultimate balance in the reserve was to be paid to the petitioner whenever all indebtedness for which it was security had been discharged. Reporting his income for 1949 and 1950, petitioner, an accrual basis taxpayer, did not include as taxable income the amounts credited to the reserves. The Commissioner included such amounts in his income and the Tax Court affirmed.[1] On appeal, *held*, reversed. At no time during the taxable years in question was any excess in the reserves payable to the petitioner. Therefore, his right to receive the sums in the reserve funds was contingent and not accruable as income. *Johnson v. Commissioner*, (4th Cir. 1956) 233 F. (2d) 952.

An accrual taxpayer is required to declare a fund as income when the right to receive it becomes fixed.[2] An obligation subject to a substantial contingency is not accruable.[3] In the principal case, the Tax Court felt its decision was governed by *Shoemaker-Nash, Inc.*[4] and ruled that petitioner's right to receive the reserved amount became fixed at the time the notes were sold to the finance companies, there being no reason to believe that collection was improbable. This is the first case involving reserves withheld by finance companies from a trailer or automobile dealer to reach a United States court of appeals. In reversing the Tax Court, the Court of Appeals for the Fourth Circuit relied upon an earlier Third

[1] Johnson v. Commissioner, 25 T.C. 123 (1955).

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

[3] Cassatt v. Commissioner, (3d Cir. 1943) 137 F. (2d) 745, affg. 47 B.T.A. 400 (1942); Fairmont Creamery Corp. v. Helvering, (D.C. Cir. 1937) 89 F. (2d) 810; Jenkins-Wright Co., P-H T.C. Mem. Dec. ¶42,035 (1942).

[4] 41 B.T.A. 417 (1940), which has been followed in a line of cases involving automobile dealer reserves. Colorado Motor Car Co., P-H B.T.A. Mem. Dec. ¶40,178 (1940); Royal Motors, Inc., P-H T.C. Mem. Dec. ¶45,255 (1945); Town Motors, Inc., P-H T.C. Mem. Dec. ¶46,173 (1946); Ray Woods Used Cars, Inc., P-H T.C. Mem. Dec. ¶52,290 (1952).

Circuit holding on similar facts,[5] which decision in turn was based upon the single case involving auto dealer reserves[6] in which the Tax Court reached a decision contrary to the *Shoemaker* case. Inasmuch as the finance companies in the principal case were entitled to charge uncollectible losses against the reserve, the Court concluded that the right to receive payments was sufficiently contingent and uncertain as to render it non-accruable. No recognized test exists by which to determine whether a right to receive is sufficiently contingent to prevent accrual.[7] It is quite clear, however, that an accrual taxpayer receiving payment by means of a promissory note which appears to be collectible cannot refuse to accrue the amount of the obligation merely because it might not be collectible when due.[8] This is a normal business risk which should not justify postponement of accrual.[9] The petitioner's right to receive payments out of the reserve fund was also contingent in the sense that the reserve could be charged with any matured obligation owing to the finance company. Such charges against the reserve account would result in the petitioner receiving less cash from the reserves, although he would receive the full benefit of the reserve credit through a reduction in his obligations.[10] The Third Circuit holding which the court in the principal case relied on attempted to distinguish *Shoemaker* by the fact that in the latter case there was no express agreement that the reserves could be diminished by charges for delinquent and unpaid notes, for absent that provision a reserve account merely affects the time of payment and not the right to receive it. The *Shoemaker* agreement did provide, however, that the dealer was required to purchase repossessed cars from the finance company at a price equal to the unpaid balance of the note, and the reserve fund

[5] Keasbey and Mattison Co. v. United States, (3d Cir. 1944) 141 F. (2d) 163, where notes of purchasers of asbestos products were sold to finance companies which credited a portion of the consideration to a reserve fund to liquidate possible losses from uncollectible notes.

[6] Beaudry, P-H B.T.A. Mem. Dec. ¶41,114 (1941), wherein the court distinguishes the Shoemaker case on the grounds that here the dealer did not have the right to receive, either periodically or ultimately, any portion of the reserve less than a certain percentage of the total notes outstanding. On the other hand, in the Shoemaker case (as in the principal case), the dealer had the right to receive the ultimate balance in the reserve. This difference would seem to justify the Board of Tax Appeals in rejecting the Shoemaker case as controlling.

[7] For a discussion of accruability of obligations subject to contingencies, see Holland, "Accrual Problems in Tax Accounting," 48 MICH. L. REV. 149 (1949). An accountant analyzes dealer reserves in 26 ROCKY MT. L. REV. 78 (1953), and suggests a test for determining accruability which is factually and theoretically unsound.

[8] Automobile Ins. Co. v. Commissioner, (2d Cir. 1934) 72 F. (2d) 265; Spring City Foundry Co. v. Commissioner, note 1 supra. See also K. Taylor Distilling Co., 42 B.T.A. 7 (1940).

[9] See Elmer v. Commissioner, (2d Cir. 1933) 65 F. (2d) 568; Alworth-Washburn Co. v. Helvering, (D.C. Cir. 1933) 67 F. (2d) 694.

[10] The possibility that an obligation due from another may be used to satisfy a liability to that person that arises in the future should have no effect upon the accruability of the obligation at the time it is first established. See Luther Burham, 33 B.T.A. 1100 (1936), affd. (8th Cir. 1937) 89 F. (2d) 725.

was to serve as security for just such obligations. Thus the two agreements, though dissimilar in language, make the reserve funds equally contingent.[11] In the principal case petitioner's practice of taking a specific bad debt charge-off each time an item was charged to the reserve by the finance company was also shown. The Tax Court ruled that this was inconsistent with the existence of the dealer reserve, since the reserve in effect constituted a bad debt reserve for the petitioner. The court of appeals dismissed this phase of the case, however, on the ground that during the taxable years in question petitioner had not taken a specific bad debt charge-off of any item which had also been charged against his reserve. The principal case is subject to objections on both theoretical and practical grounds. If mere uncertainty of payment, inherent in every debtor-creditor relationship, is to be considered sufficient reason for not accruing an obligation, then the whole theory of accrual accounting in regard to commercial transactions is undermined.[12] As a practical matter the taxpayer escapes the policing power which the government exercises in determining whether the reserve for bad debts is reasonable or not.[13] The taxpayer also secures the benefit of two inconsistent practices by adopting the specific bad debt charge-off method while maintaining a dealer reserve. Even where there has been no double deduction for the same bad debt, there is, nevertheless, a distortion of the taxpayer's income through a bunching of specific bad debt charge-offs and dealer reserves in the same year.[14] Finally, the taxpayer is permitted to adopt what is in effect a tax avoidance scheme. If purchasers' notes are held by the dealer, the entire face value of the notes is accruable, but by selling the notes to finance companies, that portion which is credited to the dealer's reserve is rendered non-accruable. This writer believes that the recent refusal[15] of the Tax Court to follow the principal case[16] is justified in law and policy.

A. Duncan Whitaker, S. Ed.

[11] In cases before the Tax Court subsequent to the Keasbey case, note 5 supra, reserves were held to be accruable income even though there was an express agreement that losses due to delinquency could be charged against the reserves. Town Motors, Inc., note 4 supra; Ray Woods Used Cars, Inc., note 4 supra.

[12] See Taylor Distilling Co., 42 B.T.A. 7 (1940).

[13] I.R.C., §166 (c). If the dealer reserve is excluded from gross income there is no basis for applying statutory restrictions applicable only to deductions from gross income.

[14] By changing the terms of the agreements with respect to the dealer reserves, the taxpayer can in effect freely shift back and forth between the specific bad debt charge-off method and the reserve method.

[15] Albert M. Brodsky, 27 T.C. No. 23 (1956), which involved similar dealer reserves.

[16] The Commissioner has assessed similar deficiencies against the petitioner for the years 1951-1954. Non-acquiescence in the principal case was reasonably to be expected.