



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
THE FIRST NATIONAL BANK IN GLENDALE)

Appearances:

For Appellant: Geo. E. Farmer, Cashier; F. L. Eagle,
Accountant; Frank Mergenthaler, Attorney
For Respondent: Chas. J. McColgan, Franchise Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of The First National Bank in Glendale to a proposed assessment of an additional tax in the amount of \$419.81, based upon the return of the above bank for the taxable year ended December 31, 1931.

In 1931 the Appellant discovered for the first time that during the years 1926 to 1931, inclusive, one of its employees had embezzled from it sums of money totaling \$37,617.23.. The greater portion of this amount was recovered by Appellant on insurance policies which it held. The entire amount probably would have been so recovered were it not for the fact that one of its policies provided that the insurer be notified of loss resulting from an embezzlement within eighteen months of the time the embezzlement occurred. Due to the delay in discovering the embezzlement, Appellant was unable to meet this condition. Although pursuant to an arrangement with the employee guilty of the embezzlements whereby the employee apparently agreed to make restitution of the amount embezzled Appellant received miscellaneous notes and securities from the employee to apply on the defalcations, Appellant was unable to recover, either from its insurance companies or from the employee, \$9,808.64 of the amount embezzled. This amount was charged off on Appellant's books during the year 1931 as a bad debt after it was discovered that the notes and securities received from the employee were worthless.

In its return covering the year 1931, Appellant deducted the above amount in computing its net income. The Commissioner, however, disallowed the deduction on the grounds that it represented a loss applicable to prior years. Certain other deductions were also disallowed by the Commissioner, but the disallowance of the above item is the only matter involved in the instant appeal. Appellant contends that this item should have been allowed as a deduction either under Section 8(d) of the Act as a loss "sustained during the taxable year and not compensated for by insurance or otherwise," or under Section 8(e) of the Act

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as a debt "ascertained to be worthless and charged off within the taxable year."

A provision of the Federal Revenue Act similar to Section 8(d) of the state Act has been interpreted as authorizing the deduction of losses resulting from embezzlement only in the year in which the embezzlement occurred, regardless of when the embezzlement was discovered or when the loss resulting therefrom was charged off. (See Klein, Federal Income Taxation, par. 18:35, and United States v. C.C.C. & St. L. Ry. Co., an unreported opinion by the United States District Court of the Southern District of Ohio, referred to in Farish v. Commissioner, 31 Fed. 2d. 79). Inasmuch as the loss sought to be deducted by Appellant was occasioned by embezzlements occurring prior to 1931, it would seem questionable whether Section 8(d) of the Act can be regarded as authorizing the deduction thereof in 1931.

However, it should be noted that in Farish v. Commissioner, 31 Fed. 2d 79, it was held that a loss resulting from an embezzlement could be deducted as a "bad debt" in the year in which it was discovered that the person committing the embezzlement could not make restitution, pursuant to an agreement so to do, of the amount embezzled, notwithstanding the embezzlement occurred in a prior year.

The facts of the instant case, we think, bring it within the rule of the Farish case. Although the arrangement between the Appellant and its employee whereby the employee agreed to restore the sums embezzled is not set forth as clearly as it might have been, it does appear that there was some such arrangement entered into in good faith by Appellant. Furthermore, it appears that during the year 1931 Appellant discovered that the employee would not be able to make restitution of the amount embezzled. Consequently, we hold that the deduction contended for by Appellant should be allowed under Section 8(e) of the Act as a debt ascertained to be worthless and charged off during the taxable year 1931.

In conclusion, we think it proper to observe that if losses resulting from embezzlement could be deducted only in the year in which the embezzlement occurred, taxpayers would often be denied any deduction of such losses. Where embezzlements occur over a number of years, it may be difficult or impossible to ascertain the exact amount embezzled in any particular year or years. Furthermore, it may well happen, as in the instant case, that the embezzlements will not be discovered until it is too late to claim a deduction for the loss resulting therefrom if the deduction must be taken in the year of the embezzlement.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action

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of the Franchise Tax Commissioner in overruling the protest of The First National Bank in Glendale against a proposed assessment of an additional tax in the amount of ~~\$419.81~~ based upon the net income of said bank for the year ended December 31, 1931, be and the same is hereby modified. Said action is reversed insofar as the Commissioner disallowed as a deduction the sum of ~~\$9,808.64~~ representing a debt ascertained to be worthless and charged off during the year 1931. In all other respects, said action is sustained.

The correct amount of the tax to be assessed to The First National Bank in Glendale is hereby determined as the amount produced by means of a computation which will include the allowance as a deduction of the above amount in the calculation thereof, The Commissioner is hereby directed to proceed in conformity with this order and to send the said bank a notice of assessment revised in accordance therewith.

Done at Sacramento, California, this 3rd day of June, 1933,
by the State Board of Equalization,

R. E. Collins, Chairman
Fred E. Stewart, Member
Jno. C. Corbett, Member
H. G. Cattell, Member

ATTEST: Dixwell L. Pierce, Secretary