THE TIME FOR TAKING DEDUCTIONS FOR LOSSES AND BAD DEBTS FOR INCOME TAX PURPOSES

ROBERT C. BROWN †

The present article is concerned solely with the question of when deductions for losses and bad debts can be taken for the purpose of federal or other taxes based upon net income. No consideration is given to the allowable amount of such deductions, or as to whether or not particular sorts of items are deductible at all; except, indeed, in so far as such questions are necessarily involved in the problem of when they may be taken. Otherwise, it is assumed that the deduction can be taken sometime.

The problem here presented is in large part correlative with the question of when income is realized for tax purposes.¹ However, the problem is not quite the same in all respects because of the more limited scope of such deductions. Nevertheless, the primary question as to both income and deductions is normally that of realization by the taxpayer.

The importance of this problem is fairly evident under all of the Federal Revenue Acts, including the existing Act of 1934. The first reason is because of the rather seriously fluctuating rates of taxation prescribed in the different acts. The government desires to get all income possible into high tax years and to assign the deductions to years when the rates are lower. The interest of the taxpayers is, of course, precisely opposite to this. Fairness to both the government and the taxpayers thus requires that the time element be determined accurately and fairly.

Another reason for the great importance of this question of the time for the deduction of losses and bad debts is the effect of the Statute of Limitations, which, as it affects both sides in income tax controversies, is relatively quite short. Here, too, there is possible unfairness to both sides; but on the whole the taxpayers are more likely to lose. Failure to take a deduction in what is later decided to be the proper period, either because he did not then realize that it was presently deductible or perhaps because he did not know of it at all, is likely, through the running of the short statutory period, to deprive a taxpayer of all the benefit from this deduction item.²

It appears that this problem has been under consideration by Congress for some time, and that it is realized that the present situation is often unfair

† A. B. 1914, Wesleyan University; LL. B. 1917, S. J. D. 1930, Harvard University; author of *Reduction of Tax Exemptions by Reason of Receipt of Tax-Exempt Income* (1932) 80 U. OF PA. L. REV. 534; *State Taxation of Interstate Commerce, and Federal and State Taxation in Inter-governmental Relations—1930-1932* (1933) 81 U. OF PA. L. REV. 247, and of numerous other articles in various legal periodicals; Professor of Law, Indiana University.

1. See Magill, *When is Income Realized?* (1933) 46 HARV. L. REV. 933.

2. See (1934) 19 IOWA L. REV. 631.

to the government and still more often to the taxpayers. Nevertheless, no substantial remedial provision could be agreed upon in the Revenue Act of 1934.³ The problem, therefore, remains.

It should also be noted, before going further, that several other complications of the tax provisions relating to these deductions will not be considered here. For example, no consideration will be given to the provisions of some of the Revenue Acts with respect to net losses.⁴ Similarly, the problem of inventory losses will not be considered here; nor the present tendency, shown especially in the 1934 Act, to limit the deductibility of capital losses. Finally, no consideration will be given to the problem of bad debt reserves. Such reserves, when permitted, are upon the theory of averaging, based on the general experience of the business, and are not predicated upon the bad debts which actually show up in the taxable year. Indeed, a taxpayer who is entitled to deduct an addition to a reserve for bad debts, and actually does so, is *ipso facto* precluded from taking any other deductions with respect to bad debts in that year.

In view of the difficulty of recognizing and sometimes of even knowing about such deductions—a difficulty which confronts nearly every taxpayer more or less frequently—it would appear that these deductions should be determined, at least in the first instance, upon a practical rather than a purely theoretical basis. The remark of Judge Learned Hand that “taxes, like other human affairs, must be determined without the gift of divination”,⁵ should be given especial weight under these circumstances. This theory assumes that the taxpayer should determine, in the first instance, the proper date for taking the deduction, and that he should not be reversed by the Bureau of Internal Revenue unless his decision was not merely mistaken as it now appears (with the added advantage of hindsight), but that it was clearly unreasonable and unfair at the time at which he was compelled to make his decision. As will presently appear, however, a considerable tendency has been directly the opposite. The position of the Bureau has generally been that such deductions—at least for losses—can and must be taken by the taxpayer according to what were the actual facts as now appearing, rather than on the basis of what he knew, or could reasonably have been expected to know, at the time. Even when it is yet a matter of real dispute, the Bureau apparently thinks that the taxpayer is bound to know not merely all the facts but what the Bureau itself will think the facts to mean. All this is more reminiscent of medieval metaphysics than of the practical com-

3. See Tyler and Ohl, *The Revenue Act of 1934* (1935) 83 U. OF PA. L. REV. 607, 643-644.

4. See, for example, *Jarvis v. Heiner*, 39 F. (2d) 361 (C. C. A. 3d, 1930). There is no such provision in the 1934 Act.

5. *DeLoss v. Commissioner of Internal Revenue*, 28 F. (2d) 803, 804 (C. C. A. 2d, 1928), *cert. denied*, 279 U. S. 840 (1929). See also *South Dakota Concrete Prod. Co.*, 26 B. T. A. 1429, 1432 (1932), where the Board said, “The deductions are practical necessities due to our inability to read the future.”

mon sense which is reasonably to be expected of men engaged in the very practical activity of administering an important revenue measure in a modern and highly organized state; nevertheless, such is the actual trend. Even attempts of Congress—notably in the Revenue Acts of 1921 and 1924⁶—to liberalize the situation as to losses to some degree have been given little weight by the Bureau, which is still generally committed to its highly metaphysical standpoint in this matter.

However, the Board of Tax Appeals, and even more clearly the courts, have often taken a somewhat less rigid, and therefore more practical and fairer, point of view. But even these supposedly more impartial tribunals are still more or less under the influence of the same metaphysical ideas. Even yet many courts give little more than lip service to the frequently and explicitly phrased idea that taxation is a practical matter. The present statement of the Circuit Court of Appeals for the Seventh Circuit that “the decisions do not appear always to be consistent”,⁷ is certainly far from an exaggeration of the situation.

Losses

A rather fundamental distinction, at least in theory, is derived from the taxpayer's basic method of keeping books.⁸ If he keeps his books on the accrual basis, he has considerably more leeway than if on a cash basis. While even on the cash basis there are no absolutely fixed rules, yet in general a taxpayer is not entitled to deduct losses until they are actually sustained.⁹ Thus, where his loss is incurred in the form of a liability to a third person, to whom he gives notes to cover his liability, the loss is not deductible until the notes are actually paid.¹⁰

The taxpayer who keeps books on the accrual basis has a larger opportunity for discretion. He is entitled to (indeed, he must) deduct all losses which are reasonably ascertainable, even though not actually sustained. Probably the leading case on this point is *United States v. Anderson*,¹¹ which involves the munitions tax imposed by the federal government during the World War. The litigating taxpayers incurred liability for these taxes in 1916 because of operations in this year, though the taxes were not actually due and payable until 1917. A reserve for the estimated amount of the munitions tax was set up in 1916, but the actual amount could not be precisely ascertained until 1917. The United States Supreme Court, speaking

6. See 3 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 26.64. See also *DeLoss v. Commissioner of Internal Revenue*, 28 F. (2d) 803, 804 (C. C. A. 2d, 1928), *cert. denied*, 279 U. S. 840 (1929).

7. *Commissioner of Internal Revenue v. Highway Trailer Co.*, 72 F. (2d) 913, 914 (C. C. A. 7th, 1934), *rev'g* 28 B. T. A. 792 (1933).

8. See PAUL AND MERTENS, *op. cit. supra* note 6, § 26.53.

9. *Osterloh v. Lucas*, 37 F. (2d) 277 (C. C. A. 9th, 1930).

10. *Eckert v. Burnet*, 283 U. S. 140 (1931), *aff'g* 17 B. T. A. 263 (1929) makes this distinction somewhat more clearly. See also I. T. 1167, Cum. Bull., June 1922, p. 149; A. R. M. 201, Cum. Bull., June 1923, p. 86.

11. 269 U. S. 422 (1926).

through Mr. Justice Stone, held that the munition taxes must be deducted in 1917. The Court says that the taxes had accrued in 1916 "in the economic and bookkeeping sense."

While the *Anderson* case did not strictly involve a deduction for losses, its principle has been applied in cases of that sort.¹² The courts require, however, that the amount of the loss be reasonably ascertainable, though actual precision to the penny is not required.¹³

The status of the taxpayer who keeps books on an accrual basis might thus seem reasonably satisfactory. But most taxpayers keep books—if they keep any at all—on the cash basis, and so do not have this advantage. Even provisions for spreading out income, like those for installment sales, are not applicable to losses.¹⁴ And, as will presently appear, even the taxpayer on the accrual basis may have serious difficulty with losses about which he does not know or about which he cannot tell whether or not they will subsequently be regarded as reasonably determinable in amount.

Turning now to the problem as affected by the kind of losses, the first and easiest category is a known loss, the amount of which can be reasonably ascertained. Where such a loss is caused by a casualty, it must be immediately deducted, even though the precise amount cannot be ascertained in that year¹⁵ and even if it may be made good by payments to third persons in subsequent years.¹⁶

A more troublesome problem occurs in connection with the abandonment of property, the title to which is retained by the taxpayer. The Bureau has recognized that such an abandonment of real property may justify the taking of a loss at the time of such abandonment,¹⁷ though with the proviso that it must actually be shown that the interest thus abandoned is actually worthless.¹⁸ There are numerous court decisions to the same effect,¹⁹ especially in connection with oil and mining interests in real estate.²⁰

12. *Spring City Foundry Co. v. Commissioner of Internal Revenue*, 292 U. S. 182 (1934); *Malleable Iron Range Co. v. United States*, 65 Ct. Cl. 441 (1928); *Deerland Turpentine Co.*, 4 B. T. A. 1236 (1926).

13. *Adams-Roth Baking Co.*, 8 B. T. A. 458 (1927). See also, to the same effect, *S. R. Davis*, 9 B. T. A. 755 (1927). This last decision was, however, reversed without opinion by the Circuit Court of Appeals, 7th Circuit. See PAUL & MERTENS, *op. cit. supra*, note 6, § 26.58, n. 58.

14. *Martin v. Commissioner of Internal Revenue*, 61 F. (2d) 942 (C. C. A. 2d, 1932); *Sack v. Burnet*, 66 F. (2d) 223 (App. D. C. 1933).

15. *Whipple v. United States*, 25 F. (2d) 520 (D. Mass. 1928); *Quito Electric Light & Power Co.*, 10 B. T. A. 538 (1928); *Edward H. R. Green*, 19 B. T. A. 904 (1930); *Ferguson v. Commissioner of Internal Revenue*, 59 F. (2d) 893 (C. C. A. 10th, 1932).

