CENTER FOR REAL ESTATE AND URBAN ECONOMICS
WORKING PAPER SERIES

WORKING PAPER 86-113

BAD DEBT DEDUCTIONS FOR THRIFTS:
TAX POLICY AND G.A.A.P.

BY

ALAN R. CERF

These papers are preliminary in nature: their purpose is to stimulate discussion and comment. Therefore, they are not to be cited or quoted in any publication without the express permission of the author.
CENTER FOR REAL ESTATE AND URBAN ECONOMICS
UNIVERSITY OF CALIFORNIA AT BERKELEY

The Center was established in 1950 to examine in depth a series of major changes and issues involving urban land and real estate markets. The Center is supported by both private contributions from industry sources and by appropriations allocated from the Real Estate Education and Research Fund of the State of California.

INSTITUTE OF BUSINESS AND ECONOMIC RESEARCH
J. W. Garbarino, Director

The Institute of Business and Economic Research is a department of the University of California with offices on the Berkeley campus. It exists for the purpose of stimulating and facilitating research into problems of economics and of business with emphasis on problems of particular importance to California and the Pacific Coast, but not to the exclusion of problems of wider import.
BAD DEBT DEDUCTIONS FOR THRIFTS:
TAX POLICY AND G.A.A.P

by

Alan R. Cerf

Professor of Business Administration
University of California, Berkeley

Working Paper 86-113
July 1986

Financial support for this research was provided by the Center for Real Estate and Urban Economics, University of California, Berkeley.
BAD DEBT DEDUCTIONS FOR THRIFTS:
TAX POLICY AND G.A.A.P.

ABSTRACT

Taxpayers currently may deduct a bad debt under the specific write-off method or through the creation of a reserve for bad debts. Thrift institutions are allowed special methods for computing the addition to the reserve including the percentage of taxable income method. The objective is to stimulate mortgage lending. Tax reform proposals have called for the elimination or scaling back of the deduction under the reserve method.

The objective of this paper is to study two questions. (1) Should there be a tax deduction for additions to reserves for all corporations or should deductions be limited to specific write-offs? (2) Should thrifts have special preferential methods for determining the amount of the deduction?

An analysis of the arguments supports the allowance of the reserve method. Deductions allowed should be the same as determined for the financial statements under generally accepted accounting principles (G.A.A.P).

Thrifts should also compute their reserve based on experience. The percentage of taxable income method is uneven in its impact on thrifts since it only helps profitable companies. The criterion of economic neutrality is violated when special treatment is given to particular taxpayers or industries. Alternatives to tax preferences should be studied to determine if there is a more cost effective way of stimulating mortgage lending.
BAD DEBT DEDUCTIONS FOR THRIFTS: TAX POLICY AND G.A.A.P.

INTRODUCTION

Proposed tax reform includes many significant changes for thrift institutions (thrifts). An important potential change in the law relates to the ability to deduct an amount for additions to the reserve for bad debts.

Taxpayers in general may either deduct bad debts as they become wholly or partially worthless or may take a deduction for an addition to a reserve for bad debts based on experience. Thrifts may take a deduction based on an addition to a reserve determined under one of three methods. These methods are (1) experience method, (2) percentage of loans outstanding method, (3) percentage of taxable income method. Commercial banks may use the first two methods. These methods will be described in a separate section.

The President's Tax Proposal (PTP) called for repeal of the reserve method for all taxpayers including financial institutions. The House Bill would repeal the bad debt reserve for most corporations except small banks and thrifts. Thrifts have the percentage of taxable income method reduced from 40% to 5%. The Senate Finance Committee (SFC) repeals the addition to the reserve for bad debts for all taxpayers except financial institutions. Thrifts have the percentage of taxable income method reduced from 40% to 25%. This article is concerned with two issues. (1) Should there be a tax deduction for additions to reserves for bad debts for all corporations or should deductions be limited to specific write-offs? (2) Should thrifts have
special preferential methods for determining the amounts of the deduction?

ENVIRONMENT

Congress is considering a drastic revision of the tax law. The President's Tax Proposal established a blue print for tax reform which called for lowering tax rates substantially as the tax base is broadened. The role of taxes in business planning would be substantially reduced. Resource allocation should be determined by market forces and not be distorted by tax factors. Traditionally the tax law had been used to favor certain types of investments and certain types of industries. Real estate, for example, has been provided incentives through accelerated depreciation allowances and special treatment of capital gains.

PTP and the House and Senate versions of tax reform assume lower tax rates will facilitate economic growth. Lower tax rates will provide more capital for investment and the market will direct it to areas where it will be more productive. Tax considerations will play a smaller role in decisions and businesses will be able to be more efficient. The tax reform measures also have the objective of holding down interest rates and helping control inflation.

PTP allowed only a limited number of special deductions and exclusions. These were described as "those that are widely used, and generally judged to be central to American values." Included are home mortgage interest, certain social benefits, and charitable contributions. The number of preferences have expanded in
the House and Senate bills, but the basic thrust towards removal of tax preferences remains.

Thrifts as a result of their mortgage lending aspect are given special treatment by Congress. Both commercial banks and thrifts are provided preferential treatment on the theory that the addition to the bad debt reserve will help preserve the safety and soundness of the financial system. At a time where there is considerable concern for the banking and thrift industries, Congress does not want to cause reductions in cash flow through additional tax liabilities.

Changes in the bad debt rules are only one of the direct tax impacts of tax reform on thrifts. Reduction in corporate tax rates from a top rate of 46% to 36% in the House bill and 33% in the Senate bill are an important benefit. There will also be an impact for some institutions because of changes in net operating loss carryovers and changes in the corporate minimum tax.

A study was made by Price Waterhouse for the U.S. League of Savings Institutions which estimated the impact of the Ways and Means reform bill (H.R. 3838) on the tax burden of thrifts for the period 1986-1990. On average the bill is expected to increase the tax burden of thrifts by 3.7 billion or 16.4%. Reduction of the percentage of taxable income deduction amounts to 9 billion and the restriction of the use of the cash method of accounting adds 1.2 billion. This is offset by the projected drop in the corporate tax rate from 46% to 36% which is expected to reduce taxes by 6.8 billion for the five year period.
Most difficult to predict, and probably of the most significant impact on thrifts, is the indirect impact of other changes in the law. The continued allowance of interest deduction for home mortgages together with disallowance of most other interest deductions may likely increase the demand for home mortgages as the basic source of borrowing for many consumers. Removal of benefits for real estate in general and tax shelters in particular may have a negative impact on many institutions that have equity participations in these ventures or who have large loan-to-value receivables. The proposed tax reform changes will result in many economic adjustments as the changes work through the economic system.

ECONOMIC IMPACT

Opponents of the repeal of the bad debt deduction argue that the bad debt reserve is an essential tool to assure safety and soundness of the financial institutions. One argument is that the proposed tax law change would cause institutions to maintain less reserves. The result would be that efforts to accumulate and maintain prudent capital levels would be hampered.\(^1\)

Leading regulators are opposed to the repeal of the bad debt reserve deduction. Federal Reserve Board chairman Paul Volcker said he opposed the repeal of the bad debt reserve deduction for banks in a written response to a question from the Senate Banking Committee Chairman, Jake Garn\(^2\). At the time of this statement

\(^1\)See David Cohen, ABA Banking Journal, February 9, 1986, p. 9.
the House passed tax bill (HR3838) carried a provision to repeal the bad debt deduction for large banks and to include present reserves in taxable income over a five year period. The Senate Finance Committee was considering a similar proposal.

Volcker stated that a repeal of the provision "would tend to discourage banks from maintaining as large loan loss reserves as otherwise, at some risk in terms of safety and soundness criteria." Further he said he was "strongly inclined toward measures that will encourage banks to build up and maintain adequate loan loss reserves because I think this will promote their safety and soundness. Thus, viewed from this perspective along, I would not favor adoption of the proposed tax treatment. . . ."

A similar view was expressed in a speech by William Seidman, Chairman of the FDIC. He stated, "Here we were, working very hard to increase reserves for the soundness and stability of the system, and there they were, working very hard to take away the deduction."

These statements raise the issue of whether the repeal of the bad debt deduction for tax purposes would cause financial institutions to establish smaller reserves. Certainly there is a real cash flow impact in that firms having less tax deductions would pay more taxes and in turn have less available cash.

Accounting income and taxable income do not agree in many instances. The criteria for determination of taxable income are different than the criteria for determining accounting income in accordance with generally accepted accounting principles (GAAP). Financial institutions could therefore determine their reserves
for earnings purposes and financial condition purposes on the basis of the reserve method and at the same time compute their taxes according to the tax rules. Here we will argue that the tax rules for bad debts should be the same as GAAP.

CURRENT LAW

Taxpayers generally have the opportunity of either deducting bad debts in the year in which they become wholly or partially worthless or they may create a bad debt reserve and deduct a reasonable addition to the reserve each year. The purpose of the reserve is to estimate the portion of the obligations held by the taxpayer at the end of the year which will become worthless in the future. Debts that become worthless during the year are charged against the reserve. Additional methods are allowed for commercial banks and thrift institutions which are unavailable to other taxpayers. The deductible amount is based on a firm's taxable income or outstanding debts rather than actual loss experience.

Qualifying Loans

Three methods are available for savings and loans. These are (a) the percentage of taxable income method, (b) the six year moving average experience method and (c) the allowable percentage of outstanding loans method.

The nature of loans outstanding dictates the rules to be followed. Loans are classified as nonqualifying loans or as

-------------

3See IRC 166(a) for deduction of specific debts which become worthless in whole or in part.

4See IRC 593 and Reg.1.592-2.
qualifying loans. A qualifying real property loan is one that is secured by an interest in real property or secured by an interest in real property that is to be improved out of the proceeds of the loan. Any other type of loan is a nonqualifying loan.

Nonqualifying Loans

Reserves for nonqualifying loans are computed on the basis of a six year moving average of the institution's own experience using the same rules as are applied by other taxpayers.

Percentage of taxable income method.

The amount determined under this method is the sum equal to 40% of the institution's taxable income less the amount added to the reserve for losses on nonqualifying loans. Taxable income is specially computed for this purpose. The maximum deduction is equal to 40 percent of taxable income. If the amount determined is greater than the amount determined under the experience method, this amount must be reduced by 20% of the excess of the amount allowable over the additions that would have been deductible had the taxpayer used the experience method.

A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. The deduction is unavailable if less than 60% of its total assets are qualifying assets.

In addition to the above limitations, the deduction is available only to the extent that the total amount accumulated in the reserve for losses on qualifying real property loans does not exceed 6 percent of such loans at year-end.
Experience method.

In lieu of the percentage of taxable income method, the experience method may be used. Generally a taxpayer will be permitted to add to bad debt reserves the amount called for on the basis of their actual experience as shown by losses for the current year and the five preceding years.

Percentage of eligible property loans method.

The percentage of eligible loans method allows a current deduction for additions to reserves sufficient to maintain a tax reserve of up to 0.6 percent of eligible loans outstanding. The amount determined under this method must be reduced by the amount of the addition to the reserve for losses on nonqualifying loans. Also, there is an 80 percent limitation on the amount of deduction in excess of the deduction that would be allowed under the experience method.

The percentage of taxable income method, the six year moving average method and the allowable percentage method are subject to another limitation. This is the so called 12% of deposits limitation. The sum of the reasonable additions to reserves for qualifying and non qualifying loans may not be more than 12% of the total deposits or withdrawable accounts at the close of the taxable year, minus the sum of the taxpayer’s surplus, undivided profits, and reserves at the beginning of the taxable year.

Tax preferences.

The excess of the larger deduction by use of either the percentage of taxable income method or the percentage of real property loans method over a deduction based on actual loss
experience is a tax preference item. An amount equal to 59 5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.⁵

ELIMINATION OF RESERVE FOR BAD DEBTS

PTP sets forth the hypothesis that the use of the reserve method for bad debts distorts the timing of taxable income and discriminates between firms according to the change in level of accounts receivable and changes in loss experience. A hypothetical numerical example is given in PTP to support these contentions. (PTP p.218).

Specifically the following is stated:

In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred income. (p.216)

An example is given here to determine if there is a distortion of income and if there is a discrimination between firms. Facts are basically the same as in the PTP example with the addition of certain clarifying assumptions. Assume at the end of each period, management examines the accounts receivable and estimates the percentage of accounts that will go bad. At that time the account bad debts is charged (tax deduction) and the reserve for bad debts is increased to bring accounts receivable net of the reserve to net realizable value. Now assume that receivables of one period are either collected in the next period or

⁵I.R.C. 57 and 291.
become worthless and are written off during the following period. When accounts are identified as worthless they are written off against the reserve. The tax deduction arises when the bad debts account is charged. The actual write-off does not create a tax deduction. Assume further that management's expectations are borne out and the amount they expect to go bad in fact does become worthless in the subsequent period. The firm ceases business in year five.

The facts are presented below in Table I.

Table I.
Example of Deductions with the Reserve for Bad Debts Method

<table>
<thead>
<tr>
<th>Year</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Receivables end of year</td>
<td>1000</td>
<td>1500</td>
<td>1500</td>
<td>1000</td>
<td>0</td>
</tr>
<tr>
<td>Percent estimated to be bad</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Tax deduction</td>
<td>10</td>
<td>15</td>
<td>30</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>Balance reserve end of year</td>
<td>10</td>
<td>15</td>
<td>30</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>Receivables net of reserve</td>
<td>990</td>
<td>1485</td>
<td>1470</td>
<td>980</td>
<td>0</td>
</tr>
</tbody>
</table>

Does the bad debt deduction distort annual taxable income? The bad debts are properly associated with the receivables in the year that they arise. Management does not know which ones but does have expectations with high probability that a certain percentage will go bad. The experience of thrifts undeniably supports the fact that bad debts will occur.
Double entry accounting causes income determination and financial condition to be dependent on each other. Does the accounting cause a distortion in balance sheet values? Again the answer is no. Accounts receivable net of bad debts are shown at net realizable value as they should be under generally accepted accounting principles.

Contrary to the statement in PTP, firms with increasing receivables or worsening loss experiences do not benefit. If receivables go up and the percentage of receivables that are going to go bad stays the same or goes up then there should be a larger charge to bad debts. Bad debts are not future losses. They are current losses which cannot be identified with specific receivables.

The statement that firms with improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income also is incorrect. Firms with improved loss experience or declining loan portfolios should have less bad debts and so should have less charge to bad debts.

Where there is a distortion is when firms overestimate their bad debts. If a firm expects $15 of bad debts in a certain year and estimates $20 and in fact the bad debts turn out to be $15, it will have to correct this error in future periods. Problems arise from overenthusiastic estimates of bad debts not from problems with the accounting method. The key accounting assumption is that bad debts should be related to the period in which they arise even if the specific receivable cannot be identified.
Consider the following statement made in PTP (p.216)

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

The above statement includes misconceptions. First the accounting for bad debts with proper estimates relates bad debts to the period in which the loan or sale is made and therefore is not a preferential tax treatment. Accrual basis taxpayers include revenues in taxable income and do not claim they have paid tax ahead of time.

It is unlikely that tax deductibility encourages lenders to make risky loans. The relationship of income received to the amount of the loan would not make this a good choice. A 33 percent taxpayer making a $100,000 loan with the expectation of receiving 10 percent per annum would not make a loan that had a high probability of going bad. If the loan is good he receives $10,000 and keeps $6,667 after tax. If the loan is bad he loses $100,000 which is offset by a $33,333 deduction so he loses $66,667. It seems unlikely that the result would be a distortion between debt and equity financing as claimed in PTP.

In summary there seem to be misconceptions about the implications of the reserve for bad debts. The objective is to match the bad debts with the period in which the sales or loans are made. These are not future losses. Rather they are losses which cannot be identified until later.
GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

PTP (page 242) rejects GAAP in accounting for receivables as follows:

The suggestion to recognize reserves based on GAAP was not adopted because any reserve system is inevitably based to some extent on expectations as to future losses. The more accurate method to determine the amount and timing of the appropriate deduction for bad debts in a taxable year is to judge the loss which has occurred by examining the loan portfolio at the close of the taxable year based on the facts and circumstances known at that time.

PTP rejects the argument that a reserve based on GAAP better reflects economic income compared to the specific write-off method because additions to a reserve based on GAAP reflect current diminutions in the value of the loan portfolio while the specific charge-off method delays the deduction until a time after the loss has actually occurred.

*What is the basis for GAAP?*

To evaluate this argument the basis for GAAP will be considered. Basic accounting tells us that financial condition and income determination must be considered together. If an asset is decreased, a loss must be recognized assuming no changes in other assets, liabilities or equity accounts.

GAAP states accounts receivable net of allowances for uncollectible accounts are effectively stated at the amount of cash estimated as realizable. (Accounting Research Bulletin 43, ch3a)

GAAP provides that an estimated loss from a loss contingency shall be charged to income if (a) it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and (b) the amount of the loss can be
reasonably estimated. Collectibility of receivables is an example of a loss contingency.

Losses from uncollectible receivables shall be accrued when the above conditions are met. These conditions may be considered in relation to individual receivables or in relation to groups of similar types of receivables. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable (Financial Accounting Standard 5, 22).

Guidance is given in case a reasonable estimate of the loss is a range. If some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. If no amount within the range is a better estimate than any other amount, however, the minimum amount of the range shall be accrued. (Financial Accounting Standards Board Interpretation 14, 3).

Different emphasis GAAP and tax

GAAP as one of its criteria emphasizes conservatism. It is concerned with not overestimating income, working capital, and financial condition. The Treasury is interested in collecting taxes based on the statutory definition of taxable income. A key question is: when should a loss be recognized? GAAP suggests that bad debts can be recognized even though the specific loan or receivable that is going to be worthless cannot be specified. The Treasury considers these losses to be future losses until the specific worthless or partially worthless account can be identified.
Timing - "The all events test."

GAAP considers the specific charge-off method delays the loss until after the loss has occurred. The Treasury doesn't agree. The following is from the reasons for change in the general explanation of the Senate Finance Committee bill (p. 155).

Use of the reserve method for determining losses from bad debts results in deductions being allowed for Federal income tax purposes for losses that statistically may or may not occur in the future. In this regard, the reserve for bad debts is inconsistent with the treatment of other deductions under the all events test. Moreover, use of the reserve method allows a deduction prior to the time that the losses actually occur.

Although it may not be possible to identify which specific receivable or loan will become worthless, experience supports the contention that in any period there will, in fact, be bad debts and on the basis of experience they can be reasonably estimated. Bank and thrift regulators are currently struggling with the opposite problem. Firms have to be required to establish enough of a reserve for bad debts.

The "all events test" is primarily concerned with minimizing disputes with the Internal Revenue Service and the taxpayer. It is not a sound criteria for determining income.

The specific charge-off method does not properly match revenues and expenses because it does not relate bad debts to the period in which the sales or loans are made. An accrual basis taxpayer recognizes sales revenue or interest revenue. Period costs including bad debts should be related to this revenue.
Banks, thrifts and other taxpayers.

The Senate Finance Committee believes that the reserve method of accounting for bad debts should continue to be permitted for financial institutions.

Financial institutions generally are required by government regulators to maintain capital sufficient to support the level of lending and other activities that they engage in. The committee is concerned that the repeal of the reserve method at this time could jeopardize the ability of financial institutions to meet their capital requirements. (General explanation p.155)

The committee then allows certain finance companies to also use the reserve method. This is supported on the basis that certain finance companies are important competitors of financial institutions and, in order not to provide an unfair competitive advantage, they should also be able to use the reserve method.

In PTP it was argued that financial institutions should not be able to use the reserve method because they received more favorable tax treatment than lenders in other industries (p.239). The Senate Finance Committee reverses this position and gives financial institutions and certain finance companies special preference. This violates the idea of neutrality and leaves in effect a modification of a complicated system of alternatives for financial institutions.

A preferable solution would be to allow the reserve for bad debts for all accrual basis taxpayers. Bad receivables and bad loans are well supported by history. Management in connection with audits by regulators for regulated industries and reviews by independent auditors could establish the bad debt reserve.
Overenthusiastic estimators could be penalized by a market interest charge when their reserves became out of line with experience.

SPECIAL TREATMENT FOR THRIFTS

The logic for repealing the special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve is found in PTP (p.240-242). PTP advocated the repeal of the bad debt reserve method for financial institutions. As explained earlier the Senate version repeals the bad debt reserve method for nonfinancial corporations. The result is that commercial banks and thrifts have preferential treatment relative to other corporations. PTP claims that the effect of present law is "either to increase the after-tax income of depository institutions or to enable depository institutions to offer loans at artificially low rates" (p.240).

This statement ignores the nature of the accounting for the reserve for bad debts which was explained in the previous section. True, there would be a preference relative to other corporations. The solution is not to deny the banks and thrifts. Rather, all accrual basis corporations should be allowed the reserve for bad debt method.

PTP objects to the choice of methods allowed to banks and thrifts. It is pointed out that one method allows banks to maintain a reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. This method therefore only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. PTP points out that in 1983, an estimated
73 percent of commercial banks found the percentage method to be more beneficial, while only 27 percent found the experience method to be more advantageous (p.241).

It is true that allowance of several methods allows certain corporations to benefit relative to others. It also adds complexity to the system. The answer proposed here is to allow management to determine the addition to the reserve based on experience. In the case of banks and thrifts this amount would be reviewed by regulators and in the case of public corporations reviewed by independent auditors. Firms that continually over-estimated their bad debts to reduce taxes could be penalized by having to pay interest on excessive amounts in their reserves.

PTP discusses the percentage of taxable income method (p.241) and points out that only profitable thrifts benefit from the method. Also in 1981 and 1982 most thrifts couldn’t benefit from the method because they did not have taxable income. In 1983, an estimated 60 percent of thrifts found the percentage of taxable income method to be beneficial, while the remaining 40 used the percentage of outstanding loans method.

It seems clear that the percentage of taxable income method provides a preference to banks and thrifts relative to other corporations. A further problem is that it benefits only a segment of banks and thrifts.

Given that the percentage of taxable income method violates the concept of neutrality, continuation of the method would seem to depend on whether there was an overriding reason which was more important. If the answer is the need for an incentive to
residential lending, then the question is whether this is the preferable method for doing so. Alternatives other than tax incentives may be preferable.\textsuperscript{6}

Thrifts determine reserves based on expected loan losses. Regulators review these reserves to see if they are adequate. Adequacy of reserves should depend on expected collections and the desire to show receivables at net realizable value, not on the tax deductibility of the reserves. There does not seem to be a sufficient argument for the retention of the percentage of taxable income method in addition to the experience method.

PTP claims the choice of method distorts the investment decisions of some depository institutions because the percentage of taxable income method is only available if a certain percent of the thrift's assets are invested in loans on residential real estate, liquid assets or certain other assets. "The linkage between a lower effective tax rate and residential mortgage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk." Whether this is true will not be argued here. Given the portfolios of some institutions, they might have had less risk if they had more of their portfolio in mortgages. It is true however that the method does violate the concept of neutrality. The real issue is whether there is an overriding reason to support residential mortgage lending through the tax code or whether there are better methods.

\textsuperscript{6}See the alternatives suggested in the Congressional Budget Office report, "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives."
CONCLUSION

Tax and GAAP conformity

Generally accepted accounting principles correctly provide for a charge to income for additions to the reserve for bad debts based on estimated bad debts. There is no dispute that bad debts or bad loans are an integral part of a business. The question is when these bad debts should be recognized.

The reserve method provides for a better matching of revenues and expenses than the specific write-off method. Sales revenue or interest revenue is included in periodic income and this should be matched by the estimated bad debts for the period. Experience indicates there will be bad debts for each period. The problem is that it is impossible to predict exactly which accounts will be bad and, therefore, the specific charge-off method causes a lag in recognition of the bad debts. The reserve method is also consistent with the accounting model in that it results in the valuation of net receivables at net realizable value and therefore does not distort capital.

Verifying the additions to the reserves in the case of firms that wish to defer taxes by overestimating reserves poses a problem. Firms are concerned with the net income they report to their shareholders, so this will somewhat offset the desire to overestimate reserves. The deduction for tax purposes should be limited to the charge on the income statement. Management does not have sole discretion in determining the reserve. Public corporations have reserves reviewed by independent auditors. Regulated companies such as the thrifts and banks have their
reserves checked by regulatory authorities. Finally, firms could be charged a market rate of interest for obvious overstatements. 

Special treatment for thrifts

Removal of the reserve method for thrifts and commercial banks causes more cash to flow to the treasury because of the smaller deductions allowed and therefore more taxable income. At a time when there is considerable concern over the soundness of commercial banks and thrifts removal of the reserve method is not likely to have desirable economic consequences. 

Given that the ability to deduct an addition to reserve for bad debts is restored for all accrual basis taxpayers, then Congress should reevaluate special preferences for thrifts. There are numerous alternatives for the stimulus of home building and multi-family housing other than tax preferences. 

The percentage of taxable income method only helps profitable thrifts. It is not clear that it causes more residential mortgage lending then would occur if this method did not exist and therefore may be a wasteful tax expenditure. The important philosophical thrust of economic neutrality is violated by the allowance of these special preferences. Whenever any industry is given special preferences, then other industries can argue they are important to the welfare of the economy and should also get preferences. Alternatives to tax preferences should be studied to determine if they are likely to be a more cost effective way of accomplishing Congressional objectives in stimulating mortgage lending.
REFERENCES


