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Charles G. White

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## A Misunderstanding of the Function of a Bad Debt Reserve When Incorporating Under Section 351

One of the primary benefits of section 351 of the Internal Revenue Code of 1954 is that owners of an unincorporated business may avoid recognition of gain upon incorporation of the business.<sup>1</sup> Prior to 1962 it was generally believed that a business which used the "reserve"<sup>2</sup> method of accounting for bad debt losses incurred no adverse tax consequences when the business was incorporated in a section 351 transfer.<sup>3</sup> However, since 1962 the Internal Revenue Service persistently has contended that when a proprietorship or partnership incorporates, the transferor (the owner of the business being incorporated) realizes ordinary income to the extent of the balance of its reserve for bad debts.<sup>4</sup> The recognition of gain to a transferor in these circumstances generally is thought to be justified by the tax benefit rule.<sup>5</sup> The tax court consistently has upheld the contention of the Internal Revenue Service, and has held that the transferor is taxed on the amount of the reserve for bad debts at the time of incorporation.<sup>6</sup> The courts of appeals have differed as to whether there is a tax benefit on account of bad debt reserves when a proprietorship or partnership transfers its assets to a controlled corporation under section 351. This question primarily is discussed in terms of whether gain is realized by the transferor. In 1966 the Ninth Circuit, in *Estate of Schmidt v. Commissioner*,<sup>7</sup> rejected the position of the Internal Revenue Service and the reasoning of the tax court, holding that no income is realized under such circumstances. However, in 1969 the Fifth Circuit, in *Nash v. United States*,<sup>8</sup> adopted the view of the Internal Revenue Service and held that a partnership which transfers its assets to a controlled corporation under section 351 realizes ordinary income to the extent of its bad debt reserves.

<sup>1</sup> INT. REV. CODE of 1954, § 351. This section provides that "no gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation." Unless otherwise indicated all further references are to the Internal Revenue Code of 1954.

<sup>2</sup> INT. REV. CODE of 1954, § 166(c).

<sup>3</sup> See *Estate of Schmidt v. Commissioner*, 355 F.2d 111, 112 (9th Cir. 1966), where the court stated:

We find it remarkable . . . that no reported case has been found prior to this one in which the Commissioner has taken this position. Yet there must be literally thousands of businesses transferred by taxpayers to corporations in exchange for stock in which the transferring taxpayers used the reserve method of accounting for bad debts. It was not until the Revenue Ruling 62-128 [see note 4 *infra*] . . . that the Commissioner took a published position on that position.

<sup>4</sup> Rev. Rul. 128, 1962-2 CUM. BULL. 139; *Nash v. United States*, 414 F.2d 627 (5th Cir. 1969); *Estate of Schmidt v. Commissioner*, 355 F.2d 111 (9th Cir. 1966); *Schuster v. Commissioner*, 50 T.C. 98 (1969).

<sup>5</sup> B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 3.17, at 114 (2d ed. 1966).

<sup>6</sup> *Nash v. United States*, 414 F.2d 627 (5th Cir. 1969); *Estate of Schmidt v. Commissioner*, 42 T.C. 1130 (1964), *rev'd*, 355 F.2d 111 (9th Cir. 1966); *Schuster v. Commissioner*, 50 T.C. 98 (1969).

<sup>7</sup> 355 F.2d 111 (9th Cir. 1966).

<sup>8</sup> 414 F.2d 627 (5th Cir. 1969).

## I. INTERNAL REVENUE CODE SECTIONS 351 AND 166

The predecessor of section 351 was first enacted in 1921,<sup>9</sup> and the provision as originally enacted remains basically unchanged today. The primary motivation for enacting the section was the realization that incorporation may not result in real economic gain to the owner of the business.<sup>10</sup> A witness appearing before the Senate Finance Committee in 1921<sup>11</sup> gave an example of an unincorporated business with substantially appreciated property. When the owner incorporated the business, the Internal Revenue Service (formerly the Bureau of Internal Revenue) proposed to treat the transaction as a taxable event. The witness observed that “[w]hen the transaction was over the owner of the incorporated business had exactly what he had before; only a piece of paper held by him read a little differently and perhaps was of a different color, but his interest was identical.”<sup>12</sup>

