BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PETERSON LUMBER AND FINANCE COMPANY)

Appearances:

For Appellant: Preston D. Orem, Attorney At Law

For Respondent: 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 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 Peterson Lumber and Finance Company, a corporation, to his proposed assessment of an additional tax in the amount of $288.44 for the year ended December 31, 1936, based upon the income of the corporation for the year ended December 31, 1935.

The proposed assessment resulted from the disallowance by the Commissioner of the following deductions claimed by the Appellant:

Additional credit at the end of 1935 to the reserve for bad debts	$4,000.00
Notes charged off as worthless during the year	3,138.54
Credit to the reserve for bad notes	1,000.00
	$8,138.54

The first item was disallowed on the ground that the sum of $5,185.63 already credited to the reserve for bad accounts in 1935 constituted a sufficient allowance, The second item was disallowed on the ground that the notes were in fact ascertained to have become worthless prior to 1935. The Appellant now concedes that the third item does not represent a proper deduction for 1935, so that no further consideration need be given it,

The relevant provisions of the Bank & Corporation Franchise Tax Act are contained in Section 8(e) of the Act, which permits the deduction of

> "Debts ascertained to be worthless and charged off within the income year, or, in the discretion of the commissioner, .a reasonable addition to a reserve for bad debts. When satisfied that

> a debt is recoverable in part only the commissioner may allow such debt to be charged off in part."

At the outset, mention should be made of several fundamental principles which must be observed in the determination of the above matters:

1. Except as to amounts credited to a reserve, a deduction on account of bad debts may only be taken in the year in which both the charge off and the ascertainment of worthlessness occurred. (Avery v. Commissioner, 22 F. (2d) 6; Cross v. Commissioner, 54 F. (2d) 781; American Cigar Co. v. Commissioner, 66 F. (2d) 425, cert. den. 290 U. S. 699.)

2. The ascertainment of worthlessness mentioned in the above section has reference to ascertainment by the taxpayer, who is the judge of worthlessness in the first instance (Selden v. Heiner, 12 F. (2d) 474; Commissioner v. Burdette, 69 F. (2d) 410; Moore v. Commissioner, 101 F. (2d) 704.) So long as he has a reasonable expectation that the debt or any part of it may be paid, he need not charge it off, and ordinarily a fair degree of latitude should be allowed him in this regard. (Blair v. Commissioner, 91 F, (2d) 992; Commissioner v. MacDonald Engineering Co., 102 F. (2d) 942.)

3. The taxpayer may not, however, postpone a deduction by disregarding facts which patently indicate worthlessness. (Avery v. Commissioner, 22 F. (2d) 6; Cross v. Commissioner, supra; Ellen Hyde Scorril, 36 B.T.A. 1214.) "A bare hope that something might turn up" to permit a recovery is immaterial. (Joseph R. Rudiger, 22 B.T.A. 204.)

4. When the Commissioner disallows a deduction, his action is presumed to be correct and the taxpayer has the burden of establishing his right to the deduction. (Welch v. Helvering 290 U.S. 111; Jones v. Commissioner, 38 F. (2d) 550; Continental Pipe Mfg. Co. v. Poe, 59 F. (2d) 694; Jones v. Commissioner, 103 F, (2d) 681; Imperial Type Metal Co. v. Commissioner, 106 F. (2d) 302.)

5. When the Commissioner disallows an addition to a reserve for bad debts, his action carried with it more than a mere presumption of correctness, since the statute expressly provides that the allowance is "in the discretion of the Commissioner." His action may not, accordingly, be set aside unless an abuse of discretion on his part *is* established. (Art Metal Construction Co, v. United States, 17 Fed. Supp. 854, 863.)

The following are the only facts appearing in the record having any bearing on the question of the propriety of the $4,000.00 credit to the reserve for bad debts:

On January 1, 1935, this account showed a credit balance of $1734.50. During the year amounts aggregating $5992.67 were charged to it, and at the close of the year it was credited with the sum of $5,185.63, which amount was computed at one and

one-half percent of Appellant's net sales during 1935. This left a credit balance in the account at the close of 1935 of $927.46, amounting to 1.67 percent of the Appellant's accounts receivable at that time, which aggregated approximately $55,000.00. It further appears that during 1933 and 1934 the additions to the reserve were computed at one percent of net sales, and that at the close of those years the balance in the reserve account was equal to .91 percent and 1.93 percent, respectively, of the accounts receivable.

The Appellant has offered no explanation as to why it was necessary to make a further credit to the reserve, nor has it submitted any evidence whatsoever concerning the condition of the accounts receivable at the close of 1935. If it should be assumed that the reserve account was insufficient to take care of anticipated losses, this would appear to be due to the fact that the credits to the account in prior years were unreasonably small rather than the result of circumstances first becoming known in 1935, when, according to Appellant, business conditions were substantially improved over the preceding years. Manifestly for an allowance to be "reasonable" it must be computed as accurately as possible in accordance with the facts first becoming known to the taxpayer during the period for which the allowance is claimed. Just as the Act permits the deduction of specific bad debts only for the period in which they were reasonably ascertained to be worthless, (See Avery v. Comr., supra) its allowance as a deduction of "a reasonable addition to a reserve for bad debts" does not permit a taxpayer, by making less than a reasonable allowance in one year, to justify a correspondingly greater allowance in a subsequent year. Under the circumstances we are unable to conclude that the action of the Commissioner in disallowing the additional credit of $4,000 constituted an abuse of discretion on his part.

The only question remaining for determination is the propriety of the Commissioner's action in connection with the notes receivable, The items disallowed are as follows:

Date of Note	Maker	Maturity	Original Amt.	Unpd. Bala in 1935
12/31/30	E. D. Barrett	3/31/31	$ 650.32	$ 501.79
6/22/31	M. H. Hait	9/21/31	183.18	159.08
3/6/30	H. Clyde Walters	6/4/30	500.00	450.00
12/31/30	Fred Cave	3/31/31	563.22	563.22
12/31/30	G. R. Paulus		315.36	200.36
12/31/30	Bathrick Bros.	12/31/31	2,524.43	-251.61
4/26/32	R.E. Robertson		1,012.48	1,012.48

Referring first of all to the note of Fred Cave in the sum of $563.22, it is our opinion that the Appellant has sustained the burden of proving that the note was actually ascertained to be worthless in 1935. It appears that the Appellant, to secure this note obtained a quit claim deed from the maker the property being subject, however, to two deeds of trust. It further appears that Appellant operated the property for several years for the benefit of itself and the other two creditors until November, 1935, when it was sold for a sum which was insufficient to allow

any payment on account of the amount due the Appellant. In our opinion, the fact that the Appellant assumed the burden of operating the property up to the time of sale establishes its good faith in carrying the obligation on its books, and indicate: that until that time there was a possibility that something would be realized upon it. Assuming that the security was inadequate to meet fully the claims of all the creditors and that the Appellant could have partially charged off the debt in an earlie: year, we do not think this fact compelled the conclusion that the debt was worthless. Under circumstances that appear to be very similar, the Circuit Court of Appeals for the seventh circu was held in Commissioner v. MacDonald Engineering Co., 102 F. (2d)(1939) 942, "that as long as there was any possibility of any recovery" the account was properly kept upon the books.

Of the other notes involved herein, the Appellant has conceded that those of Bathrick Bros. and R. E. Robertson in the amounts of $251.61 and $1,012.48, respectively, should have been written off in a prior year and were not proper deduction for 1935. This leaves for determination the propriety of the deductions claimed on account of the Barrett, Hait, Walters and Paulus notes. The facts *concerning* these obligations are all very similar. They were executed in 1930 and 1931, and with the exception of the Paulus note, the maturity date of which has not been given, matured within ninety days. The last payment on the Hait note was received on December 31, 1932, and no payments were received on any of the other notes subsequent to 1931. Suit was instituted against E. D. Barrett on January 23, 1932, but no collections were ever made and on May 28, 1932, Barrett was adjudicated a bankrupt. Security was at one time held for the Walters note, but it became worthless and a judgment against him was obtained on February 5, 1932. Judgment against Paulus was obtained on August 25, 1932, and was followed by supplements proceedings which failed to disclose any property.

The only explanation offered by Appellant for not charging these notes off prior to 1935 despite the long period in which no payments were made was that the notes were the result of sale of lumber and other building materials, that in view of the depressed condition of the building industry from 1931 to 1934, it was not until 1935 that building contractors whose financial condition had been rendered precarious by the depression had an opportunity to re-establish themselves and that Appellant was able to determine that the particular debtors in question were not going to meet their obligations, and that therefore these notes were not ascertained to be worthless until that year. Mo further justification has been offered as to why the year 1935 was chosen in which to make the charge off except that during that year the statute of limitation ran against the enforcement of' the Hait note and that in the other cases the action was the result of the credit manager's best judgment based on all the facts,

In our opinion the expectation from.1931 to 1934 that business conditions would ultimately improve, and Appellant's hope that its debtors would thereby be enabled to meet their obligations, did not constitute a sufficient reason for carrying these

notes on the books. The Appellant has not attempted to justify its action by showing that during this period it carried any other accounts or notes receivable that were in a condition comparable to the notes under discussion and that were paid off in 1935 or in some subsequent year. For all that appears from the record herein the seven notes involved in this appeal were the most hopeless of all the obligations on Appellant's books. In view of the failure of all attempts at collection, considered in conjunction with the circumstance that all seven of the notes did in fact prove to be uncollectible, it can hardly be said that Appellant's action was reasonable. We must conclude, accordingly, that it has not sustained the burden of establishin that these notes were ascertained to be worthless in 1935.

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 Peterson Lumber Company, a corporation, to a proposed assessment of an additional tax in the amount of $288.4 for the year ended December 31, 1936, based upon the income of the corporation for the year ended December 31, 1935, be and the same is hereby modified. Said action is reversed insofar as it resulted from the disallowance by the Commissioner of the amount of $563.22 as a deduction from Appellant's gross income for the year 1935, said amount being the unpaid balance on the note of Fred Cave charged off during said year. Said Commission is hereby directed to allow said amount as a deduction from Appellant's gross income for said year. In all other respects said action is sustained.

-Done at Sacramento, California, this 15th day of November, 1939, by the State Board of Equalization.

Fred E. Stewart, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary