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SUGGESTED MODIFICATIONS OF THE BAD DEBT PROVISION OF THE FEDERAL REVENUE ACT

RANDOLPH E. PAUL

INTRODUCTORY

The desirability of rules of law depends upon their workability. In his introduction to Hohfeld’s *Fundamental Legal Conceptions*, Professor Walter Wheeler Cook has developed the thought that there is not the distinction sometimes supposed between theory and practice; that what does not work well in practice is thus proved not to be good theory; and that a theory must be tested not only in the abstract world of ideas, but also in concrete terms of applicability to the actual conditions of life. Our income tax legislation can hardly claim immunity from this pragmatic test of value; on the contrary, it particularly is supposed to deal with actualities and to produce practical results.

The entire body of the income tax statute might be tested with profit in the light of this principle of jurisprudence. A general application of the test being obviously impossible in the limited space afforded by a short article, attention will be directed in this paper to an application of the principle to the bad debt provision of the income tax statute and a consideration of how that provision actually works in practice. The bad debt provision furnishes

2Hofeld, Fundamental Legal Conceptions (1923). Walter Wheeler Cook’s exact statement is as follows:

‘‘Hohfeld is an idealist, a theorist’—these and similar remarks the present writer has heard all too often from the lips of supposedly practical men. Granted; but after all ideals are what move the world; and no one recognized more clearly than did Hohfeld that ‘theory’ which will not work in practice is not sound theory. It is theoretically correct but will not work in practice is a common but erroneous statement. If a theory is ‘theoretically correct it will work; if it will not work, it is ‘theoretically incorrect’. Upon these propositions Hohfeld’s work was based; by these he would have it tested. ‘Theory’, to which he devoted his life, was to him a means to an end—the solution of legal problems and the development of our law so as to meet the human needs which are the sole reasons for its existence. In the opinion of the present writer, no more ‘practical’ legal work was ever done than that which is found in the pages of Hohfeld’s writings, and it is as such that the attempt has here been made to outline the more fundamental portions of it, in the hope that it may thus be brought to the attention of a wider circle of readers.”


BAD DEBT PROVISION

an advantageous point of application because it affects a wider group of taxpayers than do many provisions of the statute. It is a provision which is availed of by small taxpayers as well as large. It is almost safe to say that hardly any taxpayer filing returns reporting reasonably substantial income fails to find it necessary, over a period of years, to deduct debts which have become worthless. The need for working simplicity is, therefore, insistent. While many provisions of the income tax statute are necessarily complicated, and perhaps unavoidably obscure to the initiated as well as the uninitiated, the bad debt provision can be made reasonably simple and workable. As it now stands, it is not; and as it is perhaps necessarily administered, it imposes the burden of unraveling wholly superfluous complexities upon already much harassed taxpayers.

THE STATUTE

The language of the bad debt provision of the Federal Revenue Act is deceptively straightforward. The act provides:

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

Debts ascertained to be worthless and charged off within the taxable year

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6 Other things being equal, simplicity is certainly desirable. WILLISTON, op. cit. supra note 1, at 151.

7 One needs always to be vigilant in defense of unavoidable complexity. Panaceamongers are constantly urging simplicity. The sooner it is realized that much of the income tax law is inherently and unavoidably complicated, the better off we shall be. As Napoleon said, simplicity and precision are to a degree irreconcilable. FRANK, LAW AND THE MODERN MIND (1930) 310. In the preface to HOLMES, FEDERAL TAXES (6th ed. 1925), Mr. Holmes observed:

"The most common complaint against the income tax law is that it is so complicated. There is a widespread public demand that the law be made more simple, there is at the same time much complaint against the hardships and inequalities resulting from the inelasticity of the statute. These two currents of thought and opinion necessarily produce a dilemma. It would be very easy for congress to pass a simple income tax statute. The 1913 Act, the first income tax law, was, compared with the 1924 Act, a short and simple law. But if it had imposed taxes at the rates now in force it might well have wrecked the industry and commerce of the country. Any law imposing tax at high rates must fit into the complicated commercial and industrial structure to which it so closely relates. The moment this necessity is recognized and regarded, the law resulting must be to a large measure complex."


The bad debt provision, in contrast with the provisions referred to in the next footnote, furnishes an example of badly needed possible increased simplicity.

8 Provisions such as the reorganization provision, § 112, the installment sales provision, § 44, the provision as to corporate credits for purposes of the undistributed profits surtax, §§ 26, 27, the provisions for the taxation of insurance companies, §§ 201-207, to mention only a few of many available examples, cannot be made too simple. All references are to the REVENUE ACT OF 1936, supra note 5.

9 Supra note 5.
The above-quoted language is, in practice, far from being as simple as it sounds. Its administration has been speckled with many question marks, many of which as yet have not been authoritatively answered. When is a debt "ascertained to be worthless"? Does the rise and fall of the business cycle affect the answer to this question, and if so, how and to what extent? By what procedure is a debt "charged off"? When is a charge-off made "within the taxable year"?10 In the case of partial worthlessness, is the taxpayer under compulsion to charge off the full amount of worthlessness accrued during the taxable year or be forever precluded from the allowance of such accumulated partial worthlessness as a deduction? Is a debt, secured by collateral of less value than the debt, "partially worthless" where the debtor is not responsible? Is the action of the Commissioner of Internal Revenue in disallowing deduction on account of partial worthlessness subject to judicial review?11 These questions have been a thorn in the flesh of taxpayers and government for years. They remain, after a long period of administration and judicial review, in large part unsolved. The limited solution so far achieved has been due to gallant salvage work by the Board of Tax Appeals and the courts—work which at times looked more to the end to be accomplished than the means adopted, thus introducing problems perhaps more serious than the problem solved.

A further question of importance arises when an attempt is made to coordinate the bad debt and capital loss provisions of the statute. This question, involving the relationship of these apparently overlapping provisions of the statute, will produce its share of anxiety in the next few years for taxpayers, and perhaps in the end a fair aggregate of unforeseen deficiencies to be added to a total of deficiencies which will strain tax-paying capacity. It is the purpose of this article to discuss some of these questions, and to suggest some remedies that could be applied by a diligent 75th Congress to their solution.

The Complexities of the Statute in Practice

Returning to the proposition that the income tax statute, as well as other statutes, should stand or fall by the test of results rather than abstractions, let us examine in detail some of the difficulties and perplexities of both govern-

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11The Board of Tax Appeals has recently answered this question in the affirmative. American Fork & Hoe Co., 33 B.T.A. 1139 (1936); judicial review was early established by the courts in Stranahan v. Com'r, 42 F. (2d) 729 (C. C. A. 6th, 1930) cert. denied 283 U. S. 822 (1931); Magill, Finality of Determinations of the Commissioner of Internal Revenue (1928) 28 Col. L. Rev. 563, 565.
ment and taxpayer in connection with the bad debt provision, and see how specific problems encountered have been solved.

THE YEAR OF DEDUCTIBILITY

We may first discuss the requirement, with respect to wholly worthless debts, that the ascertainment of worthlessness must be "within the taxable year." It has been frequently held that worthless debt deductions cannot be deferred; that bad debts can be deducted under the statute only when they are ascertained to be worthless; that the deduction cannot be shifted, in the interest of reduction of tax liability, to some year other than the year in which the debt actually becomes worthless. A worthless debt, like a loss on account of the worthlessness of stock, must be taken "now or never." The taxpayer has no option to choose the year of deductibility, but must at his peril deduct in the year of final worthlessness. The year of final worthlessness is a year when only an incorrigible optimist would continue to hope, but it is not a year when a confirmed pessimist would cease to hope. The law calls for a fair middle course by a reasonable man.

Worthlessness, like its antithesis, value, is a question of fact. It may be clear in some cases exactly when a debt becomes worthless, but in a majority of cases the precise point of time when the worthlessness occurs is far from certain, even after many facts are collected, and even in some cases until extended efforts to collect are made. In short, it is usually no easier to ascertain lack of value than to ascertain value, and the difficulty of determining value for income tax purposes is almost proverbial. In recognition of these considerations, the courts have developed the now familiar doctrine that there is a large discretionary element in the ascertainment of worthlessness. A considerable latitude or margin for the play of judgment is allowed under this theory to a taxpayer acting in good faith.

Why is no ascertainment of partial worthlessness required as to partially worthless debts? Does the taxpayer ascertain complete and the Commissioner partial worthlessness? Why any distinction?

Avery v. Com'r, 22 F. (2d) 6 (C. C. A. 5th, 1927); Katharine H. Putnam, 31 B.T.A. 241 (1934); Hiram R. Lloyd, 34 B.T.A. 301 (1936).


See H. D. Lee Mercantile Co. v. Com'r, 79 F. (2d) 391 (C. C. A. 10th, 1935); Steele Cotton Mill Co., 1 B.T.A. 299 (1925) and cases cited in Paul and Mertens, op. cit. supra note 10, at § 28.49.

Proof of worthlessness requires the proving of a negative. See Worcester Bank & Trust Co., et al., Ex'rs, 13 B.T.A. 630 (1928); DeLoss v. Com'r, 28 F. (2d) 803 (C. C. A. 2nd, 1928), cert. denied 279 U. S. 840 (1929).

Almost all debt charge-offs bring forth the same opposing contentions from Government and taxpayer. In the light of the principles stated, the Government's sometimes ungenerous contention is almost invariably that the debt claimed to have become worthless in the taxable year became worthless in a previous year—usually a year as to which the Statute of Limitations has run against credit or refund to the taxpayer, or a year in which the taxpayer had no income or was in a lower tax bracket, or a year in which the taxpayer could not comply with the requisite discussed below that he must have charged off the worthless debt on his books. If these arguments fail, the Government will argue that the debt has not yet become worthless, though in years of increasing rates or increasing income this contention may end in gain to the taxpayer. It is infrequently admitted without a struggle that the taxpayer's debt became worthless in the year in which he returned the item as worthless. On the other hand, the taxpayers are just as freely opportunistic about their claims of worthlessness. Ascertainments of worthlessness have an uncanny way of fixing themselves upon years in which the taxpayers have considerable income which is subject to high surtax brackets, and of avoiding years in which the taxpayer has no gross income against which to offset a worthless debt and in which, therefore, there will be no use in taking the deduction.

The result of this conflict of interest may be a stimulating game of hide and seek, but it is more provocative of litigation than immediate revenue or tax saving, and it serves to postpone with a hardly desirable effect the determination of tax liability and the settlement of cases. No one is to blame for this result as long as the statute remains in its present form. Only an "eighteenth-century faith in human nature" would expect anything else. It is entirely proper for the representatives of the Government to be zealous to prevent the opportunistic juggling of bad debt deductions, and taxpayers can hardly be blamed for attempting by way of deductions to retrieve some salvage value out of disastrous loans and extensions of credit. A realistic treatment of the situation will not fly in the face of the twentieth-century human nature of Government representatives and taxpayers' counsel, but in


The same contentions are usually made in worthless stock deduction cases, and in other cases in which a loss is sought as a deduction on account of the worthlessness of assets. See, e.g., William Ritchie, Jr., 11 B.T.A. 607 (1928); Quito Electric Light & Power Co., 10 B.T.A. 538 (1928); Humble & Gulf Coast Oil Co., 5 B.T.A. 328 (1926); Dixie Groves & Cattle Co., 5 B.T.A. 1274 (1927).

As indicated above, the taxpayer guesses at his peril. See DeLoss v. Com'r, 28 F. (2d) 803 (C. C. A. 2nd, 1928), cert. denied 279 U. S. 840 (1929), and case cited in note 15.

As to this conflict of interests, see Clapp v. Heiner, 51 F. (2d) 224 (C. C. A. 3rd, 1931).

recognition of natural motivations will attempt, if possible, to remove the cause of the difficulty.

NECESSITY OF CHARGE-OFF WITHIN THE TAXABLE YEAR

Mental Charge-offs

As indicated above, the statute requires, as a condition of deductibility of worthless debts, a charge-off of the debt on the books of the taxpayer—not merely a charge-off, but a charge-off "within the taxable year". This requirement is supposed to evidence abandonment and to constitute a test of good faith.\(^2\)\(^7\) It is predicated upon the assumption, commonly known to be contrary to fact,\(^2\)\(^8\) that taxpayers keep books. A large proportion of taxpayers do not keep books. It has therefore been necessary to invent a theory of informal charge-off where the taxpayer keeps no books of account. In such cases, to avoid discrimination between taxpayers in the same situation except for the fortuitous circumstance that one keeps books where the other does not,\(^2\)\(^9\) the Board of Tax Appeals and the courts have developed the pious but fraudulent fiction\(^3\)\(^0\) that a taxpayer keeping no books may eliminate all debts from his assets by a mental process tantamount to an admission to himself that the debts ascertained to be worthless are no longer considered by him to be part of his assets. It has been held that such a subjective charge-off meets the statutory requirement.\(^3\)\(^1\) "Thus the process of psychoanalysis has spread to unaccustomed fields."\(^3\)\(^2\) This rule, that no actual charge-off is necessary where individual taxpayers keep no books, has been said to be "perhaps unduly liberal", but undoubtedly it would impose hardship to compel all taxpayers to keep books\(^3\)\(^3\) as a condition to deductibility. Certainly for ob-

\(^2\) Fairless v. Com'r, 67 F. (2d) 475 (C. C. A. 6th, 1933).
\(^4\) It is not to be concluded that book entries are unimportant. They may be extremely important. Income is computed in accordance with the method of accounting regularly employed by the taxpayer in keeping his books; such method of accounting frequently helps to determine the time as to which income and deductions are to be accounted for. The books of the taxpayer are, in short, assumed to reflect the facts, and, from the evidential viewpoint, books, if they are kept, are far from unimportant. The point here is that there is no income tax compulsion that they be kept. See Paul and Mertens, op. cit. supra note 10, at §§ 5.07, 11.18.
\(^6\) Shiman v. Com'r, 60 F. (2d) 65 (C. C. A. 2nd, 1932); Squier, et al., Ex'rs, v. Com'r, 68 F. (2d) 25 (C. C. A. 2nd, 1933); Stephenson v. Com'r, 43 F. (2d) 348 (C. C. A. 8th, 1930); McCloud v. Com'r, 43 F. (2d) 351 (C. C. A. 8th, 1930); Jones, et al., Ex'rs, v. Com'r, 38 F. (2d) 350 (C. C. A. 7th, 1930); Peters v. United States, 10 F. Supp. 145 (Ct. Cls., 1935); J. H. Perry, 22 B.T.A. 13 (1931); F. A. Spencer, 21 B.T.A. 859 (1930); Robert Mitten, 11 B.T.A. 731 (1928); Guthrie Shaw, Ex'r, 9 B.T.A. 459 (1927); H. E. Newton, 7 B.T.A. 1153 (1927); see the discussion of the Jones and Stephenson cases in the Shiman case.
\(^8\) See Brown, supra note 3, at 65.
vious reasons the courts do not wish to go that far, and to keep from doing so, they have been obliged to stretch the language of the statute to the limit of flexibility, if not beyond that limit.

**Charge-offs Physically Made in Early Part of Following Year**

The impractical requirement that bad debts, to be deductible, must be charged off "within the taxable year" calls for even greater imaginative efforts on the part of the Board of Tax Appeals and the courts, in disregard of what every business man, as well as every accountant and lawyer, knows. It is a matter of general knowledge that taxpayers do not close their books for a fiscal period until a reasonable time after the period. They could not possibly do so. Few corporations having complicated accounts are able to close their books for a calendar year until February first of the year following. Since it is obviously advisable for a taxpayer charging off worthless debts to await developments through the fiscal period in which he expects to make a charge-off, so that he may act on the basis of all possible information, it is nothing short of absurd of the statute to require that the charge-off be made "within the taxable year". As a matter of fact, there is no such requirement, though the statute says there is: the courts and Board of Tax Appeals have smuggled in the liberal doctrine that the phrase "within the taxable year" must be read in the light of modern business practice, so that where a debt is ascertained to be worthless within the taxable year, but the entry on the books is not physically made until the early months of the next year, the debt is nevertheless deductible. In other words, with a greater sense of reality than Congress showed in framing the bad debt provision, the Board of Tax Appeals and the courts have refused to quibble over the omission of a charge-off within the taxable year when the debts were deducted in the returns filed the following March. Here we have an example of how circumstances, which cannot alter

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46A comparable recent failure of realism is evident in the undistributed profits surtax, which requires a taxpayer to determine its dividend policy during the taxable year before it can know what its net income will be. Its net income may not be determinable as a matter of fact, until years later upon the audit of the return. See Paul and Mertens, op. cit. supra note 10, at § 32A.13, Supplement; Stempf, New Factors in Federal Income Taxation (1936) 62 Journal of Accountancy 242, 247.

47See Fairless v. Com'r, 67 F. (2d) 475 (C. C. A. 6th, 1933). Here again the cases run to esoteric distinctions. The taxpayer may deduct if the debt is ascertained to be worthless in the taxable year but the physical entry is not made until the following
BAD DEBT PROVISION

statutes, may "help to fix their meaning", and we see how far the courts, exercising a high degree of ingenuity, may go on a journey into the field of legislation to save a statute which, given a literal construction, would be highly unjust and completely unworkable.

PARTIALLY WORTHLESS DEBTS

If the bad debt provision is analyzed with care, a further question appears with respect to partially worthless debts. The first part of the provision refers to wholly worthless debts; the second part in different language refers to partially worthless debts. Under the first compulsory provision, the creditor must charge off and claim a deduction for bad debts in the year of worthlessness or lose the deduction. The second part of the statute clearly contemplates that the debtor shall first obtain the approval of the Commissioner of Internal Revenue before he may be permitted deduction for a partially worthless debt. This second part of the provision has no compulsory language requiring the taxpayer to see partial worthlessness as a deduction in any particular year. The statute seems to leave to the taxpayer the question whether he will seek a deduction for partially worthless debts in any year prior to complete worthlessness.

This second part of the provision was inserted for the benefit of taxpayers, the Congressional intent, no doubt, being to enable taxpayers, by means of the deduction for partially worthless debts, truly to reflect their net income for the taxable year. The taxpayer would seem to have the privilege under this second part of the provision of abstaining from making a deduction on account of partial worthlessness until complete worthlessness transpires, with the result that he may or may not in his discretion seek deduction; if he fails to do so, he is not precluded from seeking deduction on account of com-
plete worthlessness established in a subsequent year, even though there might have been partial worthlessness in a prior year.

The question is further complicated in the case of debts secured by collateral. A creditor must exhaust security for a debt before he can take a bad debt deduction.¹⁴ Is a secured debt only partially worthless as long as the collateral has any remaining value, or is the difference between the face of the debt with interest and the value of collateral the debt? On principle the collateral would seem analogous to the personal responsibility of the debtor, perhaps an extension of that responsibility, in effect the definite pledging of part of the debtor's assets to the specific debt.¹⁵ If this is true, the whole debt is the debt, and the debt is only partially worthless as long as the collateral has value; at least, it is not wholly worthless, if the whole debt is the debt.¹⁶ Independently of the partial worthless debt provision, deductibility is postponed until the collateral is sold, and the balance of the debt remaining unpaid by the application of the proceeds of the sale may then be deducted, if the debtor is irresponsible.¹⁷ In any event, what a maze of uncertainty for taxpayers who deduct and for government officials who must decide.

THE RELATIONSHIP OF THE LOSS, CAPITAL LOSS, AND BAD DEBT PROVISIONS OF THE STATUTE

One does not reach the end of the complexities of the delusively simple bad debt deduction provision within the four corners of the provision itself. It is frequently necessary in construing revenue statutes to decide which of two overlapping provisions applies to a particular situation.¹⁸ Inquiry is therefore proper as to the relationship between the bad debt provision and other provisions of the act.

¹⁵It is stated in Regulations 94, art. 23 (k)-1:
"... In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor."
¹⁶This seems to be implicit in the cases. See Equity Silk Corporation, 21 B.T.A. 1114 (1931); J. R. Young, 5 B.T.A. 656 (1927); Laurens Hardware Co., 5 B.T.A. 287 (1926).
¹⁷F. A. Spencer, 21 B.T.A. 859 (1930); Farmers & Merchants Bank of Nocona, Texas, 10 B.T.A. 709 (1928); Kansas City Pump Co., 6 B.T.A. 938 (1927); Mt. Vernon National Bank, 2 B.T.A. 581 (1925).
¹⁸Frequently the meaning of a statute may be determined by reference to the rule of statutory construction, that no part of the statute should be permitted to perish by construction. PAUL AND MERTENS, op. cit. supra note 10, at § 3.07. This rule does not help in solving the problem under discussion, because both the bad debt provision [REVENUE ACT OF 1936, § 23 (k), infra note 51] and the capital gain provision [REVENUE ACT OF 1936, § 117, 49 STAT. 1691 (1936), 26 U. S. C. A. (Supp. 1936) § 117] have plenty of meaning wholly independently of the specific overlapping under discussion.
BAD DEBT PROVISION

Here we find extraordinary confusion. The statute provides for the deduction of losses “sustained during the taxable year”. Farther on in the same section is the bad debt provision, the principal subject of discussion. To the man of the street there is no difference between losses and bad debts. A bad debt is to him merely a particular kind of loss. But the provisions are separate and the arrangement of the statute suggests the problem, still not wholly solved after many years of income tax legislation and litigation, whether this loss provision and the bad debt provision are mutually exclusive. This question, as we shall see, is far from academic. The distinction between losses and bad debts may be important enough under some circumstances to be decisive of deductibility. The problem has been acute as to the status of bonds. After some early hesitation, the decisions under earlier statutes turned in the direction of allowing worthless bonds as a deduction under the worthless debts provision, as distinguished from the loss provision. The fact that bonds have been sold at a nominal price does not preclude deductibility under the worthless debt provision of the statute. It may be

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§§ 23 (e), (f), 49 STAT. 1659 (1936), 26 U. S. C. A. (Supp. 1936) §§ 23 (e), (f).


In Llewellyn v. Electric Reduction Co., 275 U. S. 243 (1927), the Supreme Court avoided a decision on this point. In Spring City Foundry Co. v. Com'r, 292 U. S. 182 (1934), rehearing denied, 292 U. S. 613 (1934), the Court said that the two provisions were mutually exclusive. This case was decided under the 1918 law, which had neither a capital loss provision nor a provision for the deduction of partially worthless debts. The debt was only partially worthless, and the taxpayer, failing to be entitled to a bad debt deduction, tried to secure a loss deduction. See Katharine H. Putnam, 31 B.T.A. 241 (1934).

“Losses are generally deductible only if incurred in a trade or business or in a transaction entered into for profit, but deductible bad debts may have arisen in a merely personal relationship. Furthermore, a loss is deductible when it is sustained, a bad debt when the creditor ascertains worthlessness. See Porter v. United States, 20 F. (2d) 935 (S. D. Idaho, 1927), affd 27 F. (2d) 882 (C. C. A. 9th, 1928), cert. denied 279 U. S. 875 (1928) ; and PAUL AND MERTENS, op. cit. supra note 10, at §§ 28.06, 26.36, for a more complete discussion of this distinction.


Katharine H. Putnam, 31 B.T.A. 241 (1934). Cf. Carl P. Dennett, 30 B.T.A. 49 (1934). However, the Putnam case is not at all clear on this point. It is possible to distinguish between sales for a real consideration and sales involving only a nominal consideration. In the case of the latter it may perhaps be argued that there is no real sale, since virtually nothing is received on the sale. There is a technical passage of title, but the sale in its ordinary sense may be argued to imply a transaction in which something is received for that which is transferred.
that Congress did not intend to place bonds and notes in the class of debts, and it will also be noted that the regulations are permissive as to the treatment of bonds and notes as bad debts.

So much for the ordinary loss provision. Under the 1934 and 1936 Acts, the amount of gain or loss recognizable depends upon the period of holding the capital assets sold or exchanged. Generally speaking, the longer a capital asset sold or exchanged has been held previous to its disposition, the smaller will be the recognizable gain or loss to be taken into account in computing net income. Moreover, the 1934 and 1936 Acts embody a severe limitation upon the deductibility of capital losses: they may be deducted only to the extent of "$2,000 plus the gains from such sales or exchanges". On the other hand, a wholly worthless debt, if allowable as a deduction at all, is allowable to the entire extent of the debt. These provisions accentuate the importance of the distinction between losses and debts.