16. *Eagle Piece Dye Works*, 10 B. T. A. 1360 (1928).

17. G. C. M. 3890, Cum. Bull., June 1928, p. 168.

18. A. R. R. 3699, Cum. Bull., Dec. 1923, p. 123; G. C. M. 3890, Cum. Bull., June 1928, p. 168.

19. *Kilby Car & Foundry Co.*, 4 B. T. A. 1924 (1926); *Brumback v. Denman*, 48 F. (2d) 255 (N. D. Ohio 1930), *aff'd*, 58 F. (2d) 128 (C. C. A. 6th, 1932); *Ingle v. Gage*, 52 F. (2d) 738 (W. D. N. Y. 1931); *Ashland Iron & Mining Co. v. United States*, 56 F. (2d) 466 (Ct. Cl. 1932).

20. A. H. Fell, 7 B. T. A. 263 (1927); *Belridge Oil Co.*, 11 B. T. A. 127 (1928); *Sam Cook*, 25 B. T. A. 92 (1932). See also *Berrymont Land Co. v. Davis Creek Land & Coal Co.*, 110 W. Va. 305, 158 S. E. 651 (1931) (construing the federal income tax statute).

The fact that the taxpayer's lease on the property has not yet expired,²¹ or that he has not yet secured permission from the public authorities to make the abandonment, where that is required,²² does not necessarily preclude the deduction of the loss at the date of abandonment. But where the taxpayer continues operations,²³ or where other circumstances indicate that the abandonment is merely temporary,²⁴ the loss cannot be taken until the taxpayer's interest in the property is extinguished. Normally, however, such an abandonment of land is at least a *prima facie* basis for ascertaining the deductibility of the loss sustained at the date of abandonment.

The same principle has been applied to other than real property. Where such business property is definitely abandoned in a taxable year by giving up the business as unprofitable, the loss may be deducted in that year, even though the property is not disposed of.²⁵ But here, even more than in the case of real property, the abandonment is not necessarily sufficient of itself to justify a deduction; it must be shown by the taxpayer that the abandonment is permanent and that it was actuated by a definite determination that the particular business activity for which the property is used is or will become unprofitable.²⁶

Somewhat on the border line between property losses through abandonment and losses through casualties is a loss incurred through governmental activity, particularly seizure. Here it may well be said that the taxpayer has been compelled to abandon property through the casualty of unexpected governmental action, and that the loss thereby incurred is deductible when the government thus acts. And so it is generally held.²⁷ The leading case is *United States v. White Dental Co.*²⁸ Here an American corporation (the taxpayer) had a German subsidiary of which it held substantially all the stock, and to which it had made large advances. In 1918 the German government seized all the assets and business of the German corporation as enemy property. The American corporation charged off in its return for that year its entire investment in the German corporation, as a loss. This deduction was disallowed by the Bureau, on the theory that the American corporation had a chance to recover something from the German government after the war. In fact, in 1924 the taxpayer did secure

21. A. H. Fell, 7 B. T. A. 263 (1927). See also *Brumback v. Denman*, 48 F. (2d) 255 (N. D. Ohio 1930), *aff'd*, 58 F. (2d) 128 (C. C. A. 6th, 1932).

22. *Belridge Oil Co.*, 11 B. T. A. 127 (1928).

23. *Henry C. Rowe*, 19 B. T. A. 906 (1930).

24. *Coalinga-Mohawk Oil Co. v. Commissioner of Internal Revenue*, 64 F. (2d) 262 (C. C. A. 9th, 1933); *Boggs Oil Corp.*, 19 B. T. A. 940 (1930).

25. *Dean v. Hoffheimer Bros. Co.*, 29 F. (2d) 668 (C. C. A. 6th, 1928); *Charles M. Monroe Stationery Co.*, 15 B. T. A. 1227 (1929); *Reuben H. Donnelley Corp.*, 26 B. T. A. 107 (1932); *United States v. Hardy*, 6 F. Supp. 946 (S. D. W. Va. 1933), *aff'd*, 74 F. (2d) 841 (C. C. A. 4th, 1935).

26. I. T. 2167, Cum. Bull., June 1932, p. 29. But *cf.* *Royal Packing Co. v. Commissioner of Internal Revenue*, 22 F. (2d) 536 (C. C. A. 9th, 1927).

27. *G. C. M.* 10630, Cum. Bull., Dec. 1932, p. 97; *James H. Post*, 12 B. T. A. 510 (1928).

28. 274 U. S. 398 (1927).

an award by the Mixed Claims Commission, none of which had been realized, however, at the time of the Court's decision. The Court held that the deduction should have been allowed in 1918. Speaking by Mr. Justice Stone, it said: "It would require a high degree of optimism to discern in the seizure of enemy property by the German government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The Taxing Act does not require the taxpayer to be an incorrigible optimist."²⁹

All this is true, but it is also true that an omniscient person would have known that the taxpayer was fated to recover a small percentage of its loss after the war, and that the actual loss would therefore not be the full amount there shown. The case is therefore an authority that the deductibility of losses is to be computed upon a practical rather than a metaphysical basis. The fact that the taxpayer actually does recover something from the government in subsequent years does not invalidate the deduction in the year when the loss was, or at least in all human probability seemed to be, sustained. And it has even been held that governmental activity which reduced the value of assets of the taxpayer by a definitely ascertainable amount gave rise to an immediately deductible loss even though the assets were not abandoned and were even useful to a limited extent.³⁰ So far we seem to have a practical rather than a theoretical test.

The most frequent controversy in this sort of problem is with respect to corporate stocks which are claimed to have become worthless. When such stocks have become actually worthless, the cost or other proper basis must be immediately charged off as a loss, and cannot be held and the deduction taken at a later date.³¹ Thus, when a holder of trust company stock was apprised that the stock had become worthless, and the corporate assets were taken over by another trust company on an agreement of the stockholders of the first company to guarantee it against loss, the taxpayer was obliged to take the loss at that time, and could not take it when he was obliged in a later year to make good on his guaranty agreement.³² The Board held that the payment on the guaranty fund did not show that the

29. *Id.* at 403.

30. *Liberty Baking Co. v. Heiner*, 37 F. (2d) 703 (C. C. A. 3d, 1930). In this case the taxpayer bought small wrappers for its loaves of bread, to comply with the government regulation of the size of such loaves during the war. In 1918 this government regulation was removed, and the taxpayer had to use two wrappers on each loaf of bread of the larger size then made. It was held that the taxpayer could charge off in 1918 one-half the cost of these smaller wrappers, although they were not used up until the next year.

31. *Remington Typewriter Co.*, 4 B. T. A. 880 (1926); *Paul N. Myers*, 7 B. T. A. 1072 (1927); *John A. Krue*, 12 B. T. A. 448 (1928); *Smith & Rumery Co.*, 21 B. T. A. 352 (1930); *Darling v. Commissioner of Internal Revenue*, 49 F. (2d) 111 (C. C. A. 4th, 1931), *cert. denied*, 283 U. S. 866 (1931); *Ludlow Valve Co. v. Durey*, 57 F. (2d) 583 (N. D. N. Y. 1931); *William Gahagen*, 22 B. T. A. 828 (1931); *Dalton v. Bowers*, 56 F. (2d) 16 (C. C. A. 2d, 1932); *John Crosby Brown*, 27 B. T. A. 176 (1932); *Forbes v. Commissioner of Internal Revenue*, 62 F. (2d) 571 (C. C. A. 4th, 1933); *Falls City Ice Co.*, 27 B. T. A. 1346 (1933); *Monmouth Plumbing Supply Co., Inc. v. United States*, 4 F. Supp. 349 (S. D. Fla. 1933); *Johnson, Drake & Piper, Inc. v. Helvering*, 69 F. (2d) 151 (C. C. A. 8th, 1934).

32. *Lemuel S. McCleod*, 19 B. T. A. 134 (1930).

stock was any more worthless than it appeared to be previously. It is even held, though not with entire justice, that a taxpayer must take such a loss even though he is erroneously advised by a representative of the Bureau that it is not deductible;³³ or that he does not know that the stock is worthless though in fact it is.³⁴ While the fact that the corporation remains a going concern will generally be regarded as showing that the stock has not yet become wholly worthless, this may not be so in peculiar circumstances,³⁵ as where the property is merely operated to keep it from further depreciation.³⁶ A receivership or adjudication in bankruptcy of the corporation is ordinarily sufficient proof of the worthlessness of the stock, even though the proceeding is not yet terminated.³⁷ A reorganization of the corporation does not preclude a finding that the stock is worthless if the stockholders are in fact given no interest in the reorganized corporation, except by subscribing on an equal basis with the general public.³⁸ The mere fact, however, that a stockholder to whom the corporation is indebted cancels the debt in whole or in part, is obviously no proof that the stock is yet worthless; the only possible motive for such a transaction would be an attempt to save his investment in the stock.³⁹

It is also held that the fact that sales of the stock are made by others than the taxpayer at nominal amounts does not necessarily prove that the taxpayer's own stock has not become entirely worthless.⁴⁰ On the other hand, a sale by the taxpayer definitely proves that he has sustained a loss at the time of the sale.⁴¹ Unfortunately, however, it does not prove that the stock had not become worthless before this time; in fact it is generally so held when the sale by the taxpayer is obviously for a merely nominal amount and is therefore not much more than a matter of form. In such cases the loss must be taken when the stock became worthless and not at the later time when such a nominal sale was effected.⁴² However, the sale of stock at a loss does not, of course, prove in itself that the stock is worth-

33. *Darling v. Commissioner of Internal Revenue*, 49 F. (2d) 111 (C. C. A. 4th, 1931), *cert. denied*, 283 U. S. 866 (1931). See also *Volker v. United States*, 40 F. (2d) 697 (W. D. Mo. 1929).

34. *Leigh Carroll*, 20 B. T. A. 1029 (1930). Perhaps the decision can be sustained from an equitable standpoint, on the theory that the taxpayer ought to have known of the worthlessness of the stock. See also *Jarvis v. Heiner*, 39 F. (2d) 361 (C. C. A. 3d, 1930).

35. *Homer M. Preston*, 7 B. T. A. 414 (1927); *State Bank of Springfield*, 11 B. T. A. 410 (1928). See also *Volker v. United States*, 40 F. (2d) 697 (W. D. Mo. 1929).

36. *Henry Adamson*, 17 B. T. A. 17 (1929).

