High Plains Agricultural Credit Corporation v. Commissioner, T.C. Memo. 1976-96

Section 166(g) of the Internal Revenue Code exclusively governs the deductibility of additions to a bad debt reserve for taxpayers acting as guarantors, endorsers, or indemnitors, and disallows such deductions for non-dealers in property.

Summary

High Plains Agricultural Credit Corporation (HPACC), a lending institution, rediscounted loans made to farmers and ranchers with the Federal Intermediate Credit Bank (FICB) with recourse. HPACC sought to deduct additions to its bad debt reserve for both these rediscounted loans and loans it retained. The Tax Court ruled against HPACC, holding that Section 166(g)(2) of the Internal Revenue Code (IRC) specifically prohibits deductions for additions to a bad debt reserve by guarantors, endorsers, or indemnitors who are not dealers in property. The court further determined that the Commissioner did not abuse his discretion in disallowing deductions for additions to the reserve for retained loans, finding the existing reserve adequate given HPACC's limited bad debt experience.

Facts

High Plains Agricultural Credit Corporation (HPACC) was in the business of making loans to farmers and ranchers. HPACC entered into a "General Rediscount, Loan, and Pledge Agreement" with the Federal Intermediate Credit Bank (FICB). Under this agreement, HPACC rediscounted many of its loans to FICB. These rediscounted loans were transferred with recourse, meaning HPACC remained liable to FICB if the borrowers defaulted. Specifically, HPACC endorsed the notes and agreed to repurchase any obligation not paid when due. HPACC claimed deductions for additions to its bad debt reserve for the tax years ending September 30, 1967, 1968, and 1969, including amounts related to the rediscounted loans.

Procedural History

This case originated in the U.S. Tax Court. The Commissioner of Internal Revenue had determined deficiencies in HPACC's income tax for the years in question by disallowing the claimed deductions for additions to the bad debt reserve.

Issue(s)

1. Whether section 166(g) of the Internal Revenue Code allows HPACC to deduct additions to a reserve for bad debts when those additions are attributable to loans rediscounted to FICB with recourse.

2. Whether the Commissioner abused his discretion by disallowing deductions for additions to the bad debt reserve for loans retained by HPACC in the taxable years 1967, 1968, and 1969.

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Holding

1. No. The court held that section 166(g)(2) of the IRC prohibits deductions for additions to a bad debt reserve for taxpayers acting as guarantors, endorsers, or indemnitors who are not dealers in property, and HPACC, not being a dealer in property, falls under this prohibition for the rediscounted loans because it acted as a guarantor/endorser.

2. No. The court held that the Commissioner did not abuse his discretion because the existing reserve for bad debts was reasonable in relation to the loans retained by HPACC, especially considering HPACC's limited history of bad debts.

Court's Reasoning

The court reasoned that HPACC, through its agreement with FICB, acted as both an endorser and a guarantor. The agreement required HPACC to endorse the notes and repurchase defaulted obligations, thus establishing recourse. The court rejected HPACC's argument that it was "more than a guarantor" due to its "primary liability," stating that the distinction between primary and secondary liability is irrelevant under Section 166(g). The court emphasized that Section 166(g) was enacted to resolve conflicting court decisions regarding bad debt reserves for dealers in property selling with recourse, and Congress intended it to be the exclusive provision governing such deductions for all guarantors, endorsers, and indemnitors, not just dealers. Quoting legislative history, the court noted that Section 166(g) was designed to address situations where a dealer sells customer debt obligations with recourse, and the IRS's position, now codified in Section 166(g), is to disallow reserve deductions for such contingent liabilities. The court cited prior cases like *Wilkins Pontiac* and *Foster Frosty Foods*, which, prior to the enactment of 166(g), wrestled with similar issues. The court concluded that even if HPACC was considered a guarantor or endorser, Section 166(g)(2) explicitly disallows the claimed deductions because HPACC admitted it was not a dealer in property. Regarding the retained loans, the court found the Commissioner's disallowance of deductions reasonable. The court noted that when considering only the loans retained by HPACC (excluding the rediscounted loans), the existing bad debt reserve represented a significant percentage of these outstanding debts, and in the absence of significant prior bad debt experience, the Commissioner's determination was not an abuse of discretion. The court stated, "Our discussion above indicates that debts discounted are not 'debts outstanding' and, accordingly, are not relevant to the computation of a reserve."

Practical Implications

High Plains Agricultural Credit Corporation provides a clear interpretation of Section 166(g) of the Internal Revenue Code. It establishes that Section 166(g) is the exclusive provision for deducting additions to a bad debt reserve for taxpayers acting as guarantors, endorsers, or indemnitors. Crucially, for non-dealers in

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property who transfer debt obligations with recourse, this case confirms that Section 166(g)(2) disallows deductions for additions to a bad debt reserve related to these recourse obligations. This decision is particularly relevant for lending institutions and other businesses that discount or sell loans or receivables with recourse. It highlights the importance of understanding the limitations imposed by Section 166(g) on bad debt reserve deductions in such transactions. Furthermore, the case reinforces the broad discretion afforded to the Commissioner in determining the reasonableness of additions to bad debt reserves, especially when historical bad debt experience is limited. Later cases would rely on *High Plains Agricultural Credit Corporation* to interpret and apply Section 166(g) in similar contexts involving recourse debt obligations and bad debt reserves.

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