Many creditors have seen fit in the last few years to sell debts at auction or otherwise. The motivation of the taxpayer in these cases has been, no doubt, to definitize the fact of worthlessness from the evidential standpoint; thus, in a sense, the sale is a response to a Treasury attitude of skepticism as to claims that particular debts are worthless in a particular period. It may be also that a sale of a debt would constitute an ascertainment of worthlessness and be a substantial compliance with the charge-off rule in the sense that the debt was, by the sale, effectively eliminated from the taxpayer's book assets, and in the sense that the taxpayer showed his bona fide intention by the sale (1) to treat the debt as uncollectable, and (2) to eliminate it as an asset.

Taxpayers who sell debts may incur a substantial risk under the 1934 and

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Regs. 94 and 86, art. 23 (k)-4; Reg. 77, art. 194.


The problem was somewhat different under the capital gain and loss provision of the 1932 Act and previous acts, which taxed capital gains and recognized capital losses on a different basis, capital assets being assets, of a description indicated in the statute, held for more than two years, gains being taxable, at the election of the taxpayer, at a flat 12½% rate, and losses being deductible by subtracting 12½% of the capital loss from the amount of tax computed without reference to such loss. These capital gain and loss provisions did not apply to corporations. Revenue Act of 1932, § 101 (c) (8), 47 Stat. 192 (1932).


See text supported by notes 23 to 26, inclusive.


See Macdonald Engineering Co., 35 B.T.A. 3 (1936). For present purposes questions involving the bona fides of the sale, particularly where the taxpayer bids in the debt at an auction, are immaterial.
The risk inheres in the possibility that the Government may claim that the deduction is not allowable under the worthless debt provision, but is covered by an exclusive capital gain and loss provision. If this contention should be sustained, the deductibility of worthless debts would be restricted to $2,000 plus the gains of the taxpayer from sales or exchanges of capital assets. If he has no such gains, he would be allowed the deduction of the debt, whatever its amount, only to the extent of $2,000. Moreover, if the debt has been of long standing, a taxpayer having capital gains would be considerably limited as to the amount of loss to be taken into account in computing net income.

The question here is whether the bad debt provision and the capital loss provision are mutually exclusive, as were, for example, the bad debt provision and the ordinary loss provision of the 1918 law. The Revenue Act defines capital assets as "property held by the taxpayer (whether or not connected with his trade or business)". Previous revenue acts also defined the term "capital assets" as "property held by the taxpayer... (whether or not connected with his trade or business)". For purposes of this question, the definition of the term "capital assets" is the same as that contained in the act now in force. Certainly a debt is property held "Under the Revenue Act of 1932 and previous acts there was no limitation, as to corporations, on capital losses, and other taxpayers were entitled to deduct 12½% of such losses from the amount of their tax computed without considering the capital loss. Under this provision there is, in effect, no limitation on deducting capital losses unless the taxpayer is paying a surtax of over 12½%.

Under the Revenue Act of 1932 and previous acts there was no limitation, as to corporations, on capital losses, and other taxpayers were entitled to deduct 12½% of such losses from the amount of their tax computed without considering the capital loss. Under this provision there is, in effect, no limitation on deducting capital losses unless the taxpayer is paying a surtax of over 12½%.
by the taxpayer. In common parlance, bonds are regarded as capital assets, and the same would probably be true of notes, and even of accounts receivable. Where a debt is sold by the taxpayer either at auction or otherwise, or is exchanged for other property, it is a serious question whether the taxpayer may deduct the full amount of worthlessness so established by the sale, or whether he will be limited as to deductibility to the extent indicated by the capital gain and loss provision. This question will affect sales not only of open accounts or accounts receivable, but also sales of bonds and notes.

It has been decided that the bad debt provision and the ordinary loss provision are mutually exclusive. In view of the fact that the capital loss provision did not add any new items to the list of deductible items, but merely limited the amount of the loss deductible in cases of capital items, it is fairly safe to predict that the bad debt provision and the capital loss provision, charged off. In common speech, debt was regarded as created by contract between a debtor and a creditor, or, as expressed by Blackstone, a sum of money due by certain and express agreement. Buffalo, J., in First National Bank of Sharon v. Heiner, 66 F. (2d) 925, 926 (C. C. A. 3rd, 1933).

See Simon Benson, 9 B.T.A. 279 (1927); I.T. 2028, CB III-1 (1924) p. 296.


Justice Holmes refers to a debt in the case of Portuguese-American Bank v. Welles, 242 U. S. 7, 11 (1916), in the following language: ". . . which is property in the bands of the creditor." See also State Street Furniture Co. v. Armour & Co., 345 Ill. 160, 177 N. E. 702 (1931), where the Court says: "Property includes every interest in any and everything subject to the ownership of man. . . . The relationship between employer and employee with respect to unpaid wages is that of debtor and creditor, and the right of the employee to those wages is a chose in action and as such may be assigned."

According to Funk & Wagnalls' New Standard Dictionary (1923 ed.), a debt, in legal parlance, is "the sum of money due either by certain and express agreement, or established by a judgment of court as a debt of record." A right to receive what is due can hardly be anything but property.

According to 17 C. J. 1374 (which lists many definitions of the term "debt"), there is included the definition ". . . any thing had or held of or from another, his property or right, his due, . . . ." Various types of indebtedness, including open accounts and bank deposits are listed in 50 C. J. 766, under the heading "Particular Rights, Claims, or Demands," a subheading of the discussion of property, such claims being regarded as choses in action, a classification of the broad term "property."

Cf. the flat statement of Mr. Justice Strong in Murray v. Charleston, 96 U. S. 432, 440 (1878): "Debts are not property. A non-resident creditor cannot be said to be, in virtue of a debt due to him, a holder of property within the city."


Supra note 52.

G. C. M. 16793, CB XVI 36-8287 (1936), ruling that a loss on the sale of residential property, which had been held non-deductible previous to the new capital gains and losses provisions, De Ford v. Com'r; 29 F. (2d) 532 (C. C. A. 3rd, 1928), Regulations 77 and 74, art. 171, was not deductible despite the injection of § 23 (j) into the Revenue Act of 1934 [48 Stat. 669, U. S. C. (1934) tit. 26], providing that "losses from sales or exchanges of capital assets shall be allowed only to the extent provided in § 117 (d)," because that provision served only as a cross-reference to § 117 (d), and did not add to the list of loss items deductible under the act prior to the addition of § 23 (j).
as now constituted, will also be held to the mutually exclusive, as the latter is merely an adjunct to the ordinary loss provision. It follows that a taxpayer who attempts to secure a bad debt deduction, where he has made a sale of the debt in order to obtain proof of complete or partial worthlessness, may under this reasoning lose a substantial part of the benefit Congress may have intended for him in the bad debt provision. Compromises of indebtedness raise somewhat analogous questions.\textsuperscript{78}

THE DEPRESSION AND THE BAD DEBT PROVISION

It has been said that the determination of debt worthlessness requires an answer to a difficult and sometimes complex factual question. The rules as to the establishment of worthlessness in the ordinary case, related to a normal economic period, are to some degree established.\textsuperscript{79} A great number of factors enter into the determination of worthlessness, the elaboration of which would undoubtedly extend unduly an article intended to discuss merely new aspects of the worthless debt problem. The determination of worthlessness bothers taxpayers under ordinary conditions, as the volume of litigation on the subject shows. The cases now under discussion with the Bureau of Internal Revenue, and coming to trial before the Board of Tax Appeals and the courts, are cases in which the determination of worthlessness must be related to an abnormal period of violent economic depression. The cases are almost completely silent as to the effect of the depression in connection with determination of lack of value.\textsuperscript{80}

\textsuperscript{78}See Hale v. Helvering, 85 F. (2d) 819 (App. D. C., 1936). In this case it was held that a transfer to the debtor of a note on which the debtor appeared as maker, was not a “sale or exchange” within the capital loss provision of the statute. If this is sound, the transaction would seem to be a “purchase”, the note being analogous to cash used in making a purchase. It would seem to follow that a cancellation of an indebtedness in return for mortgaged property would be a purchase; if this is true, no gain would be realized on such a transaction, even though the value of the property purchased was far in excess of the purchase price, the excess of value being mere appreciation in value. See PAUL AND MERTENS, op. cit. supra note 10, at § 5.10; see also Imperator Realty Co., 24 B.T.A. 1010 (1931). But this does not mean that there may not be a “sale or exchange” where a debt is transferred by the creditor to a third party.

\textsuperscript{79}See PAUL AND MERTENS, op. cit. supra note 10, at § 28.48 to § 28.89.

\textsuperscript{80}To some extent the cases treat the determination of value under depression conditions. See Great Northern Ry. Co. v. Weeks, 297 U. S. 135 (1936); St. Joseph’s Stockyards Co. v. United States, 298 U. S. 39 (1936); Higginbotham-Bailey-Logan Co., 8 B.T.A. 566, 579 (1927), referring to the “deplorable conditions of 1920”; Lamb Lumber & Implement Co., 6 B.T.A. 429 (1927); Bonbright, Valuation of Real Estate for Tax Purposes (1934) 34 Cor. L. Rev. 1397. The cases to some extent also treat the determination of value under abnormally inflated conditions, see e.g., Strong v. Rogers, 14 A. F. T. R. 1207 (D. C. N. J. 1932), aff’d 72 F. (2d) 455 (C. C. A. 3rd, 1934), cert. denied 293 U. S. 621 (1934).

Judicial notice will, of course, be taken of the depression. The depression began at the end of 1929. In its early period it was expected, like the War in 1914, to last only a short time, and there remained for some time in the public mind an attitude of substantial underlying optimism. Conditions became progressively worse, however, and in 1931 the depression had attained unprecedented proportions. By 1933, at the time of the inauguration of President Roosevelt, both economic and psychological conditions were probably at their worst. Shortly thereafter a wave of half-suspicious enthusiasm developed which expressed itself in many ways, including a considerable bulge in the stock market in the summer of 1933. This apparently returning prosperity was a false alarm, and in reaction conditions sank to lower levels, from which they did not return until fairly recently.

It is probable that many business concerns in the early period of 1931 and 1932 adopted, consciously or subconsciously, an attitude that many debts, which under the temporary abnormal conditions prevailing might appear to be at least partially worthless, were not so worthless as immediately appeared. Certainly such a forward-looking policy would have been justified not only by the conditions at the time, but also by subsequent developments. Debtors might and did recover earning power; collateral might and did recover selling price. For a period debts may be said to have been in a state of suspended animation. But such an attitude on the part of creditors could not reasonably be unduly prolonged. Many creditors in 1933 felt that a debt which had been stagnant for four years of depression and which did not sufficiently revive to give further substantial promise in 1933 could with propriety be considered bad. Some debts to some degree revived and showed in 1933 a sufficient possibility of eventual collection to justify a further period of patient waiting.

This 1933 test indicated may be even more distinctly applied in 1935 and 1936. While the deductibility of bad debts is always a question of all the circumstances of a particular debt, there is a basis for a guarded generalization that debts which showed no renewed life in the returning prosperity of 1935 and 1936 were by that token finally proved worthless.

**Suggested Changes in the Statute**

The authorities referred to should be sufficient to demonstrate the necessity for a clarification and amplification of the law on the subject of the deductibility of worthless debts. Part of the clarification will necessarily be statutory. The changes indicated below are suggested:

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\[\text{Atchison, Topeka & Santa Fe Ry. Co. v. United States, 284 U. S. 248 (1932); Citizens' National Bank of Orange v. Com'r, 74 F. (2d) 604 (C. C. A. 4th, 1935). For cases discussing the depression and the changed business conditions since 1929, see cases cited supra note 80.}\]
1. Omit the requirement that debts ascertained to be worthless must be "charged off within the taxable year." This would do away with a part of the statute which now is virtually a dead letter, both as to (a) the necessity of a charge-off at all in the case of taxpayers not keeping books, and (b) the necessity of a charge-off within the taxable year in the case of taxpayers keeping books.

2. Make an exception to the usual statute of limitation upon refunds and credits so that the taxpayer may claim credit or refund after the expiration of three years after his return is filed or two years after the tax is paid, whichever period ends last, and without reference to the regular Statute of Limitations as to the amount of tax allocable to a bad debt deduction, where a deduction for bad debts is denied for the taxable year on the ground that worthlessness in fact occurred in a previous year. This exception might also be extended to losses on account of the worthlessness of assets.

3. Coordinate more effectively the worthless debt provision and the capital gain and loss provision of the statute, so that the respective orbits of the two provisions are clearer than they now are, and so that it may be known definitely by taxpayers whether a sale of a debt will be treated as a sale of a capital asset, and whether the term "capital assets" is intended to comprise worthless debts.

4. Eliminate the confusion now existing as to partially worthless debts so that it is clear what is meant by the phrase "when satisfied that a debt is recoverable only in part" and so that there is no distinction between the treatment of wholly and partially worthless debts.

5. Some or all of these changes might be made to some degree retroactive, particularly those which will facilitate determinations as to the worthlessness of debts during the depression.

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Footnotes:

82 Now contained in § 23 (k), supra note 51.
84 This exception to the statute of limitations would be comparable to the exception formerly existing in cases in which the proper adjustment of tax liability was allowed over a period of years when the Commissioner decreased the invested capital in one year (thus increasing the tax), and the decrease was due to the failure of the taxpayer to take proper deductions in previous years. See Revenue Act of 1924, § 281 (c), 43 Stat. 301; Revenue Act of 1921, § 252, 42 Stat. 268. See also cases cited in Paul and Mertens, op. cit. supra note 10, at § 51.26.
85 This phrase is used in § 23 (k), supra note 51, with respect to partially worthless debts, but not with respect to wholly worthless debts.
86 Under revenue acts previous to the Revenue Act of 1932, the Commissioner's permission to charge off a partially worthless debt was a condition precedent to such a charge-off, as the statute had been construed in Com'r v. Liberty Bank & Trust Co., 59 F. (2d) 320 (C. C. A. 6th, 1932). There was considerable uncertainty under the statute at that time as to whether the Commissioner's permission was necessary before the actual charge-off, or only in the audit of the taxpayer's returns. The Revenue Act of 1932 and subsequent revenue acts have clarified this situation by unmistakable language, giving the Commissioner a discretion as to the allowance of partially worthless debts as a deduction, but taking away his discretion as to the taxpayer's charge-off of partially worthless debts.
CONCLUSION

It has been said that a statute has to be drawn with reference to what is "usual and probable." The bad debt provision of the revenue statute is drawn with reference not even to what is possible or unusual, but rather in large part to what does not ever occur at all. It is predicated upon the assumption that all taxpayers keep books, which almost everyone knows they do not, and upon the further assumption that taxpayers keeping books close their books within the taxable year, when a moment's thought is enough to show such a closing would be impossible because no one could know until midnight of December 31st what income he will receive by that time. No cognizance whatever is taken of the period required for making closing entries, a period which in the case of a large concern cannot be too short. No recognition is given to the simple thought of investors that bonds and notes would be embraced within the term "capital assets," as that term vaguely floats in the mind. A distinction is made in the statute, which certainly is not prevalent in the minds of most business men, between losses and bad debts. No realization is indicated of the obvious difficulty of determining the sometimes highly complex factual question if, as, and when value disappears, a question frequently requiring detailed analysis which no one can make within the taxable year and at the same time attend to his principal business. The result of this almost undiluted lack of respect for practical considerations is a statute which neither says what it means nor means what it says.

It is therefore entirely clear that when the statutory provision as to the deductibility of worthless debts is considered in "terms of things and results," the only test worth while, it appears in its true light as wholly out of touch with reality. It fails completely to express the intention of Congress as that intention has been formulated in the decisions. However much they may disagree with conclusions of fact in particular cases, reasonable taxpayers will quarrel with few of the interpretations so far made of the bad debt provision. The point is deeper than that. The point is that the statute, in its present form, demands that the courts, if they wish to reach a commonsense result avoiding widespread injustice, absurdity, and hardship, must

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89 See discussion of the relationship of the loss, capital loss and bad debt provisions of the statute, supra page 204.
90 See authorities cited in note 3. The Germans and French are more realistic about debtors. In The Paradoxes of Legal Science (1928) 28, Judge Cardozo quotes § 242 of the German Civil Code, which states: "The debtor is obliged to perform his service as good faith and regard to business custom dictate." (Italics supplied.) §§ 1134, 1359 of the French Code Civil are to the same effect.
91 Supra note 4.
93 Holmes, op. cit. supra note 4, at 101, 102 suggesting the test of common sense.
disregard the plain language of the statute. The courts must save us often enough when we do not know the laws we pass, nor the meaning of the laws we have passed. Where we know better and could easily make the statute clear, it is an imposition upon the courts to place upon them the difficult and questionable task of ignoring, against established canons of construction, language which literally interpreted, or even interpreted with some freedom not amounting to complete disregard, would produce results assumed to be far from the Congressional intent.\(^9\)

It is not only the courts which must depend upon the process of guessing what Congress meant. The taxpayer must read the statute not in its lines, but between its lines. Thus the law lacks, at a point of need, the element of certainty. The bad debt deduction is almost universally availed of by commercial houses. It is necessary to suit this provision to commercial conditions.\(^9\) The need of certainty in commercial law has often been recognized.\(^9\) The "common man"\(^9\) wants certainty, and where it is possible to give it to him without sacrificing other values, he should have it. He has had misfortune enough when he has lost his money, and is entitled to protection\(^9\) from the ambiguity that resides in the present statute and prevents him from proceeding intelligently in connection with problems constantly arising in his business.\(^9\)

It may sometimes be a wise policy\(^10\) to leave well enough alone,\(^10\) but it seems a dangerous practice to leave unamended a statutory provision the plain meaning of which has to be disregarded in practice. To do so leaves too much to the process of judicial legislation, necessary as such legislation

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\(^9\)See PAUL AND MERTENS, op. cit. supra note 10, at § 3.03. Here would be an opportunity for Mr. Justice Cardozo's "intimate channel of connection between legislatures and courts." CARDozo, op. cit. supra note 90, at 64.