37. *In re Harrington*, 1 F. (2d) 749 (W. D. Mo. 1924). But *cf.* *Walter E. Templeman*, 20 B. T. A. 493 (1930).

38. *Union C. DeFord*, 19 B. T. A. 339 (1930). See also *A. J. Wallace*, 23 B. T. A. 858 (1931).

39. *Deeds v. Commissioner of Internal Revenue*, 47 F. (2d) 695 (C. C. A. 6th, 1931).

40. *Wesch v. Helburn*, 5 F. Supp. 581 (W. D. Ky. 1933).

41. *John C. Shaffer*, 28 B. T. A. 1294 (1933).

42. *Gowen v. Commissioner of Internal Revenue*, 65 F. (2d) 923 (C. C. A. 6th, 1933), *cert. denied*, 290 U. S. 687 (1933); *James L. Byrd*, 21 B. T. A. 1183 (1931); *A. J. Wallace*, 23 B. T. A. 858 (1931); *Harry C. Kayser*, 27 B. T. A. 816 (1933).

less.⁴³ Indeed, if it is a real sale, it proves quite the contrary. The sales which are disallowed as bases for determining the loss on a stock investment are those for a purely nominal price, which are, therefore, not entitled to be regarded really as sales.

The net result, however, is that a taxpayer who is well advised will claim the loss on stock which he believes to be of dubious value, immediately. If the loss is then allowed, well and good; if not, he has an opportunity to claim it in a later year. But if he does not claim it soon enough, the Statute of Limitations is likely to prevent his claiming it at all.⁴⁴

A taxpayer who is obliged to pay an obligation upon which he is a surety or is otherwise secondarily liable, is generally regarded as having sustained a loss, which loss is deductible in the year when the amount of such loss is definitely ascertainable.⁴⁵ The same is true as to the liability for a known tort⁴⁶ or for a deliberate breach of contract.⁴⁷ Such items, however, are apt to fall in the category of known but unascertainable losses, to be considered presently.

A mere misappropriation of corporation funds by an officer is generally unknown to the corporation until a subsequent period, and therefore usually falls under the category of unknown losses. However, if the misappropriation is known at once, and the amount is reasonably ascertainable, the loss may be immediately deducted.⁴⁸

The same general principles apply to other sorts of known deductible losses. When the transaction is completed, or when the taxpayers have done all that they are required to do and have no other substantial rights, the loss may be taken,⁴⁹ even though some attempt is made to recoup part of the loss by another separate transaction.⁵⁰

It may be said that the sustaining of a loss in connection with another transaction which is not yet completed, does not prevent the deduction of the loss. The problem is only whether the loss itself is actually ascertained. Thus, where a taxpayer entered into a hedging contract to protect a future commodity contract, and the hedging contract was closed out in 1920 at a loss, the loss was held to be deductible in 1920, and not in the subsequent

43. J. Harry Ladew, 22 B. T. A. 443 (1931). See also John C. Shaffer, 28 B. T. A. 1294 (1933).

44. See (1934) 19 IOWA L. REV. 631.

45. *M. A. Burns Mfg. Co. v. Commissioner of Internal Revenue*, 59 F. (2d) 504 (C. C. A. 9th, 1932); *Landers Bros. Co. v. Commissioner of Internal Revenue*, 60 F. (2d) 85 (C. C. A. 6th, 1932). See also *Deerland Turpentine Co.*, 4 B. T. A. 1236 (1926).

46. *Malleable Iron Range Co. v. United States*, 65 Ct. Cl. 441 (1928).

47. See *George C. Peterson Co.*, 1 B. T. A. 690 (1925).

48. *Bank of Wyoming*, 22 B. T. A. 1132 (1931).

49. *Mrs. J. C. Erwin*, 7 B. T. A. 919 (1927); *Burnet v. Riggs National Bank*, 57 F. (2d) 980 (C. C. A. 4th, 1932); *George Levenworth*, 27 B. T. A. 21 (1932). But cf. *S. R. Davis*, 9 B. T. A. 755 (1927), where a loss of this kind was denied as a deduction, on a finding that the transaction was not completed. The decision of the Board was, however, reversed by the Circuit Court of Appeals, 7th Circuit, and the loss allowed. See note 13, *supra*.

50. *W. H. Dail, Jr.*, 19 B. T. A. 1036 (1930).

year when the future contract was closed out.⁵¹ Conversely, the fact that the other contract is closed out does not permit the taking of an unsustained loss.⁵² In other words, a transaction connected but not identical with the one as to which the loss is claimed is immaterial in this problem, except as it may affect the actual realization of the loss.⁵³

It is obvious, therefore, that the problem of the deduction of known and ascertainable losses is involved in much confusion. When consideration is made of the question of deductibility of known losses, the amount of which cannot be reasonably ascertained, the confusion in the authorities is multiplied.

Of course, if the loss, while clearly predictable, is not yet actually sustained (or at least accrued, where the taxpayer keeps his books on that basis), it is not deductible.⁵⁴ Thus, where a taxpayer bought land thinking he had obtained the entire interest and found through litigation that he had acquired only a one-seventh interest, no loss was actually sustained, and none was therefore deductible until he sold the land.⁵⁵ And *a fortiori* a mere estimate of expected future losses cannot be deducted.⁵⁶ The transaction giving rise to the loss must be not merely contemplated but actually consummated.⁵⁷ A rather peculiar application of this rule occurs in *Squier v. Commissioner of Internal Revenue*,⁵⁸ where the plaintiffs' decedent held most of the stock and was active in the affairs of two affiliated corporations. His death caused the stock of these corporations to become worthless. It was held that no loss was sustained by the decedent, though probably a deductible loss was sustained by his estate. It is a little difficult to see how either the decedent or his estate sustained a loss, but certainly the court seems correct in saying that the decedent did not sustain a loss which came about only through his own death.

But even the government has not been absolutely inflexible in this requirement. The applicable ruling in the regulations is as follows: "In general losses must be evidenced by closed and completed transactions."⁵⁹ Obvi-

51. *Edward R. Bacon Co. v. Reinecke*, 26 F. (2d) 705 (N. D. Ill. 1928).

52. *P. Canizzaro & Co.*, 19 B. T. A. 380 (1930). See also *LaSalle Cement Co. v. Commissioner of Internal Revenue*, 59 F. (2d) 361 (C. C. A. 7th, 1932), *cert. denied*, 287 U. S. 624 (1932).

53. *Max Sarfert*, 5 B. T. A. 977 (1926); *Hans Pederson*, 14 B. T. A. 1089 (1929); *George Levenworth*, 27 B. T. A. 21 (1932); *John C. Shaffer*, 28 B. T. A. 1294 (1933).

54. *A. R. R.* 185, Cum. Bull., Dec. 1920, p. 156; *Wilford C. Saeger*, 9 B. T. A. 890 (1927); *Osterloh v. Lucas*, 37 F. (2d) 277 (C. C. A. 9th, 1930); *Seiberling v. Commissioner of Internal Revenue*, 38 F. (2d) 810 (C. C. A. 6th, 1930); *Clark Dredging Co. v. Commissioner of Internal Revenue*, 63 F. (2d) 527 (C. C. A. 5th, 1933).

55. *George C. Beidleman*, 7 B. T. A. 899 (1927). See also *Daniels & Fisher Stores Co. v. United States*, 56 F. (2d) 477 (Ct. Cl. 1932).

56. *Brown v. Helvering*, 291 U. S. 193 (1934); *Ewing Thomas Converting Co. v. McCaughn*, 43 F. (2d) 503 (C. C. A. 3d, 1930).

57. *Joseph Z. Muir*, 4 B. T. A. 893 (1926); *W. F. Collier*, 5 B. T. A. 961 (1926); *Solomon Silberblatt*, 28 B. T. A. 73 (1933). See also *Pugh v. Commissioner of Internal Revenue*, 49 F. (2d) 76 (C. C. A. 5th, 1931).

58. 68 F. (2d) 25 (C. C. A. 2d, 1933), *aff'd* 26 B. T. A. 1407 (1932).

59. U. S. Treas. Reg. 86, Art. 23 (e)-1. Similar language has appeared in regulations under previous acts.

ously this is not, even in form, a very rigid rule.⁶⁰ It is probable, however, that the phrase "in general" is intended by the Bureau to apply only in cases of loss by casualty or the actual abandonment of property, which have already been considered. Certainly the rulings of the Bureau and even of the Board of Tax Appeals and the courts do not generally give greater leeway than this.

But even if the loss is apparently sustained, the amount may yet be considered so uncertain as to result in its being disallowed as a deduction.⁶¹ Sometimes the reasoning is that a loss, the amount of which is not definitely ascertained, is not yet sustained;⁶² but this is obviously somewhat fictitious. The rule is justified, however, from a practical standpoint. Thus, where a corporation discovered an embezzlement by one of its employees in 1917, it could not take the loss in that year because it had insurance and could not therefore determine the amount of the loss.⁶³ In any case where the amount of the loss can only be ascertained by litigation, the deduction is usually denied until the litigation is completed.⁶⁴ Similarly, where the amount of the loss can only be ascertained by finally disposing of the property or business with respect to which the loss is claimed, the deduction is denied, even though the circumstances are such that it may seem reasonably clear that the loss was actually sustained before that time.⁶⁵

Probably the leading case on this branch of the subject is *Lucas v. American Code Co.*⁶⁶ Here the taxpayer employed one Farquhar as sales manager for eighteen years from 1919. The same year Farquhar was discharged, and promptly sued for breach of contract. The taxpayer immediately set up a reserve for the estimated amount of his commissions (somewhat over \$14,000), and increased this reserve in 1920 to over \$30,000. In 1922 Farquhar secured a verdict against the taxpayer for \$21,019.19, and that verdict was affirmed by the highest court of the state in 1923. The taxpayer claimed the amount of the judgment as a deduction for 1919. This was denied by the Bureau, which ruled that the loss could be deducted only in 1923, when the amount was finally determined. The

60. See the discussion in PAUL AND MERTENS, *op. cit. supra* note 6, § 26.54.

61. *Louis Kratter*, 4 B. T. A. 52 (1926); *Lane Construction Corp.*, 17 B. T. A. 826 (1929); *Columbus Plate & Window Glass Co. v. Miller*, 38 F. (2d) 509 (S. D. Ohio 1930); *John R. Lankenau Co. v. United States*, 46 F. (2d) 158 (D. Mass. 1930); *J. N. Pharr & Sons v. Commissioner of Internal Revenue*, 56 F. (2d) 832 (C. C. A. 5th, 1932); *Burnet v. Imperial Elevator Co.*, 66 F. (2d) 643 (C. C. A. 8th, 1933); *Lyon v. United States*, 5 F. Supp. 138 (Ct. Cl. 1933); *Commissioner of Internal Revenue v. Highway Trailer Co.*, 72 F. (2d) 913 (C. C. A. 7th, 1934), *rev'd* 28 B. T. A. 792 (1933).

