BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)

UTAH CONSTRUCTION COMPANY)

Appearances:

For Appellant: John Guthrie Heywood, Attorney at Law

For Respondent: Harrison Harkins, Assistant Franchise Tax Counsel

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 Utah Construction Company to his proposed assessments of additional tax for the taxable years ended December 31, 1936, and December 31, 1937, in the amounts of $184.41 and $1,315.83, respectively.

The Appellant, in the years 1928 and 1929, performed certai work in California, pursuant to a contract with the Nevada Irrigation District. Upon completion of the work in 1929 the District was unable to pay Appellant in cash the balance due under the contract, amounting to the sum of $164,000, by reason of the fact that at that time there was no market for the bonds of the District. As a result of this situation, the Appellant accepted on account of the above balance bonds of the District of the aggregate face amount of $164,000. In reporting its income for the year 1929 the Appellant computed its profit from the above contract in the same manner as if the entire amount due under the contract had been paid in cash, and upon selling portions of the bonds in the years 1935 and 1936 it claimed deductions from gross income in amounts equal to the excess of the face amount of the bonds sold over their sale price. The Appellant has at all times involved herein reported its income on the accrual basis.

The Respondent contends that the deductions claimed are improper on two grounds: (1) Any losses that may have resulted from the sale of the bonds are allocable to Utah, the state of domicile, rather than to California, because for purposes of property taxation the bonds are said to have a "situs" in the former state; (2) the bonds when received in 1929 actually represented gross income only to the extent of their fair market value at that time, and upon their subsequent sale no loss was realized except to the extent that the fair market value upon acquisition may have exceeded the sale price.

It is our opinion, however, that the deductions are proper

and should have been allowed. When a taxpayer keeps his account; and computes his income by the accrual method, as distinguished from the method of actual cash receipts and disbursements, it is the right to receive income rather than the actual receipt that determines the inclusion of the amount in gross income. The fact that the amount due may not be fully collectible does not affect the amount of gross income that should be reported, but is material only in determining the deduction that may be taken. (Spring City Foundry Co. v. Commissioner, 292 U. S. 182.) The fact that the obligation of the debtor is evidenced by a formal document, such as a bond or a note, does not appear to have any bearing upon the question and it has, in fact, been held to be immaterial in the computation of gross income. (Commissioner v. R. J. Darnell, Inc., 60 F. (2d) 82, 84.)

The applicable statute, in determining the deduction which may be taken on account of a bond which is wholly or partially worthless, has been held to be that pertaining to bad debts. (Commonwealth Commercial State Bank v. Lucas, 41 F. (2d) 111; Pacific National Bank v. Commissioner 91 F, (2d) 103.) It is to be observed that under Section 8(e) of the Bank and Corporati Franchise Tax Act, relating to the charge off and deduction of bad debts, a taxpayer is under no obligation to charge off a debt which is worthless only in part. (Commissioner v. MacDonal Engineering Co., 102 F. (2d) 942.) It is not contended that the bonds involved in this appeal were worthless when acquired, and consequently the fact that at that time they may have been worth less than their face amount did not affect Appellant's right to deduct in future years the losses realized by sales at amounts less than face value. (Spring City Foundry Co. v. Commissioner, supra.) The Respondent has cited decisions of the United States Board of Tax Appeals to the effect that when property has been acquired in exchange for services the basis of the property for purposes of determining gain or loss on subsequent disposition of the property is its fair market value at the time of its acquisition. (W. R. Jacques, 5 B.T.A. 1051.) In none of these cases, however, did the "property" acquired consist, as here, of the obligations of the person for whom the services were performed, and in view of the considerations mentioned above, we believe that they are not relevant to the determination of this appeal.

We are likewise unable to approve of the contention of the Respondent that if any losses are recognized for the years 1935 and 1936, they should be allocated to Utah rather than to California, Section 10 of the Act expressly states that the tax shall be measured by that portion of the net income which is derived from business done in this State, and in computing such net income deductions must necessarily be allowed for all losses derived from business done in this State, Since the face amount of the bonds held by Appellant represented the balance due it for services performed in California, which amount Appellant had properly reported as gross income derived from business done in California, we believe that when some of the bonds were sold at a discount, the difference between the aggregate face value of the bonds sold and the amount received constituted a proper deduction from the measure of the tax.

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 Utah Construction Company to proposed assessments of additional tax for the taxable years ended December 31, 1936, and December 31, 1937, in the amounts of $184.41 and $1,315.83, respectively, pursuant to Chapter 13. Statutes of 1929, as amended, be and the same is hereby reversed. Said ruling is hereby set aside and the said Commissioner is hereby directed to proceed in conformity with this order.

Done at Sacramento, California, this 7th day of July, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary