

## RESERVE FOR CERTAIN GUARANTEED DEBT OBLIGATIONS

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Mr. LONG of Louisiana, from the Committee on Finance, submitted  
the following

### REPORT

[To accompany H.R. 11782]

The Committee on Finance, to which was referred the bill (H.R. 11782) to amend the Internal Revenue Code of 1954 to allow a deduction for additions to a reserve for certain guaranteed debt obligations, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

#### I. SUMMARY

This bill provides that a taxpayer who is a dealer in property may take an income tax deduction for reasonable additions to a reserve for bad debts which arise from his contingent liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of the dealer's business. The bill also provides that this is to be the only deduction allowable for additions to a reserve for bad debts for obligations of this type.

The bill contains special features designed to prevent a doubling up of deductions during the transition period. The bill also provides that for taxable years beginning before August 2, 1966, a taxpayer may establish a reserve under this new provision without obtaining permission of the Commissioner of Internal Revenue to change his method of accounting.

The new provision applies generally to taxable years ending after October 21, 1965. However, in the case of years ending before October 22, 1965, where the taxpayer claimed a deduction (under the provisions of existing law which relate to reserve for bad debts) the claimed deduction is to be allowed for past years if it would be allowable under the new provision.

The passage of this bill is favored by the Treasury Department.

## II. REASONS FOR THE BILL

The Internal Revenue Service takes the position that a dealer in property is not entitled to take a current deduction, by use of a reserve for bad debts, for losses he expects to arise in subsequent years because of his sale with recourse of customer debt obligations. For example, if a dealer sells an article under a conditional sales contract and then sells the contract to a bank with the bank reserving the right to collect any bad debts from the dealer, the Internal Revenue Service holds that an addition to a reserve for bad debts on account of the dealer's contingent liability to the bank cannot be deducted for income tax purposes. The Treasury's position has been sustained in the Tax Court of the United States, but three circuit courts of appeal have held that a current deduction can be so taken against the future losses. The Commissioner of Internal Revenue has announced that he will not follow the circuit court decisions.<sup>1</sup> The bill is designed to settle the existing controversy as to the proper treatment of such cases for both future and past years.

The bill contains a special feature called a "suspense account" which, together with the treatment of the opening balance of the new reserve for guaranteed obligations, is designed to prevent a doubling up of deductions in the transitional period during which a taxpayer is converting to the new reserve. The opening balance of the new reserve is not zero, but an amount equal to what the opening balance would have been if the reserve had been maintained in prior years. A deduction is not allowed for this opening balance. If a deduction were allowed, a doubling up of deductions would otherwise occur in the transition period, because in the transitional year or years the taxpayer, in effect, would be writing off the bad debts as they occur and also receiving the deductions for the entire balance in the reserve then being established with respect to the property sold by him.<sup>2</sup> Thus, in the transitional year or years the taxpayer's income would be understated. This would occur even if the volume of sales by the taxpayer remained constant. In addition to the effect this doubling up of deductions has in understating income of the taxpayer during the transition period, it also can involve a significant revenue loss in the case of the bad debt reserve of the type referred to here. It is anticipated that were a deduction not to be denied for the opening balance in the new reserve, there would be a transitional revenue loss of \$200 million resulting from this provision. The suggestion sometimes made that this transitional revenue loss be spread over a period of years does not, of course, reduce the amount of the loss involved. Still another aspect of the problem which should be taken into account is the fact that were the opening balance in the new reserve to be allowed as a deduction in the transitional period, the effect would be the same as a retroactive enactment of this provision, since under the new method the opening balance is attributable to obligations incurred

<sup>1</sup> See, *Bolling et al. v. Commissioner*, 357 F. 2d 3 (8th Cir. 1966), reversing T.C.J. Memo. 1964-143; *Foster Frosty Foods v. Commissioner*, 332 F. 2d 233 (10 Cir. 1964), reversing 39 T.C. 772 (1963); *Willius Pontiac v. Commissioner*, 298 F. 2d 893 (9th Cir. 1962), reversing 34 T.C. 1065 (1960); *Mike Persia Chevrolet, Inc.*, 31 T.C. 198 (1953); see also *Bright v. Commissioner*, 69-2 U.S.T.C. para. 9609; and Rev. Rul. 62-214, C.B. 1962-2, 72.

<sup>2</sup> Actually, the bad debts are charged against the reserve but by the end of the year the reserve is increased to the extent appropriate considering the obligations then outstanding. This is the equivalent, therefore, of a direct chargeoff of these bad debts. If the reserve were built up from a zero balance to the appropriate year-end level plus enough more to offset charges against the reserves for the bad debts occurring during the year, in the absence of the special feature contained in this bill, there would be larger deductions in the transition period than would otherwise be the case to the extent of the opening balance in the reserve. This represents deductions not attributable to the current period.

in prior years, back to the time this type of business first came on the books of the taxpayer. Generally, Congress does not make retroactive most of the provisions which it enacts amending the Internal Revenue Code (either increasing or decreasing tax liabilities), even though the provisions are believed meritorious.

While the absence of a deduction for the opening balance in the new reserve avoids a doubling up of deductions in the transition period, nevertheless, taxpayers receive the benefit of the new reserve system (which, in effect, provides for an earlier deduction than would otherwise be available) to the extent of any growth in their business above the level at the beginning of the transition period. In addition, the amounts placed in the suspense account are allowed as deductions in subsequent years to the extent the taxpayers' reserve would otherwise decline below the balance in this suspense account. This may occur in subsequent years, for example, because the volume of a taxpayer's business of this type declines, because he decides to hold the debt obligations himself, or because he goes out of business altogether. Thus, the effect of the treatment provided by this bill is to allow the taxpayer the advantages of the new reserve system with respect to any growth in the volume of his sales, while at the same time guaranteeing for him—if for one reason or another his business involving the guaranteed obligations declines—treatment as least as good as that which would have been provided had he not established the reserve in the first place, and instead taken the bad debt deductions as they were actually incurred.

The suspense account is not made available in cases where the taxpayer has already taken deductions in the form of additions to a reserve for bad debts with respect to the items involved in this bill in prior years (thus the opening balance in the new reserve in his case in effect merely represents the transfer of a balance from the existing general bad debt reserve), since in such cases the opening balance in the new reserve has in effect been previously deducted and there is no doubling up of deductions in the transition period.

### III. GENERAL EXPLANATION

*Reserve for guaranteed obligations.*—The bill adds a new provision to the Internal Revenue Code (a new subsection (g) in section 166) under which a deduction can be taken for additions to a reserve for bad debts arising out of the taxpayer's liability as a guarantor, endorser, or indemnitor of debt obligations attributable to his sale of property in the ordinary course of his business. This bad debt reserve may be attributable to the sale by the taxpayer of either real property or tangible personal property and services related to these properties. The debt need not initially be the debt owing to the taxpayer as long as it arises from the sale by him of the property and he is guaranteeing payment. Thus, this includes cases both where the purchaser borrows from a bank or other financial institution to make partial payment for the property and the dealer guarantees the payment of the debt, as well as where the debt is initially owing to the dealer and he discounts the paper with the financial institution which has recourse to him for payment of the debt should the purchaser fail to make the payments.

If a dealer establishes one of these new reserves for guaranteed debt obligations and also maintains a reserve for bad debts (under provisions of existing law) for accounts receivable from customers which he does not sell, the dealer is to maintain two separate reserves for income tax purposes. The amount of reasonable additions to the reserves are to be determined separately for each reserve and not on an aggregate basis.

The reserve for guaranteed debt obligations is to apply to taxable years ending on or after October 22, 1965, the date of the introduction of the bill.

*Suspense account and treatment of opening balance in reserve.*—The bill provides that for the first taxable year for which the dealer maintains the new reserve for guaranteed debt obligations, the balance of the reserve at the beginning of the year is to be the same as if he had maintained this reserve for preceding years. No deduction is to be allowed currently for this opening balance. The effect of this is to deny any doubling up of deductions in the transition period. However, this amount, for which deduction is denied, is to be placed in a "suspense account" and, as explained below, the dealer may subsequently receive deductions for part or all of this balance. As a result, the dealer whose business is increasing, receives deductions for additions to his reserve (1) to offset actual losses charged against the reserve during the year, and (2) to take into account the increase in the volume of obligations he has guaranteed. He does not generally (except through the suspense account discussed below) receive a deduction for additions to the reserve for obligations he guaranteed in the past (reflected in the opening balance of his new reserve).

The function of the suspense account is to give the dealer a deduction in subsequent years for the opening balance in his reserve for guaranteed bad debts (for which he has not up to that time received a deduction) if he goes out of the business for which the reserve is maintained, or if he no longer needs the reserve—for example, because he finances the customer paper himself rather than discounting it to others, or because his volume of credit sales declines.

The way in which this suspense account works is as follows: The initial balance of the account is the same as the opening balance of the new reserve for guaranteed debt obligations (for the first year that reserve is maintained). The balance in this suspense account may never be greater than the opening balance of the reserve in the first year it is in operation. If in any subsequent year the balance in the suspense account is greater than the then yearend balance in the reserve for guaranteed obligations, the dealer at that time is allowed an income tax deduction for the difference. The suspense account is reduced by the amount so allowed as a deduction. On the other hand, if the balance in the suspense account is less than the end-of-the-year balance in the reserve, the suspense account is to be increased by the difference (but never by more than the amount necessary to bring the suspense account to the amount of its initial balance in the suspense account). This same amount is also included in gross income of the dealer for income tax purposes. Thus, the suspense account is never increased unless it has been previously reduced, and the total of the increases in the suspense account can never exceed the total of the previous reductions in the suspense account.

The determination of the yearend balance of the reserve for guaranteed debt obligations is made after adding any addition needed to provide a reasonable reserve for the outstanding contingent liabilities for which the reserve is maintained.

No suspense account is to be provided in the case of taxpayers who for their last taxable year ending before October 22, 1965, claimed a deduction (see discussion immediately below) for an addition to a reserve for bad debts for the type of obligations covered by the new reserve. In such a case it is not necessary to have a suspense account because the taxpayer is not doubling up his deductions in the transition period.

*Taxpayers claiming deductions for years ending before October 22, 1965.*—The bill provides that if a taxpayer before October 22, 1965, claimed a deduction (for a taxable year ending before that date) for an addition to a reserve for bad debts (sec. 166(c)) on account of debt obligations of the guaranteed type referred to with respect to the new reserve, then this deduction is to be allowed (under the existing general bad debt reserve) for the prior year in question to the same extent that it would have been allowable if the new reserve had been available in the earlier year of years. However, such a deduction is to be available for one of these prior years only if the statute of limitations has not run (by December 31, 1966) for either this or any subsequent year. Thus, for example, if the taxpayer claimed a deduction under the existing general bad debt reserve for guaranteed obligations for the year 1960 and that year and all subsequent years are open, deductions may be taken for the year 1960 and all subsequent years ending before October 22, 1965 (whether or not the taxpayer claimed the deduction for all of the subsequent years). However, if the taxpayer claimed the deduction for the year 1960 and that year is still open but the year 1961 is not open, no deduction can be taken for the year 1960 or 1961. In such case, if the taxpayer also claimed a deduction for 1962, deductions can be taken for 1962 and subsequent years ending before October 22, 1965 (if all of these years are open).

*New reserve only way of taking guaranteed bad debt deductions for future.*—The bill provides that the new reserve previously described is to be the only reserve through which a deduction is to be allowed for any addition to a reserve for bad debts, which arises out of the taxpayer's liability as guarantor, endorser, or indemnitor of debt obligations. For example, if the taxpayer has an account receivable from a customer simply for services rendered (not in connection with a sale of a property) the bill provides that no deduction is to be allowed for an addition to a reserve for liabilities arising out of the sale with recourse of such a debt obligation.

*Establishing new reserve not a change in method of accounting for certain years.*—The bill provides that the establishment of a new reserve for bad debts guaranteed by the taxpayer for years ending after October 21, 1965, and beginning before August 2, 1966, is not to be considered a change in method of accounting. Therefore, during this period of time, the new reserve may be established without permission of the Treasury Department.

## CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italic; existing law in which no change is proposed is shown in roman):

## INTERNAL REVENUE CODE OF 1954

### CHAPTER I—NORMAL TAXES AND SURTAXES

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#### Subchapter B—Computation of Taxable Income

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### PART II—ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

- Sec. 71. Alimony and separate maintenance payments.
- Sec. 72. Annuities; certain proceeds of endowment and life insurance contracts.
- Sec. 73. Services of child.
- Sec. 74. Prizes and awards.
- Sec. 75. Dealers in tax-exempt securities.
- Sec. 76. Mortgages made or obligations issued by joint-stock land banks.
- Sec. 77. Commodity credit loans.
- Sec. 78. Dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit.
- Sec. 79. Group-term life insurance purchased for employees.
- Sec. 80. Restoration of value of certain securities.
- Sec. 81. *Increases in suspense account under section 166(g).*

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#### SEC. 80. RESTORATION OF VALUE OF CERTAIN SECURITIES.

(a) **GENERAL RULE.**—In the case of a domestic corporation subject to the tax imposed by section 11 or 802, if the value of any security (as defined in section 165(g)(2))—

(1) which became worthless by reason of the expropriation, intervention, seizure, or similar taking by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing of property to which such security was related, and

(2) which was taken into account as a loss from the sale or exchange of a capital asset or with respect to which a deduction for a loss was allowed under section 165.

is restored in whole or in part during any taxable year by reason of any recovery of money or other property in respect of the property to which such security was related, the value so restored (to the extent that, when added to the value so restored during prior taxable years, it does not exceed the amount of the loss described in paragraph (2)) shall, except as provided in subsection (b), be included in gross income for the taxable year in which such restoration occurs.

(b) **REDUCTION FOR FAILURE TO RECEIVE TAX BENEFIT.**—The amount otherwise includible in gross income under subsection (a) in respect of any security shall be reduced by an amount equal to the

amount (if any) of the loss described in subsection (a)(2) which did not result in a reduction of the taxpayer's tax under this subtitle for any taxable year, determined under regulations prescribed by the Secretary or his delegate.

(c) CHARACTER OF INCOME.—For purposes of this subtitle—

(1) Except as provided in paragraph (2), the amount included in gross income under this section shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(2) If the loss described in subsection (a)(2) was taken into account as a loss from the sale or exchange of a capital asset, the amount included in gross income under this section shall be treated as long-term capital gain.

(d) TREATMENT UNDER FOREIGN EXPROPRIATION LOSS RECOVERY PROVISION.—This section shall not apply to any recovery of a foreign expropriation loss to which section 1351 applies.

**SEC. 81. INCREASES IN SUSPENSE ACCOUNT UNDER SECTION 166(g).**

*The amount of any increase in the suspense account required by paragraph (4)(B)(ii) of section 166(g) (relating to certain debt obligations guaranteed by dealers) shall be included in gross income for the taxable year for which such increase is required.*

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**SEC. 166. BAD DEBTS.**

(a) GENERAL RULE.—

(1) WHOLLY WORTHLESS DEBTS.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) PARTIALLY WORTHLESS DEBTS.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) AMOUNT OF DEDUCTION.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

(d) NONBUSINESS DEBTS.—

(1) GENERAL RULE.—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any non-business debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) NONBUSINESS DEBT DEFINED.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) **WORTHLESS SECURITIES.**—This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(f) **GUARANTOR OF CERTAIN NONCORPORATE OBLIGATIONS.**—A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) shall not apply), but only if the obligation of the borrower to the person to whom such payment was made was worthless (without regard to such guaranty, endorsement, or indemnity) at the time of such payment.

(g) **RESERVE FOR CERTAIN GUARANTEED DEBT OBLIGATIONS.**—

(1) **ALLOWANCE OF DEDUCTION.**—*In the case of a taxpayer who is a dealer in property, in lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) for any taxable year ending after October 21, 1965, a deduction—*

(A) *for a reasonable addition to a reserve for bad debts which may arise out of his liability as a guarantor, endorser, or indemnitor of debt obligations arising out of the sale by him of real property or tangible personal property (including related services) in the ordinary course of his trade or business; and*

(B) *for the amount of any reduction in the suspense account required by paragraph (4)(B)(i).*

(2) **DEDUCTION DISALLOWED IN OTHER CASES.**—*Except as provided in paragraph (1), no deduction shall be allowed to a taxpayer for any addition to a reserve for bad debts which may arise out of his liability as guarantor, endorser, or indemnitor of debt obligations.*

(3) **OPENING BALANCE.**—*The opening balance of a reserve described in paragraph (1)(A) for the first taxable year ending after October 21, 1965, for which a taxpayer maintains such reserve shall, under regulations prescribed by the Secretary or his delegate, be determined as if the taxpayer had maintained such reserve for the preceding taxable years.*

(4) **SUSPENSE ACCOUNT.**—

(A) **REQUIREMENT.**—*Except as provided by subparagraph (C), each taxpayer who maintains a reserve described in paragraph (1)(A) shall, for purposes of this subsection and section 81, establish and maintain a suspense account. The initial balance of such account shall be equal to the opening balance described in paragraph (3).*

(B) **ADJUSTMENTS.**—*At the close of each taxable year the suspense account shall be—*

(i) *reduced by the excess of the suspense account at the beginning of the year over the reserve described in paragraph (1)(A) (after making the addition for such year provided in such paragraph), or*

(ii) *increased (but not to an amount greater than the initial balance of the suspense account) by the excess of the reserve described in paragraph (1)(A) (after making the addition for such year provided in such paragraph) over the suspense account at the beginning of such year.*

(C) **LIMITATIONS.**—*Subparagraphs (A) and (B) shall not apply in the case of the taxpayer who maintained for his last*



taxable year ending before October 22, 1965, a reserve for bad debts under subsection (c) which included debt obligations described in paragraph (1)(A).

(D) SECTION 381 ACQUISITIONS.—The application of this paragraph in any acquisition to which section 381(a) applies shall be determined under regulations prescribed by the Secretary or his delegate.

**[(g)] (h) CROSS REFERENCES.—**

(1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

(3) For special rule for bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 593.

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**SEC. 381 CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.**

(a) GENERAL RULE.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334 (b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354 (b) (1) are met), or (F) of section 368 (a) (1).

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

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