62. *Allied Furriers Corp.*, 24 B. T. A. 457 (1931). See also *Dresser v. United States*, 55 F. (2d) 499 (Ct. Cl. 1932).

63. *Piedmont Grocery Co. v. United States*, 66 Ct. Cl. 468 (1928), *cert. denied*, 280 U. S. 553 (1929).

64. *G. C. M.* 11774, Cum. Bull., June 1933, p. 222; *Israel T. Deyo*, 9 B. T. A. 900 (1927); *American Trust Co. v. Commissioner of Internal Revenue*, 31 F. (2d) 47 (C. C. A. 9th, 1929); *Central Trust Co. v. Burnet*, 45 F. (2d) 922 (App. D. C. 1930).

65. *Fidelity Storage Corp. v. Burnet*, 58 F. (2d) 526 (App. D. C. 1932).

66. 280 U. S. 445 (1930).

Supreme Court affirmed this ruling. The Court conceded that if the liability had been admitted and had been reasonably predictable, the loss would have been deductible in 1919. As to this the Court said:

"Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. *Weiss v. Wiener*, 279 U. S. 333, 335. Exception is made however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction, in certain circumstances, before they are absolutely realized. As respects losses occasioned by the taxpayer's breach of contract, no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test. And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful." ⁶⁷

This holding is a clear indication by the Court that losses are to be computed upon a practical rather than a theoretical basis. Unquestionably, the loss was theoretically incurred in 1919 when the contract was broken; and again an omniscient being would have known this, and also known the amount of the loss. The Court takes the sensible view that the taxpayer is neither required to be omniscient, nor is he permitted to claim omniscience merely by hindsight. Such a position should be taken in all cases.

The *American Code Co.* case has been followed in a number of other decisions; ⁶⁸ but it will soon appear that it is frequently repudiated with respect even to unknown losses, where it would appear that a practical solution would be even more essential. But this line of cases, so far as it goes, is a strong argument in favor of a practical rather than a theoretical consideration of this problem.

On the other hand, a known loss, the amount of which is readily ascertainable, can and must be deducted at once.⁶⁹ The correctness of this ruling is hardly to be doubted, though its application in particular cases is necessarily troublesome.⁷⁰ For example, there are some authorities indicating that the setting aside by the taxpayer of an estimated amount will permit the deduction of that amount even though the loss turns out later to be

67. *Id.* at 449.

68. See cases cited notes 61-65, *supra*.

69. *Malleable Iron Range Co. v. United States*, 65 Ct. Cl. 441 (1928); *Falls City Ice Co.*, 27 B. T. A. 1346 (1933).

70. *Equity Fire Ins. Co.*, 7 B. T. A. 618 (1927); *C. P. Mayer*, 16 B. T. A. 1239 (1929).

considerably different.⁷¹ The propriety of such rulings is extremely doubtful, and their reasoning has been repudiated in other authorities.⁷² The reasoning of the Board of Tax Appeals on this subject in an early decision⁷³ seems convincing. Here the taxpayer sustained a loss by fire in 1918, but the amount could not be ascertained until certain damaged machinery was repaired, which could not be done until 1919. It was held that the loss could not be deducted until 1919, the Board saying:

"In order to have been in a position to claim a deduction in 1918, the taxpayer would have been required to justify, with at least some degree of accuracy, the amount of the loss; otherwise the deduction from gross income for 1918 would have represented a mere guess, in all probability, unjust either to the Government or to itself. It is evident, therefore, that whatever amount the petitioner might have computed, with no more information than it had, would have been conjectural, because it was not in possession of information necessary to enable it to make such computation."⁷⁴

But if the loss is readily computable, it must be deducted even though there may be some possibility (apart from definite legal rights through insurance,⁷⁵ *etc.*) of recouping some of the loss.⁷⁶ The Board has extended this principle so far as to hold that where property of an American citizen was seized during the War by the government under the erroneous belief that the taxpayer was a German, the depreciation of the securities in the hands of the Alien Property Custodian could be deducted by the taxpayer as of the date of seizure.⁷⁷ The correctness of this ruling is distinctly doubtful; the taxpayer had an immediate right to sue for the return of the property, and his apparent inability to finance such a suit certainly cannot fairly be regarded as marking the sustaining of a loss through the depreciation of the securities, when depreciation took place only in subsequent years.⁷⁸

Where embezzlement takes places, the loss is usually not found out at once. When it is discovered, however, the victim undoubtedly has a claim

71. *Becker Bros. v. United States*, 7 F. (2d) 3 (C. C. A. 2d, 1925); *H. P. Robertson Co.*, 14 B. T. A. 887 (1928). It has even been held that a taxpayer may immediately deduct the amount which he pays in compromise in a subsequent year. *Producers Fuel Co.*, 1 B. T. A. 202 (1924); *Raleigh Smokeless Fuel Co.*, 6 B. T. A. 381 (1927).

72. *Consolidated Tea Co., Inc. v. Bowers*, 19 F. (2d) 382 (S. D. N. Y. 1927); *Lynchburg Colliery Co.*, 7 B. T. A. 282 (1927); *Max Kurtz et al.*, 8 B. T. A. 679 (1927); *Benjamin v. Commissioner of Internal Revenue*, 70 F. (2d) 719 (C. C. A. 2d, 1934).

73. *Pike County Coal Corp.*, 4 B. T. A. 625 (1926).

74. *Id.* at 627.

75. *T. B. R. 55*, Cum. Bull., Dec. 1919, p. 123; *A. R. R. 542*, Cum. Bull., June 1921, p. 143.

76. *Missouri Valley Bridge & Iron Co.*, 14 B. T. A. 1162 (1929); *Mummert Lumber & Tie Co.*, 16 B. T. A. 1188 (1929).

77. *Richard G. Wagner*, 9 B. T. A. 925 (1927); *Albert F. Galloway, Trustee*, 10 B. T. A. 747 (1928); *cf. Commissioner of Internal Revenue v. Brown*, 54 F. (2d) 563 (C. C. A. 1st, 1931), *cert. denied*, 286 U. S. 556 (1932).

78. See *Paul Haberland*, 21 B. T. A. 446 (1930).

against the embezzler and may be able to secure a note or other definite promise from him to repay.⁷⁹ Where that is the case, the loss may well be regarded as unascertainable. This, too, becomes a practical question; but if the rights of reimbursement are apparently of any substantial value, the loss is usually regarded as unascertainable until the amount which will actually be realized is determined. The language of Mr. Chief Justice Hughes, in a case where the taxpayer's partner paid a debt to him by embezzling trust funds, which funds the taxpayer was compelled to restore in a later year, is instructive upon this point.

"The instant case aptly illustrates the importance of this principle and calls for its application. Huff himself received the entire amount embezzled. He received this amount in payment of notes given to him by his firm to cover his advances to the firm. If he was liable to restore the amount taken from the trust fund, he himself had the full sum that was to be restored. So far as his individual estate was concerned, he had lost nothing by the embezzlement. If Huff had learned of the embezzlement immediately upon the payment to him and had at once restored the entire amount to the trust fund, he would have been in the same position as that in which he was before he received the money; that is, he would have held the partnership notes, for his advances to the partnership, which had not been properly discharged. Huff's personal wealth would have remained the same as it was prior to the embezzlement, and his individual gains or losses would have turned not upon the embezzlement but upon the result of the partnership business."⁸⁰

It would appear that most of the authorities on this particular question can be justified upon the basis that the problem of the time for the deduction of a loss is practical rather than theoretical. As has been seen, there may well be dispute in many cases as to whether the loss is sufficiently determined in amount as to justify the deduction; but the very consideration of this question is an admission that the problem is a practical rather than a theoretical one. If one is to decide on a theoretical basis, the amount of the loss is immaterial. The only question is whether or not the loss has actually been sustained, and if so, it must, according to this theoretical view, be taken immediately. Even if lip service is given to the theoretical view, any consideration of the problem as to whether the loss, which has concededly been sustained, can be reasonably computed, is itself an application of the practical, rather than the theoretical, test.

It must be conceded, however, that occasionally, though rarely, the actual time when a known loss takes place may be somewhat doubtful. This is pointed out by the decision of the Board in the case of *Martin Veneer*

79. *Burnet v. Huff*, 288 U. S. 156 (1933).

80. *Id.* at 161.

Co.⁸¹ Here a building belonging to the taxpayer was burned on December 30, 1919, and the ruins continued to burn during New Year's Day, 1920. It was held that the loss was entirely sustained in 1919, though the precise amount could not be ascertained until 1920. It may be inferred that the loss was practically total, so that any salvage would be insignificant. On this basis the result may very probably be correct. Suppose, however, that the fire had broken out just before midnight on December 31. In that event the building would have been partially, but only partially, destroyed in 1919, and the remainder of the loss would have occurred in 1920. Yet it could never be ascertained how much of the loss occurred in each year. Perhaps the taxpayer would have been required to apportion the loss on a time basis,⁸² but such a suggestion is obviously silly. For all practical purposes, such a loss would have been fully sustained in 1920, and it should be allowed and required to be deducted in that year.

So much for known losses. As for unknown losses, in their case the confusion is, if possible, even worse.

There are undoubtedly circumstances where it is difficult to decide whether the loss may be regarded as known or unknown. For example, there may be a known event but one where it is not immediately known that such event will give rise to a loss. Thus, the taxpayer may have a definite claim against a third person, but nevertheless sustain a loss by reason of the unknown insolvency of his debtor.⁸³ However, the problem usually arises where the event giving rise to the loss is wholly unknown to the taxpayer. The typical example of this is the case of an embezzlement by one of the taxpayer's officers or employees, such embezzlement not being discovered until some time after it takes place.

While even the Bureau of Internal Revenue is not perhaps altogether consistent in its point of view with regard to such cases,⁸⁴ the strong trend of its rulings is in favor of the position that the loss by embezzlement occurs at the time the embezzlement actually takes place, and not when it is discovered.⁸⁵ Such rulings frequently favor the taxpayer,⁸⁶ but more often are to his detriment. The taxpayer will be permitted to file amended returns for the years in which the then unknown embezzlement occurred, so as to take advantage of this deduction;⁸⁷ but this will not help if the Statute of Limitations has run.

81. 5 B. T. A. 207 (1926). See also *National Sash & Door Co.*, 5 B. T. A. 931 (1926).

82. *American Multigraph Co.*, 10 B. T. A. 406 (1928).

83. *Lewellyn v. Electric Reduction Co.*, 275 U. S. 243 (1927). See also *Emil Stern*, 5 B. T. A. 89 (1926). This is usually a bad debt rather than a loss problem.

84. A. R. R. 269, Cum. Bull., Dec. 1920, p. 158; I. T. 1167, Cum. Bull., June 1922, p. 149.

85. O. 845, Cum. Bull., Dec. 1919, p. 118; A. R. M. 144, Cum. Bull., Dec. 1921, p. 139; I. T. 1470, Cum. Bull., Dec. 1922, p. 60; A. R. R. 2503, Cum. Bull., Dec. 1923, p. 131; S. M. 2040, Cum. Bull., Dec. 1924, p. 192.

86. E. g., A. R. R. 2503, Cum. Bull., Dec. 1923, p. 131.

87. O. 845, Cum. Bull., Dec. 1919, p. 118.

The courts and the Board of Tax Appeals have in many decisions taken exactly the same view.⁸⁸ It is sometimes conceded that such a result is unjust;⁸⁹ but there is a constant reiteration of the idea that the loss occurred at the time of the embezzlement even though no one knew anything about it and that therefore the loss must be taken as a deduction at that time. A more perfect example of a logical *non sequitur*, made still worse by being based upon a pure abstraction, could hardly be imagined. Mundane affairs, and especially the most unpleasantly practical subject of taxation, are a poor field for such impractical speculation.

Fortunately, the courts do not always so reason. Sometimes impliedly⁹⁰ and sometimes expressly,⁹¹ the deduction is permitted on the practical and sensible basis that the loss should be regarded as actually incurred when it is first known. Occasionally an attempt is made to rationalize this result, and make it consistent with the cases demanding that the loss be taken when the embezzlement takes place, by distinguishing cases where the embezzlement is not of the taxpayer's property but of property for which he is responsible. It is said that in such cases the embezzlement does not cause the loss, which occurs only when the payment is made to the persons whose property was embezzled.⁹² But, with submission, this is a distinction without a difference. On the basis of the metaphysical reasoning, the embezzlement does actually cause the loss to the taxpayer because it immediately subjects him to the liability of replacing the stolen property.

Sometimes, however, the deduction is permitted in the year of discovery even where this specious distinction is not applicable.⁹³ A leading case on the point is *Douglas County Light & Water Co. v. Commissioner of Internal Revenue*.⁹⁴ Here the president of the taxpayer corporation embezzled certain of its bonds. Upon discovery of the embezzlement, the corporation exacted from him a note covering the amount of the misappropriation, which note was later charged off as worthless. The court allowed the loss at the time the note was charged off. The opinion is a *per curiam* opinion—perhaps an indication that the court realized the weakness of its logic, which was to the effect that the bonds did not constitute a part of the taxpayer's assets and therefore, forsooth, the misappropriation of them

88. *United States v. Central Nat. Bank*, 15 Fed. 222 (S. D. N. Y. 1883) (construing the Revenue Act of 1864); *Howard J. Simons*, 1 B. T. A. 351 (1925); *Lawrence N. Miller*, 7 B. T. A. 581 (1927); *Peterson Linotyping Co.*, 10 B. T. A. 542 (1928); *Leigh Carroll*, 20 B. T. A. 1029 (1930); *Piggly Wiggly Corp.*, 28 B. T. A. 412 (1933); *Gottlieb Realty Co.*, 28 B. T. A. 418 (1933); *Alabama Mineral Land Co.*, 28 B. T. A. 586 (1933).

89. *First Nat. Bank of Sharon v. Heiner*, 2 F. Supp. 960 (W. D. Pa. 1932).

90. *Black v. Bohlen*, 268 Fed. 427 (W. D. Okla. 1920).

91. *Israel T. Deyo*, 9 B. T. A. 900 (1927); *Peter Frees, Jr.*, 12 B. T. A. 737 (1928); *John H. Farish & Co. v. Commissioner of Internal Revenue*, 31 F. (2d) 79 (C. C. A. 8th, 1929); *Alvin C. Cass*, 16 B. T. A. 1341 (1929).

92. *Israel T. Deyo*; *Peter Frees, Jr.*; *John H. Farish & Co. v. Commissioner of Internal Revenue*, 31 F. (2d) 79 (C. C. A. 8th, 1929), all *supra* note 91.

93. *Alvin C. Cass*, 16 B. T. A. 1341 (1929).

94. 43 F. (2d) 904 (C. C. A. 9th, 1930).

did not cause the loss to the taxpayer! It is rather an amazing proposition that a corporation sustains no damage through the illegal distribution of its own negotiable bonds when it receives no consideration therefor. But the court need not have been quite so timid. Actually it was bringing about a sensible and desirable result, and it is only to be regretted that it persisted in an impossible effort at rationalization. Much better is the frank statement of the court near the end of the opinion, as follows:

"Claimed deductions for doubtful debts or inchoate losses are not to be encouraged, and therefore the taxpayer ought not to be penalized for deferring his claim for deductions until he has in good faith resorted to reasonable measures for avoiding or minimizing a threatened loss. Owing to the tendency to lower the tax rates, postponement of such a claim works to the benefit rather than to the injury of the government." ⁹⁵

At present, tax rates are not going down, but it should not be a problem whether a particular result happens to be favorable to the government or to the taxpayer. The real question is when is the loss sustained according to practical and sensible tests. No doubt it is sometimes difficult to find an answer; but certainly the loss cannot be regarded as sustained, in any jurisdiction other than the well-known "cloud-cuckoo land", before anyone but a particular wrongdoer (who has carefully concealed it) knows anything about it.

The embezzlement situation is obviously the one of most frequent occurrence where the event which causes the loss is wholly unknown until a period—sometimes a long period—after it occurs. Another situation where essentially the same problem is presented is where the taxpayer makes a sale in one year and is compelled to make good on a non-fraudulent breach of warranty in a subsequent year. In the one case found involving this situation it was held that the loss was sustained and deductible in the year in which payment was made for the breach of warranty.⁹⁶ This, too, seems to favor the practical view here contended for, since the liability was theoretically incurred at the time of the sale. It is to be hoped that the Bureau and the courts will follow increasingly the common sense view of the situation, which frequently crops up in their own decisions, notwithstanding their fondness for attempting metaphysical thought.

Bad Debts

With respect to bad debts the situation seems easier for the taxpayer, even without the use of the provisions for a reserve.⁹⁷ Even where no

^{95.} *Id.* at 905.

^{96.} *Henningsen Produce Co. v. Commissioner of Internal Revenue*, 37 F. (2d) 821 (App. D. C. 1930).

^{97.} See Note (1930) 64 U. S. L. Rev. 36.

reserve is set up and such debts are individually considered, there is a wide scope for the voluntary action of the taxpayer and the effectiveness of his business judgment,⁹⁸ although the statute by no means gives the taxpayer *carte blanche* as to the time of taking bad debts as a deduction.

First, however, it is necessary to consider the distinction between a loss and a bad debt. They are often both present in a particular case, and it is not always easy to decide which one actually is involved in the controversy. The difference in treatment, however, makes this distinction of great practical importance. The Board of Tax Appeals has succinctly stated the importance of the distinction as follows: "The importance of the distinction lies in the fact that the statute permits bad debts to be deducted in the year in which ascertained to be bad, whereas it provides that losses are deductible only in the year in which suffered."⁹⁹

Nevertheless, there was for a time an idea given considerable judicial approval that there really is no definite distinction between bad debts and losses;¹⁰⁰ that the deduction could be taken on either basis whenever these two concepts could in any way reasonably be regarded as involved. In some cases, too, the authorities seemed to confuse the two deductions without intending to.¹⁰¹ The result of such confusion was not infrequently somewhat absurd,¹⁰² and it certainly did unduly favor the taxpayer, by permitting him to use whichever theory was most advantageous to sustain his claim. For a time, this idea was given some support by the Supreme Court.¹⁰³

The situation is complicated by the frequency with which there arise cases undoubtedly involving both sorts of deductions. For example, in the case of an embezzlement the taxpayer always has a claim for reimbursement against the embezzler.¹⁰⁴ Furthermore, a purported loan by a corporation to a third person may, because of the relationship between the officer and that third person, amount essentially to an embezzlement, and should be treated as such.¹⁰⁵ Where the claim against the embezzler is apparently of some value, it is perhaps justifiable to treat it as a debt, and

98. R. T. Coburn, 16 B. T. A. 1344 (1929); *Stranahan v. Commissioner of Internal Revenue*, 42 F. (2d) 729 (C. C. A. 6th, 1930).

99. *Hector Fezandie, Executor*, 12 B. T. A. 1325, 1332 (1928). See also Note (1930) 64 U. S. L. REV. 36.

100. *Alvin C. Cass*, 16 B. T. A. 1341 (1929); *John H. Farish & Co. v. Commissioner of Internal Revenue*, 31 F. (2d) 79 (C. C. A. 8th, 1929); *Sherman & Bryan, Inc. v. Blair*, 35 F. (2d) 713 (C. C. A. 2d, 1929); *Davidson Grocery Co. v. Lucas*, 37 F. (2d) 806 (App. D. C. 1930); *John Crosby Brown*, 27 B. T. A. 176 (1932); *Birdsboro Steel Foundry & Machinery Co. v. United States*, 3 F. Supp. 640 (Ct. Cl. 1933).

101. *Wyatt Metal & Boiler Co.*, 6 B. T. A. 673 (1927); *O. E. Fletcher*, 20 B. T. A. 1234 (1930). See also *Southern Cal. Box Co. v. United States*, 46 F. (2d) 724 (Ct. Cl. 1931).

102. See *Sawyer Tanning Co. v. J. C. O'Keefe Shoe Co.*, 23 F. (2d) 717 (D. Mass. 1927).

103. *Lewellyn v. Electric Reduction Co.*, 275 U. S. 243 (1927).

104. *Alvin C. Cass*, 16 B. T. A. 1341 (1929).

105. *Bank of Wyoming*, 22 B. T. A. 1132 (1931). See also *Parker Wire Goods Co.*, 8 B. T. A. 448 (1927).

to charge it off when it later becomes bad.¹⁰⁶ Such a procedure is a confusion between bad debts and losses, but seems inevitable in the nature of things. More usually, however, the claim against the embezzler is worthless to start with, and the loss should not be permitted to be treated as a bad debt.¹⁰⁷

Where the taxpayer, the victim of an embezzler, has a claim against sureties on his bond, such claim will of course reduce the loss.¹⁰⁸ However, in a case where the surety itself disclaimed liability and defeated an action by the taxpayer on the bond, it was held that this was a mere loss and not a bad debt, the court saying:

"It was the duty of plaintiff to take any legal steps which might enforce payment, unless the circumstances were such that there could be no reasonable expectation of obtaining payment thereby. The appeal to the Supreme Court was only another step in enforcing the plaintiff's claim which related back to the loss caused by the embezzlement."¹⁰⁹

Somewhat similar is the problem presented in *Lewellyn v. Electric Reduction Co.*¹¹⁰ Here the taxpayer in 1918 made an advance payment on a purchase of goods to be delivered in installments. In 1919 the seller defaulted, and the taxpayer brought suit against the seller and also separate suits against the broker and the bankers to whom the broker had endorsed the bill of exchange. A judgment was obtained in 1919 against the seller, but proved uncollectible. In the suit against the broker the defendant secured judgment. In 1922, while the suit against the bankers was pending, they became insolvent, and the suit was discontinued. The plaintiff claimed that it had sustained the loss in 1918, but the Court, though assuming that the bad debt and loss deductions were not mutually exclusive, held that the loss was not sustained until 1922. The gist of the reasoning is shown in the following quotation from the opinion by Mr. Justice Stone:

"But we do not think that a loss resulting from a buyer's prepayment to a seller who proves to be irresponsible is necessarily sustained, in the statutory meaning, as soon as the money is paid. The statute was intended to apply not only to losses resulting from the physical destruction of articles of value but to those occurring in the operations of trade and business, where the business man has ventured on a course of action in the reasonable expectation that the promised

106. *John H. Farish & Co. v. Commissioner of Internal Revenue*, 31 F. (2d) 79 (C. C. A. 8th, 1929); *Ledger Co. v. United States*, 37 F. (2d) 775 (Ct. Cl. 1930); *Douglas County Light & Water Co. v. Commissioner of Internal Revenue*, 43 F. (2d) 904 (C. C. A. 9th, 1930). See also *People ex rel. Central Union Trust Co. v. Loughman*, 249 N. Y. 409, 164 N. E. 333 (1928) (involving a similar problem under the New York net income tax law.)

107. *Peterson Linotyping Co., 10 B. T. A. 542* (1928); *Gottlieb Realty Co., 28 B. T. A. 418* (1933). See also *Porter v. United States*, 20 F. (2d) 935 (D. Idaho 1927).

108. *First Nat. Bank of Sharon v. Heiner*, 2 F. Supp. 960 (W. D. Pa. 1932).

109. *Piedmont Grocery Co. v. United States*, 66 Ct. Cl. 468, 474 (1928), *cert. denied*, 280 U. S. 553 (1929).

110. 275 U. S. 243 (1927), cited note 103, *supra*.

conduct of another will come to pass. Not only the future success of the business but its present solvency depends on the probable accuracy of his prophecy. Only when events prove the prophecy to have been false can it be said that he has suffered. His case is not like that of a man who fails to learn of the theft of his bonds or the burning of his house until a year after the occurrence; but rather resembles the position of a merchant who buys in one year, for sale in the next, merchandise which shifting fashion renders unsaleable in the latter. It may well be that he whose house has been burned has sustained a loss whether he knows it or not and may recover a tax paid in ignorance of that material fact. But we cannot say that the merchant whose action has been based not merely on ignorance of a fact but on faith in a prophecy—even though the prophecy is made without full knowledge of the facts—can claim to have sustained a loss before the future fails to justify his hopes.”¹¹¹

This is a somewhat liberal view as to the time when the loss is deductible, though in these particular facts it happened to favor the government. But the Court held that it was not a case of a bad debt, because the seller had not repudiated. The result is sound, but the reason why no deduction as a bad debt should have been allowed is rather because it had not been properly charged off in 1918—a requirement which will be discussed hereafter.

There are numerous cases where a stockholder of a corporation makes advances to it.¹¹² When the corporation becomes insolvent, he claims a loss on the stock and a deduction for bad debts with respect to the advances. This is entirely proper, but the two deductions should be treated separately. There is also an apparent confusion as between bad debts and losses, in the situation where a creditor has security, and his attempt to realize upon such security involves him in a loss.¹¹³ It is submitted, however, that this is actually a bad debt, the loss being merely incidental thereto, and it should be treated solely upon former basis.

For reasons already made plain, the prevailing tendency at the present time is to make a sharp distinction between bad debts and losses.¹¹⁴ Sometimes the distinction is difficult to apply, as in the case¹¹⁵ where a taxpayer

111. 275 U. S. 246-7 (1927).

112. *E. g.*, John A. Krue, 12 B. T. A. 448 (1928); Henry Adamson, 17 B. T. A. 17 (1929); *Deeds v. Commissioner of Internal Revenue*, 47 F. (2d) 695 (C. C. A. 6th, 1931); *Dalton v. Bowers*, 56 F. (2d) 16 (C. C. A. 2d, 1932); *Squier v. Commissioner of Internal Revenue*, 68 F. (2d) 25 (C. C. A. 2d, 1933), *aff'd* 26 B. T. A. 1407 (1932).

113. O. D. 604, Cum. Bull., Dec. 1920, p. 166; O. D. 687, Cum. Bull., Dec. 1920, p. 166. *Cf. Southern Cal. Box Co. v. United States*, 46 F. (2d) 724 (Ct. Cl. 1931).

114. O. D. 604, Cum. Bull., Dec. 1920, p. 166; *Porter v. United States*, 20 F. (2d) 935 (D. Idaho 1927); *Parker Wire Goods Co.*, 8 B. T. A. 448 (1927); *Hector Fezandie, Executor*, 12 B. T. A. 1325 (1928); *Bank of Wyoming*, 22 B. T. A. 1132 (1931); *Shiman v. Commissioner of Internal Revenue*, 60 F. (2d) 65 (C. C. A. 2d, 1932); *People ex rel. Central Union Trust Co. v. Loughman*, 249 N. Y. 409, 164 N. E. 333 (1928), cited note 106, *supra*.

115. *Stephenson v. Commissioner of Internal Revenue*, 43 F. (2d) 348 (C. C. A. 8th, 1930). See also *M. A. Burns Mfg. Co. v. Commissioner of Internal Revenue*, 59 F. (2d) 504 (C. C. A. 9th, 1932).

made advances to a bank of which he was a director, in an attempt to rehabilitate it. These advances proved to be uncollectible but were held to constitute bad debts rather than losses, because the purpose of the transaction was not profit. This distinction may seem a bit over-tenuous; but no criticism can reasonably be made of the holding¹¹⁶ that where a claim is made against one who is not legally liable, such claim cannot be regarded as a bad debt, because it is no debt at all. So, a voluntary release of a solvent debtor cannot be regarded as charging off a bad debt, though it may sometimes be deductible as a loss.¹¹⁷ Generally speaking, a deduction of a bad debt cannot be made if the debt was clearly worthless when acquired.¹¹⁸ However, bonds are usually to be regarded, from this standpoint, in their technical character of debts, and if they become uncollectible, the amount paid for them may be deducted as a bad debt.¹¹⁹

The application of this distinction thus remains at times difficult. However, there is no longer doubt that it must be made. Disregarding a previous intimation to the contrary,¹²⁰ the Supreme Court has held that the provisions for the deductions of bad debts and losses in the Federal Revenue Act are mutually exclusive;¹²¹ therefore, no deduction can fall under both provisions, and can be sustained, if at all, only by the provision under the terms of which the deduction by its nature falls.

With bad debts the fundamental rule is that they are a deduction when ascertained to be bad and actually charged off.¹²² Of course, debts which are not in fact uncollectible cannot be charged off and deducted;¹²³ but assuming that the debt can be shown to be bad, the taxpayer need not show that it became bad at the precise time when it was charged off.¹²⁴ It is true that the charge-off (or, at least, a partial charge-off) is theoretically subject to the approval of the Commissioner of Internal Revenue;¹²⁵ but it

116. *Emil Stern*, 5 B. T. A. 89 (1926); *Quito Electric Light & Power Co.*, 10 B. T. A. 538 (1928); *Missouri Valley Bridge & Iron Co.*, 14 B. T. A. 1162 (1929).

117. *American Felt Co. v. Burnet*, 58 F. (2d) 530 (App. D. C. 1932); *Johnson, Drake & Piper, Inc. v. Helvering*, 69 F. (2d) 151 (C. C. A. 8th, 1934). See also *George C. Peterson Co.*, 1 B. T. A. 690 (1925), where a similar ruling was made in the case of a compromise of a disputed item.

118. *Eckert v. Burnet*, 283 U. S. 140 (1931), *aff'g* 17 B. T. A. 263 (1929).

119. *Commonwealth Commercial State Bank v. Lucas*, 41 F. (2d) 111 (App. D. C. 1930); *Anna Bissell*, 23 B. T. A. 572 (1931).

120. *Lewellyn v. Electric Reduction Co.*, 275 U. S. 243 (1927).

121. *Spring City Foundry Co. v. Commissioner of Internal Revenue*, 292 U. S. 182 (1934).

122. *Ledger Co. v. United States*, 37 F. (2d) 775 (Ct. Cl. 1930). The rule was the same under the income tax law of 1864. *United States v. Mayer*, Fed. Cas. No. 15753 (D. Ore. 1865).

123. S. M. 1957, Cum. Bull., Dec. 1924, p. 122; *Pinkus Happ*, 7 B. T. A. 865 (1927); *Island Petroleum Co. v. Commissioner of Internal Revenue*, 57 F. (2d) 992 (C. C. A. 4th, 1932), *cert. denied*, 284 U. S. 646 (1932); *Continental Pipe Mfg. Co. v. Poe*, 59 F. (2d) 694 (C. C. A. 9th, 1932); *Squier v. Commissioner of Internal Revenue*, 68 F. (2d) 25 (C. C. A. 2d, 1933), *aff'g* 26 B. T. A. 1407 (1932); *Johnson, Drake & Piper, Inc. v. Helvering*, 69 F. (2d) 151 (C. C. A. 8th, 1934).

124. *H. J. Sternberg*, 21 B. T. A. 728 (1930).

125. *Commissioner of Internal Revenue v. Liberty Bank & Trust Co.*, 59 F. (2d) 320 (C. C. A. 6th, 1932).

would seem that this is nothing more than the usual implicit, if not explicit, condition that all deductions are subject to the audit of the Bureau.¹²⁶

The fundamental rule, then, is that the debt must be ascertained by the taxpayer to be bad. This means that the deduction is valid if the taxpayer first ascertains this fact in the year in which he charges off and takes the deduction. If the taxpayer reasonably believes that there is some hope of collecting the debt—especially if he takes active measures in seeking to collect¹²⁷—the deduction is justifiable even though it later becomes evident that there has been no hope for some years past.¹²⁸ This in itself shows a less stringent rule than can possibly be justified with respect to losses; and certainly an infinitely more liberal rule than is generally applied with respect to that type of deduction.

But the taxpayer must charge off the debts when he ascertains them to be worthless, or lose the benefit of the deduction.¹²⁹ He is entitled, however, to use reasonable business judgment, and will ordinarily be allowed the deduction if there was reasonable grounds to believe that the debt was bad even though these conditions could not then have been legally proved.¹³⁰ In other words, this is a question of business judgment rather than technical proof sufficient for court purposes. The point is clearly made in *Peyton Securities Co. v. Commissioner of Internal Revenue*¹³¹ where the taxpayer charged off debts owed to it by another corporation (referred to in the opinion as "Menhaden"), engaged in the fishing business. It was conceded that the taxpayer had no definite information as to the assets of its debtor, but it did know that the fishing business was highly speculative and was in fact not profitable this particular season; it also knew that its debtor was generally regarded, even before these misfortunes, as in very bad credit. The court held that the charge-off was justified, saying as to this:

"It is, therefore, going far to say that the judgment of the petitioner based, as it must have been, upon this information it then had concerning Menhaden, was at the time unjustified. We think it is an invasion of the rights of the petitioner to hold that, though it foresaw what

126. See PAUL AND MERTENS, *op. cit. supra* note 6, § 28.36.

127. *Fidelity Storage Corp. v. Burnet*, 58 F. (2d) 526 (App. D. C. 1932); *Wyatt Metal & Boiler Co.*, 6 B. T. A. 673 (1927).

128. *Charles H. Boulden*, 7 B. T. A. 490 (1927); *R. T. Coburn*, 16 B. T. A. 1344 (1929); *Douglas County Light & Water Co. v. Commissioner of Internal Revenue*, 43 F. (2d) 904 (C. C. A. 9th, 1930); *Deeds v. Commissioner of Internal Revenue*, 47 F. (2d) 695 (C. C. A. 6th, 1931); *Anna Bissell*, 23 B. T. A. 572 (1931); *Birdsboro Steel Foundry & Machinery Co. v. United States*, 3 F. Supp. 640 (Ct. Cl. 1933); *Helvering v. Ames*, 71 F. (2d) 939 (C. C. A. 8th, 1934). The fact that the debt is not yet due does not necessarily prevent its deduction. *S. M.* 2262, Cum. Bull., Dec. 1924, p. 123; *I. T.* 2194, Cum. Bull., Dec. 1925, p. 159.

129. *Avery v. Commissioner of Internal Revenue*, 22 F. (2d) 6 (C. C. A. 5th, 1927).

130. *A. R. R.* 806, Cum. Bull., June 1922, p. 156; *Anderson & Lind Mfg. Co.*, 2 B. T. A. 1297 (1925); *Jones v. Commissioner of Internal Revenue*, 38 F. (2d) 550 (C. C. A. 7th, 1930); *Miles G. Saunders*, 26 B. T. A. 519 (1932).

131. 66 F. (2d) 718 (C. C. A. 2d, 1933).

would happen and acted to write off the notes in accordance with the judgment it then had as to their value, it may not have the benefit of the statutory deduction on the theory that it could not have foreseen that Menhaden would fail. The fact is that it did foresee just that. Perhaps the basis of its prediction is somewhat meager as shown by this record, but a basis is not wholly lacking." ¹³²

However, if the taxpayer is allowed the use of ordinary business judgment in this connection, he is (not unreasonably) held to the same standard. If the debts were clearly worthless before the year in which they are charged off, and the taxpayer actually did,¹³³ or should, by using the information available to him, have known this,¹³⁴ the deduction will not be allowed. This is clearly a reasonable rule for the protection of the revenue; otherwise each taxpayer would deduct bad debts only in the years when, by reason of other substantial income, it would be profitable to him to do so. By the same token, an advance to the debtor then known to be insolvent can never be deducted as a bad debt.¹³⁵ Generally speaking, in case of doubt the decision of the taxpayer should be given great weight; but it cannot in fairness to the government be made absolutely conclusive.¹³⁶

Furthermore, a bad debt, in order to be taken as a deduction, must usually be charged off in the year in which it is ascertained to be bad;¹³⁷ it is not sufficient merely to deduct it in the return,¹³⁸ as is sufficient with respect to losses.¹³⁹ This is a statutory requirement, and imposes an additional burden upon the taxpayer. It is nevertheless justified, as giving evidence of affirmative action by him in considering the collectibility of the debt and determining that it is uncollectible within the year in which he desires to take advantage of this situation for tax purposes.

In determining the worthlessness of debts by the taxpayer, and in checking of such determination by the Bureau and by the courts, all perti-

132. *Id.* at 721.

133. *Avery v. Commissioner of Internal Revenue*, 22 F. (2d) 6 (C. C. A. 5th, 1927); *Simon Kohn*, 8 B. T. A. 547 (1927); *American Savings Bank & Trust Co. v. Burnet*, 45 F. (2d) 548 (C. C. A. 9th, 1930); *Ludlow Valve Co. v. Durey*, 57 F. (2d) 583 (N. D. N. Y. 1931); *Joseph H. Rudiger*, 22 B. T. A. 204 (1931); *Julia Dahl*, 24 B. T. A. 1167 (1931); *Louis D. Beaumont*, 25 B. T. A. 474 (1932).

134. *Audubon Park Realty Co.*, 6 B. T. A. 875 (1927); *E. S. Frischkorn*, 7 B. T. A. 431 (1927); *John A. Krueel*, 12 B. T. A. 448 (1928); *Hector Fezandie, Executor*, 12 B. T. A. 1325 (1928); *Cross v. Commissioner of Internal Revenue*, 54 F. (2d) 781 (C. C. A. 9th, 1932).

135. *Henry C. Heinz*, 28 B. T. A. 276 (1933). See also *Kinthead v. Commissioner of Internal Revenue*, 71 F. (2d) 522 (C. C. A. 3d, 1934).

136. *Wheeler-Fisher & Co. v. Commissioner of Internal Revenue*, 54 F. (2d) 294 (C. C. A. 7th, 1931).

137. *Porter v. United States*, 20 F. (2d) 935 (D. Idaho 1927); *C. P. Mayer*, 16 B. T. A. 1239 (1929); *Julia Dahl*, 24 B. T. A. 1167 (1931). The fact that the debts were not charged off, because such action would show that the taxpayer was insolvent, is immaterial. *Bank of Wyoming*, 22 B. T. A. 1132 (1931). But only debts claimed as a deduction need be charged off. *Selden v. Heiner*, 12 F. (2d) 474 (W. D. Pa. 1926).

138. *Fairless v. Commissioner of Internal Revenue*, 67 F. (2d) 475 (C. C. A. 6th, 1933).

139. *Royal Packing Co. v. Commissioner of Internal Revenue*, 22 F. (2d) 536 (C. C. A. 9th, 1927).

nent questions both of law and fact must be taken into consideration.¹⁴⁰ However, certain peculiar circumstances are of such frequent occurrence, that they may be worthy of brief consideration.

In the first place, the fact that a debt is barred by the Statute of Limitations is ordinarily sufficient proof that it is worthless and must be charged off immediately, unless the taxpayer can prove that the statute was tolled or that he had some good reason for believing that he would be able to collect anyway.¹⁴¹ It has been held, however, that where a taxpayer had a memorandum which she believed made the debt enforceable, she was justified in not charging it off, and could take it as a deduction when she first ascertained that the memorandum did not have this effect.¹⁴² This case has been criticized on the theory that the taxpayer should be held to know the law;¹⁴³ but it is submitted that this rather absurd theory certainly has no proper function in connection with a matter where, as here, the problem is rather one of business judgment.

If the taxpayer has security for the debt, the debt is presumably not worthless, even though the debtor is insolvent.¹⁴⁴ The same applies even though the security has been realized on and there is a deficiency judgment, unless the taxpayer is prepared to show that there is no reasonable chance of collecting this judgment.¹⁴⁵ If, however, the security has already turned out to be worthless—as, for example, in the case of forged documents—the taxpayer is ordinarily entitled to charge off the debt as soon as that fact is ascertained.¹⁴⁶ If the security is valid, but is insufficient, the debt cannot be charged off except where the law permits a debt to be charged off in part.¹⁴⁷

Another situation where the authorities are by no means in accord is where the debtor has been thrown into receivership, bankruptcy, or the like. Some cases seem to indicate that when this happens, the taxpayer must, or at least can,¹⁴⁸ charge off the entire debt at once.¹⁴⁹ More usually, this occurrence is not regarded as absolutely decisive,¹⁵⁰ especially when it does not appear to have come to the taxpayer's attention.¹⁵¹ Even where the

140. See PAUL AND MERTENS, *op. cit. supra* note 6, § 28.43 ff.

141. *Duffin v. Lucas*, 55 F. (2d) 786 (C. C. A. 6th, 1932).

142. *Commissioner of Internal Revenue v. Burdette*, 69 F. (2d) 410 (C. C. A. 9th, 1934).

143. See PAUL AND MERTENS, *op. cit. supra* note 6, § 28.38.

144. *Stranahan v. Commissioner of Internal Revenue*, 42 F. (2d) 729 (C. C. A. 6th, 1930); *Morris Sass*, 17 B. T. A. 261 (1929).

145. O. D. 687, Cum. Bull., Dec. 1920, p. 166.

146. O. D. 604, Cum. Bull., Dec. 1920, p. 166; A. R. R. 965, Cum. Bull., Dec. 1922, p. 116.

147. *Collin Co. Nat. Bank v. Commissioner of Internal Revenue*, 48 F. (2d) 207 (C. C. A. 5th, 1931).

148. *Sherman & Bryan, Inc. v. Blair*, 35 F. (2d) 713 (C. C. A. 2d, 1929); *Miles G. Saunders*, 26 B. T. A. 519 (1932).

149. *Wheeler-Fisher & Co. v. Commissioner of Internal Revenue*, 54 F. (2d) 294 (C. C. A. 7th, 1931); *Anderson & Lind Mfg. Co.*, 2 B. T. A. 1297 (1925).