\(^9\)CARDozo, op. cit. supra note 90, at 13, 21; WILListon, op. cit. supra note 1, at 33.


\(^9\)See Milburn Co. v. Davis-Bournouville Co., 270 U. S. 390, 400 (1926).

\(^9\)It is sometimes the better part of social and legal wisdom deliberately not to formulate rules of law. Cairns, A Note on Legal Definitions (1936) 36 Col. L. Rev. 1099, 1104. This is true of such fields of law as negligence, and may be true of tax avoidance. But in connection with the bad debt provision there is no need to prevent escape from responsibility. The creditor-taxpayer is not a person who has chosen a particular route to avoid tax; outside events have forced upon him results which he is far from choosing. He needs help, and in addition is entitled to certainty.

\(^9\)The present law, in adding uncertainty of deduction to the uncertainty of collection, reinforces the lines in Hamlet that one should "neither a borrower nor a lender be."

\(^9\)The economic concept of income, if adopted, would amount, from the viewpoint of sound administrative procedure and convenience, to an "impossible rule"; the Supreme Court therefore adopted a more or less arbitrary or nominal definition. Cairns, supra note 98, at 1104. But the same is not true of the bad debt provision enacted in recognition of economic realities but in part disregarding those very realities. The arbitrary character of the statute hinders, instead of helping, administration, so much so that the courts had to come to the rescue.
may sometimes be.\(^{102}\) Judicial legislation should be interstitial, "from molar to molecular motions."\(^{103}\) The interpretation of the bad debt provision so far made,\(^{104}\) is, to borrow an expression of Mr. Justice Cardozo\(^{105}\) used in connection with the delegation of the legislative function, liberality of construction "running riot." There are points beyond which judicial efforts in the direction of saving a badly drafted statute should not go. When we go too far in the direction of judicial legislation, we drive the judicial process underground. No one knows what the statute means or what the courts will do in fact in a given situation.\(^{106}\) No one can know, for in the absence of any rule, decisions can hardly help being little more than an expression of the individual reaction, sometimes subconscious and unrealized even to himself, and frequently vaguely apprehended, of the particular judge in a particular case. As Jerome Frank\(^{107}\) has shown, this condition obtains often enough in the law without help from Congress by way of inertia or excessive caution with relation to an ambiguous statute. It may be true, as the Supreme Court has said, that a statute of uncertain meaning will not readily be made an instrument for hardship and confusion,\(^{108}\) but the anxiety which ends in ultimate vindication in the Supreme Court (if one ever gets there) may amount to the same thing.

Judge Learned Hand, in the well known Gregory case,\(^{109}\) employed his famous metaphor that "the meaning of a sentence [in the statute] may be more than that of the separate words," just as "a melody is more than the notes." There was present in this opinion a stirring undertone of tax avoidance. The same judge was not long afterwards obliged to say that we "cannot play so fast and loose with the chosen words of a statute."\(^{110}\) The

\(^{102}\) Mr. Tilden has expressed this philosophy in his advice against changing a winning game. If codification were too rigid it might do harm. Cf. President, etc. of Manhattan Co. v. Morgan, 242 N. Y. 38, 150 N. E. 594 (1926), where the court was reluctantly constrained to hold that a codification of the Negotiable Instruments Law had foolishly made invalid important business customs developing after the codification. Business customs do change, as Mr. Justice Cardozo has pointed out in connection with ocean bills of lading, The Paradoxes of Legal Science (1928) 13; but it seems safe to depend upon the inability of business men to close their books, and make a charge-off, within the taxable year.

\(^{103}\) See Cardozo, The Nature of the Judicial Process (1921) 10, 98. See also Frank, Law and the Modern Mind (1930) Pt. one, c. 4.

\(^{104}\) Holmes, J., dissenting in Southern Pacific Co. v. Jensen, 244 U. S. 205, 221 (1917).

\(^{105}\) This should be said even though that interpretation has been in favor of the taxpayer.

\(^{106}\) See Cardozo, The Nature of the Judicial Process (1921) 10, 98. See also Frank, Law and the Modern Mind (1930) Pt. one, c. 4.

\(^{107}\) Holmes, J., dissenting in Southern Pacific Co. v. Jensen, 244 U. S. 205, 221 (1917).

\(^{108}\) This should be said even though that interpretation has been in favor of the taxpayer.


\(^{109}\) Holmes, op. cit. supra note 4, at 169, 172.

\(^{110}\) Zellerbach Paper Co. v. Helvering, 293 U. S. 172 (1934).

\(^{110}\) Frank, Law and the Modern Mind (1930).


BAD DEBT PROVISION

notes may be undependable, but one may not wish to play entirely by ear. The trouble with dependence upon free or liberal statutory interpretation of a taxing statute is that no one can be sure when it will be employed. No taxpayer knows today when some court may adopt in his case a strict interpretation of the bad debt provision of the statute. But even assuming that liberality of attitude will be constant, taxpayers who have received the benefit of a free interpretation, ignoring the plain language of the bad debt provision, should not forget that what may be done by one court in disregard of plain language to avoid injustice may also be done by another court to impose unjust tax. The principle of departing from statutory language cuts both ways. In the case of the bad debt provision, the highly desirable element of certainty, which might easily be attained, is gone.

Experience with many cases has taught us some valuable lessons for the law of bad debt deductibility. The gains we have made may profitably be put in the statute, so that we may return, so far as may be, to the practice of respecting statutory language. There are plenty of instances of the chaos that results when the courts, even for good reasons, vary from this practice. Such departures, necessary as they are in certain connections, encourage, if they do not put a premium upon, legal rationalization, and prevent certainty where it is badly needed and is possible. Judicial legislation in the province of the bad debt provision has exhausted its function. The legislature, now supplied with judicial advice, should perform its proper function. Where a remedy is so clear and available, why not act?

the 2nd Circuit Court of Appeals, December, 1936, and particularly the following language:

"Many people have changed their minds about such matters in sixty years, but the act forbids the same conduct now as then; a statute stands until public feeling gets enough momentum to change it, which may be long after a majority would repeal it, if a poll were taken."