Enactment of section 351 did not eliminate all tax problems existing in connection with the incorporation of a business. In particular, questions have been raised as to the proper tax treatment of prior bad debt deductions taken by a transferor incorporating a business. In section 166<sup>13</sup> Congress has provided the taxpayer with two methods of accounting for bad debt losses. The first method permits a bad debt deduction only after the account is determined to be partially or wholly worthless.<sup>14</sup> The other method allows a deduction for a reasonable addition to a reserve for bad debts.<sup>15</sup> By the “reserve” method the taxpayer may estimate what portion of his notes or accounts receivable ultimately will become uncollectible or worthless. He may deduct the estimated uncollectible portions currently, thereby eliminating the necessity of delaying the deduction until the accounts are finally determined to be uncollectible or worthless. As the deductions are made, a reserve equal to the sum of the deductions is established. When any account is finally “written off the books” as worthless, the account is charged to the reserve for bad debts. Since an estimated amount for uncollectible accounts was previously deducted, no deduction is allowed when the account is finally written off and charged to the reserve.<sup>16</sup> In theory the reserve for bad debts will have a “zero” balance when all the accounts either have been collected or written off the books as uncollectible.<sup>17</sup>

## II. ESTATE OF SCHMIDT V. COMMISSIONER

In *Estate of Schmidt v. Commissioner*<sup>18</sup> the taxpayer incorporated his proprietorship business and received par value stock equal to the book value

<sup>9</sup> Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227.

<sup>10</sup> S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921).

<sup>11</sup> Frederick B. Kellogg, New York practicing attorney (appearing as a witness), *Hearings on the Revenue Act of 1921 Before the Comm. on Finance United States Senate*, 67th Cong., 1st Sess. 534 (1921).

<sup>12</sup> *Id.*

<sup>13</sup> INT. REV. CODE OF 1954, § 166.

<sup>14</sup> *Id.* § 166(a).

<sup>15</sup> *Id.* § 166(c).

<sup>16</sup> See generally H. NOBLE & C. NISWONGER, ACCOUNTING PRINCIPLES 211-16 (7th ed. 1957).

<sup>17</sup> *Id.*

<sup>18</sup> 355 F.2d 111 (9th Cir. 1966).

of the business assets less liabilities and the reserve for bad debts. There was no question as to the reasonableness of the reserve. However, the Commissioner proposed to tax the amount of the reserve for bad debts to the taxpayer. The Commissioner's main contention was that the taxpayer no longer needed the reserve, the receivables having been transferred to the corporation, and that he therefore realized income in the amount of the reserve. The tax court agreed with the Commissioner, but the Court of Appeals for the Ninth Circuit reversed, and stated as its reason:

We think that the Tax Court's and the Commissioner's position disregards the economic realities of the situation. . . . [T]he value of the accounts receivable was not their face amount, but that amount less the reserve. It was this value that he transferred to the corporation. . . . What he has recovered in relation to the receivables, is [*sic*] pieces of paper—stock certificates—representing their net value, not their gross value.<sup>19</sup>

When the court stated that the stock was exchanged for the net value and not the gross value of the receivables, it gave primary consideration to the economic reality of the transaction. In other words, if there had been an outright sale to a third party (assuming the reserve for bad debts was an accurate estimate of uncollectible accounts), the amount received would equal the gross receivables less the reserve for bad debts. Hence, there would be no gain or loss on the transaction. Similarly, there should be no income or loss when a proprietor merely incorporates his business and receives consideration commensurate to the gross receivables less the bad debts reserve. Although the court did not extensively consider section 351, its decision is certainly in harmony with the purposes for which section 351 was enacted.<sup>20</sup>

### III. NASH V. UNITED STATES

In *Nash v. United States*<sup>21</sup> the taxpayers were owners of a partnership which formed eight controlled corporations. The partnership assets were transferred to the controlled corporations in exchange for the pro rata shares of stock in the corporations. Included in the assets transferred were notes receivable in the amount of \$486,853. The "contra"<sup>22</sup> account to the notes receivable was the reserve for bad debts in the amount of \$73,028. The Commissioner determined that, since the partnership had not depleted the reserve at the time of the transfer, the partnership's need for the reserve for bad debts no longer existed, and, therefore, the balance of the reserve was taxed as ordinary income to the partners. In an action by the taxpayer to recover tax assessed and paid on the bad debts reserve, the Government

<sup>19</sup> *Id.* at 113.

<sup>20</sup> *Hearings on the Revenue Act of 1921 Before the Comm. on Finance United States Senate*, 67th Cong., 1st Sess. 534 (1921).

<sup>21</sup> 414 F.2d 627 (5th Cir. 1969).

<sup>22</sup> A "contra" account is defined as "an auxiliary account . . . which is closely related to another (major, or principal) account. Auxiliary accounts are sometimes called *contra*, or *offset*, accounts if the principal account has a debit balance and the auxiliary account has a credit balance, or vice versa. . . . The allowance for doubtful accounts and accumulated depreciation accounts are contra accounts." H. FINNEY & H. MILLER, *PRINCIPLES OF ACCOUNTING—INTERMEDIATE* 3-4 (6th ed. 1965).

contended that because the taxpayer had reduced his taxable income during the period of accumulation of the reserve it was only just and proper that the reserve be reported as income when it had fully served its purpose.

The district court followed the holding in *Schmidt*, but the Court of Appeals for the Fifth Circuit upheld the Commissioner's position, and found the amount of the reserve to be taxable as ordinary income to the taxpayer. The court reasoned that where the accounts are received by the new corporation at the basis which they had in the hands of the partners, it would really amount to a recognition of a loss in the hands of the partners if they were permitted to "transfer" the reserve for bad debts to the transferee corporation.<sup>23</sup>

The court's reasoning seems untenable. There is no economic loss realized in such a transfer because the "purchase" or "transfer" price takes into account a reduction to the extent of the reserve. When the court referred to the *basis* of the accounts transferred, it was referring to gross balance of the notes receivable. However, in reality such a basis should be considered as the net of the gross receivables and the reserve for bad debts. As a comparison it is noted that the basis of depreciable equipment is required to be adjusted for the amount of the reserve for depreciation.<sup>24</sup> Obviously the court would agree that equipment transferred to a corporation would be net of the reserve for depreciation, or that a patent would be transferred at the net amount of any amortization previously taken.<sup>25</sup> Although adjustment for bad debt reserves is not provided for in section 1016,<sup>26</sup> as are patents and depreciable property, there is no doubt that the taxpayer would be required to net the reserve for bad debts against gross receivables if *all* the receivables were sold to a third party. Otherwise, the taxpayer would get the benefit of a double deduction. Therefore, assuming that the proceeds equal the "net" of the notes receivable less the bad debts reserve, there should be no gain or loss if the accounts are transferred to a controlled corporation. All that is involved is the exchange of stock certificates for partnership assets, and the same persons remain in control of the business thereby meeting the requirements of section 351.

In *West Seattle National Bank v. Commissioner*,<sup>27</sup> where the taxpayer corporation was liquidated under section 337,<sup>28</sup> the company was required to account for its unused reserve for bad debts as ordinary income. The taxpayer had sold all of its accounts but had retained its reserve for bad debts on the books. If the court had sustained the taxpayer's contention, the taxpayer would have avoided permanently the recoupment of excess

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<sup>23</sup> *Nash v. United States*, 414 F.2d 627, 630 (5th Cir. 1969).

<sup>24</sup> INT. REV. CODE of 1954, § 1016. Basically this section requires the taxpayer to decrease the "basis" of capitalized assets and expenditures to the extent of depreciation or amortization previously deducted.

<sup>25</sup> There is no record of any case holding that a company realizes ordinary income to the extent of the reserve for depreciation or previous amortization of patents when a company transfers its assets to a controlled corporation under section 351; nor are there any published Revenue Rulings indicating that the Internal Revenue Service would make such a contention.

<sup>26</sup> See note 24 *supra*.

<sup>27</sup> 33 T.C. 341 (1959).

<sup>28</sup> INT. REV. CODE of 1954, § 337.

bad debt charges made in previous years. Under such facts the Commissioner's argument is sound because the need for the reserve for bad debts indeed was no longer present. However, the *West Seattle* case is not analogous to *Nash* because in *Nash* the business continued, although in corporate form. The new corporations in *Nash* still retained their accounts, and the need for a bad debts reserve did continue to exist.

It is erroneous to contend that a need for a bad debt reserve ceases to exist when a business is incorporated pursuant to a section 351 transfer. Since section 351 is designed to protect an entity which merely has changed from proprietorship or partnership form to corporate form, there is no reason to say that the needs of the business have changed.

Probably the controversy has resulted from a lack of understanding as to the function of a bad debt reserve. A reserve for bad debts has been described as serving two functions:

- (1) To charge the loss by the sale of goods to customers whose accounts prove to be uncollectible against the period that caused the loss.
- (2) To show the estimated realizable value of customers' accounts.<sup>29</sup>

The prevailing theory is that the loss caused from uncollectible accounts occurs when the account is first obtained and not when the account is finally discovered to be uncollectible. One author has stated that "a bad debt loss results from an error in judgment, an error in granting credit and making a sale to customers who will not pay. Consequently, a *bad debt loss is incurred at the moment credit is granted . . .*"<sup>30</sup>

If the view is adopted that the loss from uncollectible accounts is sustained at the moment credit is granted, it is a *non sequitur* to say that the reserve for bad debts will produce income when a business is incorporated in a "tax-free" section 351 transfer. If the accounts receivable have already suffered a loss, theoretically the uncollectible portion is forever lost and cannot suddenly and mysteriously be recovered by the mere incorporation of a business. Furthermore, the realities of estimated losses from the extension of credit are recognized by the Securities and Exchange Commission where it has held that a reserve for bad debts is not merely optional, but is mandatory.<sup>31</sup> Such a reserve is considered necessary for fair disclosure of the portion of receivables estimated to be uncollectible.

#### IV. CONCLUSION

The problem in *Nash* regarding the taxability of a bad debts reserve when a business incorporates, appears to have evolved from an improper comparison of the factual circumstances in *West Seattle National Bank* with those in *Nash*. Those factual differences were so extensive that a completely different application of the law should have been attached to each case. It is to be recalled that in *West Seattle National Bank* the accounts

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<sup>29</sup> H. FINNEY & H. MILLER, *supra* note 22, at 176.

<sup>30</sup> W. PYLE & J. WHITE, FUNDAMENTAL ACCOUNTING PRINCIPLES 262 (1966) (emphasis added).

<sup>31</sup> *In re Metropolitan Personal Loan Co.*, 2 S.E.C. 803 (1937).

receivable had been completely eliminated from the company's assets, but the company had improperly left the reserve for bad debts on its books. However, in *Nash* the receivables were still in the business.

It appears that the result in *Nash* can easily be avoided. First, if all the accounts are sold to a third party prior to incorporation of the business (assuming the proceeds are approximately equal to the accounts receivable less the reserve for bad debts), there should be no gain or loss upon disposition of the accounts, and presumably both the receivables account and the reserve for bad debts account would reflect a "zero" balance. But, if the proceeds exceed the accounts receivable less the reserve for bad debts, then it would logically follow that taxable income would result. Another method would be to retain the notes receivable in the partnership and make periodic transfers of cash after the collectible accounts have been collected. Final disposition of uncollectible notes or accounts could be made within the partnership entity. In this manner no "illusory" gains from a reserve for bad debts would be recognized.

However, Congress did not intend to require incorporators to pursue such a circuitous route when changing a business into the corporate form, and section 351 was enacted to alleviate such problems.<sup>32</sup> Little did Congress realize that the effectiveness of this provision would eventually be nullified by a court making an improper interpretation of the function of a bad debts reserve.

When the Court of Appeals for the Ninth Circuit, in *Estate of Schmidt*, held that the bad debts reserve did not result in the recognition of ordinary income upon the event of mere incorporation, the Government did not petition the Supreme Court for certiorari.<sup>33</sup> However, it maintained its position that the transaction results in a taxable event.<sup>34</sup> While the Internal Revenue Service may have delayed a final determination in the Supreme Court as long as possible, the Supreme Court has granted certiorari in the *Nash* case,<sup>35</sup> and the Internal Revenue Service must face the ultimate test in its contention that a reserve for bad debts is not protected from recognizable gain in a section 351 transfer.

*Charles G. White*

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<sup>32</sup> See notes 9, 10 and 11 *supra*, and accompanying text.

<sup>33</sup> P-H 1966 FED. TAXES 56,378.

<sup>34</sup> *Nash v. United States*, 414 F.2d 627 (5th Cir. 1969); *Schuster v. Commissioner*, 50 T.C. 98 (1969).

<sup>35</sup> Certiorari was granted on January 12, 1970, P-H 1970 FED. TAXES 61,201.