150. *Tunnelton Bank*, 12 B. T. A. 187 (1928); *Schoellkopf v. United States*, 6 F. Supp. 225 (Ct. Cl. 1934). This is especially clear if bankruptcy proceedings were brought, but there was no adjudication. A. R. R. 3211, Cum. Bull., Dec. 1923, p. 136.

151. *Charles H. Boulden*, 7 B. T. A. 490 (1927).

debtor is in receivership or bankruptcy, there is usually some prospect that something will be realized on the debt.¹⁵² Even when a partial charge-off of bad debts is allowed, it would be difficult to ascertain under these circumstances the extent to which the debt is bad. And it goes without saying that receivership of the debtor does not necessarily prove that the debt was not already worthless in a previous year and that consequently it should have been deducted at that time.¹⁵³

The obtaining of a judgment against the debtor by the taxpayer obviously has little bearing on this question.¹⁵⁴ If the debtor has contested the suit, that may merely indicate that he has not paid because he erroneously thought he was not liable.¹⁵⁵ Even if he failed to contest the suit, it is hardly to be supposed that the taxpayer would have prosecuted it if he thought he had no reasonable chance to collect; the debt must, therefore, be regarded as not ascertained to be worthless at the time of suit. The same applies to a repudiation by the debtor of any liability.¹⁵⁶ This indicates unwillingness rather than inability to pay. Where the debtor is a government or other entity not subject to civil liability, a repudiation of indebtedness is undoubtedly to be taken more seriously; but even a repudiation by the Russian Soviet Government of its bonds was held not absolutely to prove their worthlessness so long as there was some hope that that Government would be defeated by the counter-revolutionists.¹⁵⁷ We are again confronted with the problem of reasonable business judgment, and these particular circumstances have a bearing only in so far as they are to be regarded as necessarily affecting the exercise of such judgment.

Since, as already said, a bad debt must be charged off in order to serve as the basis for a deduction, the method of charging off must be ascertained. It is clear that where the taxpayer keeps books, the debts must be charged off on the books.¹⁵⁸ Such a charge-off must be made by the taxpayer himself or by a duly authorized agent, and if a taxpayer is a corporation, the charge-off must be authorized by the Board of Directors.¹⁵⁹ On the other hand, the failure of an employee of a taxpayer who keeps his books to

152. *Spring City Foundry Co. v. Commissioner of Internal Revenue*, 292 U. S. 182 (1934).

153. *Miles G. Saunders*, 26 B. T. A. 519 (1932). Cf. *Wesch v. Helburn*, 5 F. Supp. 581 (W. D. Ky. 1933) (involving a similar problem as to losses).

154. See (1928) 12 MINN. L. REV. 417, discussing *Lewellyn v. Electric Reduction Co.*, 275 U. S. 243 (1927). Cf. *Magill, The Taxation of Unrealized Income* (1925) 39 HARV. L. REV. 82, 86-91.

155. See A. R. R. 542, Cum. Bull., June 1921, p. 143.

156. *Lewellyn v. Electric Reduction Co.*, 275 U. S. 243 (1927).

157. *Anna Bissell*, 23 B. T. A. 572 (1931).

158. *Pottash Bros. v. Burnet*, 50 F. (2d) 317 (App. D. C. 1931); *Julia Dahl*, 24 B. T. A. 1167 (1931); *Fairless v. Commissioner of Internal Revenue*, 67 F. (2d) 475 (C. C. A. 6th, 1933).

159. *Sonora Bank & Trust Co.*, 7 B. T. A. 66 (1927). It has been held, however, that a resolution of the directors in the minute-book, instructing that certain debts be charged off, is itself a sufficient charge-off. *First State Bank v. United States*, 67 Ct. Cl. 332 (1929).

charge off a bad debt will preclude the deduction of such debt, even though the taxpayer expressly directed that the account be charged off.¹⁶⁰

However, a great many individual taxpayers keep no books. In this case it is held that no charge-off being possible, none will be required.¹⁶¹ This seems perhaps unduly liberal, but undoubtedly it would impose hardships to compel all taxpayers to keep books. The government is reasonably protected by the requirements that the debts thus charged off be listed in the return and, of course, that the taxpayer establish not merely that the debts were in fact bad in that year, but that he ascertained them so to be.

Only one other problem remains, but that is of considerable practical importance. Can a debt which is ascertained to be collectible only in part be charged off to the extent of the part uncollectible?

Assuming that the amount uncollectible can be reasonably ascertained, the deduction is explicitly permitted by the present Revenue Act, and has been explicitly permitted by the 1921 Act and all subsequent Acts.¹⁶² Under some circumstances a partial deduction may be taken even though the taxpayer continues to make advances to the debtor for other reasons;¹⁶³ or certain obligations of the debtor to the taxpayer may be charged off and deducted, while others are kept on the books.¹⁶⁴

The Revenue Acts prior to 1921 did not explicitly make provision for the partial charge-off of a debt believed to be only collectible in part. The Bureau, after some hesitation, ruled that under these Acts a partial charge-off was not allowable.¹⁶⁵ This was supported by several court decisions,¹⁶⁶ and also seems to have been the view of the Board of Tax Appeals.¹⁶⁷ However this may be, the Supreme Court has recently flatly decided that the permission to make a partial charge-off of a bad debt was first given by the 1921 Act.¹⁶⁸ It follows that previous to that year debts could be charged off only as a whole and on the condition that they were wholly uncollectible. Several previous court decisions to the effect that such a partial charge-off

160. *McClure v. United States*, 1 F. Supp. 30 (S. D. Fla. 1932).

161. *Robert Mitten*, 11 B. T. A. 731 (1928); *Jones v. Commissioner of Internal Revenue*, 38 F. (2d) 550 (C. C. A. 7th, 1930); *Stephenson v. Commissioner of Internal Revenue*, 43 F. (2d) 348 (C. C. A. 8th, 1930); *Shiman v. Commissioner of Internal Revenue*, 60 F. (2d) 65 (C. C. A. 2d, 1932); *McManus v. Eaton*, 7 F. Supp. 380 (D. Conn. 1934).

162. *Jones v. Commissioner of Internal Revenue*, 38 F. (2d) 550 (C. C. A. 7th, 1930); *Commonwealth Commercial State Bank v. Lucas*, 41 F. (2d) 111 (App. D. C. 1930); *Helvering v. Ames*, 71 F. (2d) 939 (C. C. A. 8th, 1934); *A. P. McGlynn*, 4 B. T. A. 1005 (1926); *William Gahagan*, 22 B. T. A. 828 (1931).

163. *Jones v. Commissioner of Internal Revenue*, 38 F. (2d) 550 (C. C. A. 7th, 1930).

164. *A. P. McGlynn*, 4 B. T. A. 1005 (1926).

165. A. R. R. 7895, Cum. Bull., Dec. 1924, p. 114.

166. *Minnehaha Nat. Bank v. Commissioner of Internal Revenue*, 28 F. (2d) 763 (C. C. A. 8th, 1928); *Collin Co. Nat. Bank v. Commissioner of Internal Revenue*, 48 F. (2d) 207 (C. C. A. 5th, 1931).

167. *Mechanics Bank of Brooklyn*, 9 B. T. A. 1 (1927).

168. *Spring City Foundry Co. v. Commissioner of Internal Revenue*, 292 U. S. 182 (1934).

was allowable under the 1918 and previous Acts,¹⁶⁹ must, therefore, be regarded as overruled, and of no authority on this point.

Conclusion

As to the matter of the deduction of bad debts, the situation seems reasonably satisfactory. Confusion indeed occurs; but it is no more than is inevitable in a situation where difficult and complex questions of fact are necessarily involved. Congress has been liberal with respect to the provisions for this deduction, and the Bureau and the courts have carried out this liberal policy with commendable fidelity to its spirit.

With respect to losses, however, the situation is by no means so satisfactory. The statute is probably as liberal as it would be safe to make it, but the carrying out of the rules leaves much to be desired.

As has appeared, there is a tendency to draw a distinction between known and ascertainable losses, on the one hand, and, on the other, known losses the amount of which is not reasonably ascertainable. The distinction is, after all, only a matter of degree. In no case should a taxpayer, no matter how he keeps his books, be permitted to take even a loss fully realized if the amount cannot be ascertained with reasonable accuracy. This does not mean, of course, a calculation absolutely accurate to the penny, but it does mean that the taxpayer should neither be required nor permitted to take a loss, the amount of which is nothing but a wild speculation. It follows, of course, that the taxpayer should not be deprived of the benefit of this loss when the amount becomes reasonably ascertainable.¹⁷⁰ The difference between the accrual basis and the receipts and disbursements basis of keeping books should be of little consequence in this connection, except that a taxpayer who keeps his books on an accrual basis may properly be permitted to deduct at once an unrealized loss, where the amount of such loss is reasonably ascertainable in advance. But in no case should a loss be required or permitted to be deducted, irrespective of whether it has been sustained or not, if the amount is not reasonably ascertainable.

Still more unsatisfactory is the situation with regard to unknown losses. There is no possible excuse for permitting a taxpayer to take a loss which he or no one else knew anything about, and, even worse, requiring him to take it as of the time when he was still unaware of it, so that the benefit is likely to be lost through the running of the Statute of Limitations. The loss should be deductible only when discovered, and even then

169. *Sherman & Bryan, Inc. v. Blair*, 35 F. (2d) 713 (C. C. A. 2d, 1929); *Davidson Grocery Co. v. Lucas*, 37 F. (2d) 806 (App. D. C. 1930); *Southern Cal. Box Co. v. United States*, 46 F. (2d) 724 (Ct. Cl. 1931); *Murchison National Bank v. Grissom*, 50 F. (2d) 1056 (C. C. A. 4th, 1931).

170. It would still be safer for him to take the deduction early, so as to preclude any possibility of its becoming barred by the Statute of Limitations.

should not be deductible if the amount cannot reasonably be ascertained. This last limitation, however, would rarely operate.

As has been seen, the authorities on this matter are quite confused. The confusion, however, is not merely due to the involved factual situations which persistently arise, but results to a considerable extent from the failure to follow the practical test set forth above. If and when the Bureau and the courts adopt the test here advocated, the problem will not be entirely solved; there will still be difficult problems as to which there may well be reasonable differences of opinion. But a great advance will be made, in that losses will, like bad debts in most respects, be treated from the standpoint of realism and practical common sense, rather than, as now, with disturbing traces of mysticism. Such mysticism is not merely difficult to apply, but it has the much more serious disadvantage of almost inevitably bringing about a result which is unfair either to the taxpayer or the government. The practical method of approach is not merely practical; it is also fair.