BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ARBUD INVESTMENT COMPANY)

Appearances:

For Appellant: Thomas G. Cross and Company, Accountants and Auditors; Preston D. Orem, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; Frank M. Keesling, Franchise Tax Counsel; Clyde Bondeson, Senior Franchise Tax Auditor

O P I N I O N

This appeal is made pursuant to Section 23 of the Bank and Corporation Franchise Tax Act from the action of the Franchise Tax Commissioner in overruling the protest of the Arbud Investment Company to his proposed assessment of an additional tax in the amount of $333.20 for the taxable year ended December 31, 1936, based upon the income of the company for the year ended December 31, 1935. The Appellant does not question herein the action of the Commissioner with respect to the disallowance of the deduction claimed by the Appellant in its return of income of the amount of certain dividends, but confines its appeal to the matter of the deductibility of the amount of a bad debt.

In its return of income for the calendar year 1935, the Appellant deducted from its gross income the sum of $4,500 as a bad debt. This amount represented the unpaid balance on a promissory note executed by George E. Jaeger in the principal sum of $10,428.46, payable to J. Harold Peterson, dated November 15, 1928, and due six months after date. The note was transferred to the Appellant in 1929, the unpaid balance at the time of transfer being $5,000. An additional $500 was paid on the *no* in 1929. The Commissioner disallowed the deduction of the amoun remaining unpaid on the note upon the ground that the indebtedne actually became worthless prior to 1935 and that the Appellant could not, accordingly, have reasonably ascertained that it became worthless in that year.

Section 8(e) of the Bank and Corporation Franchise Tax Act sets forth two conditions precedent to the deduction of a bad debt for a given year: (1) an ascertainment within that year that the debt is worthless, and (2) a charge-off of the debt within that year. No question has been raised in this appeal concerning the failure of the Appellant to charge off the debt in question during the year 1935 and the only matter to be considered is, accordingly, whether the Appellant reasonably ascertained that the debt was worthless during that year,

It is contended by the Commissioner that the debt became worthless either in 1933, on the ground that the limitation period for enforcing payment expired in that year; or in 1934, when the Commerce Guardian Trust and Savings Bank, another creditor of Mr. Jaeger, was unable to obtain payment from him of a $6,000 note and Mr. Peterson, who was at that time the Vice-President of Appellant and who had guaranteed payment of the note, was forced to make arrangements for its payment. The latter circumstance is said by the Commissioner to be conclusive evidence of the fact that the Appellant knew in 1934 that it would not be able to obtain collection of the debt due it. Inasmuch as it appears that Mr. Jaeger's note to Appellant was executed in Ohio and that the Ohio Statute of Limitations applicable thereto is fifteen years (Throckmorton's Ohio Code, Baldwin's 1936 Certified Revision, Section 11,221), the Commissioner's contention as to the worthlessness of the note in 1933 by reason of the expiration of the limitation period in that year is clearly untenable.

As respects the other contention of the Commissioner, the Appellant offered evidence establishing that in 1934, despite its knowledge that Mr. Jaeger had failed to pay his obligation to the Commerce Guardian Trust and Savings Bank, it had reasonable grounds for believing that he would pay the obligation due Appellant and that it did not ascertain that the debt was worthless until the following year when it was learned that he had given up his former employment, lost his home through foreclosur and left the town where he had resided, leaving liabilities that he was unable to satisfy.

It further appears that at the time the note was made, Mr. Peterson was President of the Hixon-Peterson Lumber Company by which Mr. Jaeger was employed at a salary of $400 per month; that Mr. Jaeger was at that time the owner of property worth from $15,000 to $25,000; that his failure to meet his obligation was due to the fact that with the coming of the depression his salary was reduced to $150 per month; that Mr. Peterson, by reason of his former connection with the Hixon-Peterson Lumber Company, considered Mr. Jaeger a valuable employee of that company and believed that so long as he remained in its employment there was a chance that he would be able to meet the obligations; and that it was not until 1935, where Mr. Peterson learned of the termination of Mr. Jaeger's employment and of his consequent inability to pay his debts that the note was actually ascertained to be worthless and charged off on the books of the Appellant.

The foregoing facts establish, in our opinion, that the debt was reasonably ascertained to have become worthless in 1935. The only circumstance known to the Appellant in 1934 which might be regarded as an indication that the debt was then worthless was the fact that Mr. Jaeger was unable to meet his note to the Commerce Guardian Trust and Savings Bank. We do not, however, consider that this fact compelled the conclusion that the debt due Appellant was worthless in view of all the circumstances surrounding the case.

Our conclusion herein is supported by decisions of the United States Board of Tax Appeals disallowing deductions for bad debts in cases in which the only facts indicating worthlessness were inability to meet obligations or temporary insolvency. Moore v. Commissioner of Internal Revenue (1927) 8 B.T.A. 749; Merrill Trust Company v. Commissioner of Internal Revenue (1931) 21 B.T.A. 1395. In applying Section 23(kk) of the Federal Revenue Act, which is similar to Section 8(e) of tht Bank and Corporation Franchise Tax Act, the United States Circuit Court of Appeals has stated the rule to be as follows:

> "If the taxpayer has reasonable expectation that the debt or any part of it may be paid, he is under no duty to charge it off, and the rule is that ordinarily in mkaing this determination he is allowed a fair degree of latitude. Blair v. Commissioner of Internal Revenue (1937) 91 F. (2d) 992,994.

We are, accordingly, of the opinion that the debt involved herein was properly deductible as a bad debt by the Appellant in its return of income for the year ended December 31, 1935, and that the action of the Commissioner in disallowing the deduction thereof and in overruling the protest of the Appellant to his proposed assessment of an additional tax based upon the disallowance of the deduction thereof was not in accordance with law.

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 of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Arbud Investment Company, to his proposed assessment of additional tax in the amount of $333.20 for the taxable year ended December 31, 1936, based upon the return of income of said company for the year ended December 31, 1935, be and the same is hereby modified. Said action is reversed insofar as the Commissioner disallowed the deduction as a bad debt of the amount of $4,500 due said company by George E. Jaeger. In all other respects said action is sustained.. The correct amount of the tax to be assessed to the Arbud Investment Company is hereby determined as the amount produced by means of a computation which will include the allowance as a deduction of the said amount of $4,500 in the calculation thereof. The Commissioner is hereby directed to proceed in conformity with this order and to send to the Arbud Investment Company a notice of assessment revised in accordance therewith.

Done at Los Angeles, California, this 14th day of December, 1938, by the State Board of Equalization.

Richard E. Collins, Chairman
Wm. G. Bonelli, Member
Andrew J. Gallagher, Member

ATTEST: Dixwell L. Pierce, Secretary