BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
F. T. AND FUMIKO MITSUUCHI)

Appearances:

For Appellants : & J. Marion Wright, Attorney at Law

For Respondent: & W. M. Walsh, Assistant Franchise Tax
P. Smith,
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Commissioner oh the protest of F. T. and Fumiko Mitsuuchi to a proposed assessment of additional personal income tax in the amount of $2, 010.61 for the year 1941.

On December 8, 1941, the Appellants were the owners and holders of bonds of the Tokio Electric Co., Ltd., having a face value of $60,000.00 and which had cost them $34,980.80. The underlying assets of that firm were located in Japan. On their joint income tax return for the year 1941 Appellants claimed a deduction from gross income in said mount of $34,980.80 as a war loss. The Commissioner, however, considered the loss as one subject to the capital loss limitation of $2,000.00 under Section 9.4(d) of the Personal Income Tax Act and, accordingly, disallowed the deduction to ths extant of $32,980.80. The correctness of his action in so doing is the only question presented for our consideration herein.

Section 8.3, setting forth certain special provisions regarding losses incurred by reason of the destruction or seizure cf property on and after December 7, 1941, as a result of the war, was added to the Personal Income Tax Act by Chapter 353, Statutes of 1943, which became effective May 7, 1943. Section 130(i) of that Chapter, provided, however, that Section 8.3 should be applicable with respect to taxable years ending after December 6, 1941. The Commissioner has not questioned the deductibility of the entire $34,980.80 in the Appellant's return of income if Section 8.3 is applicable to the year ended December 31, 1941. He contends, however, that the Section is constitutionally inapplicable to that year by reason of its conflict with Section 31 of Article IV of the California Constitution, prohibiting gifts of public money. He does not question the constitutionality of Section 8.3 as applied prospectively, but argues rather merely that it cannot be applied in the determination of tax liability for the year 1941 inasmuch

as that liability had become fixed and determined prior to the adoption of the Section in 1943. In support of this position, he cites an Opinion of the Attorney General of the State of California of September 12, 1944, (4 Ops. Cal. Atty. Gen. 173) holding Section 8.3 unconstitutional as applied to losses from securities which were capital assets and which became worthless during 1941 or 1942, .

We have on many occasions referred to our reluctance as an administrative agency to beconie a final arbiter of constitutional questions arising in connection with appeals to us from the action of the Franchise Tax Commissioner. In most instances the contention of unconstitutionality has been raised by an Appellant and it has been our practice to reject the contention in order that a judicial determination might be had thereon. On the other hand, in the few instances in which the issue has been presented by the Commissioner, we have similarly left the matter open for judicial determination by upholding the position of the Commissioner. See, e.g., Appeal of Ralph G. Lindstrom, July 15, 1943. Inasmuch as a taxpayer is in a position to present the constitutional question to the courts after an adverse decision of this the Commissioner is unable to do so, it is only by sustaining the action of the Commissioner in both situations that a judicial decision may be had on the issue of constitutionality.

The situation presented by this appeal is extremely similar to that of the Lindstrom Appeal. There, the Commissioner asserted the unconstitutionality of Section 7.1 of the Personal Income Tax Act, effective February 4, 1941, as applied to the taxable year 1940 and referred to an opinion of the Attorney General of October 2, 1941, holding that the Section as so retrospectively applied would be violative of Section 31 of Article IV of the California Constitution. Here, we are concerned with the retrospective application of Section 8.3 of the Act and the Attorney General has expressed the view that the Section as so applied would conflict with that provision of tha Constitution. For the reason above mentioned and in accordance with our action in the Lindstrom Appeal, we must uphold the position of the Commissioner on the constitutional question.

The Appellants further contend, however, that wholly apart from Section 8.3 of the Act, the amount of their asserted loss is deductible in its entirety under Section 8(d)(2) of the Act as a loss in a transaction entered into for profit or under Section 8(d)(3) as a casualty loss. The pertinent portions of the Section road as follows:

> "Sec. 8. Deductions from Gross Income. In computing net income there shall be allowed as deductions;
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> "(d) Losses. Losses sustained during the taxable year and not compensated for by insurance or otherwise:
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> "(2) If incurred in any transaction entered into for profit, though not connected with the trade or

"business; or

"(3) Of property not connected with the trade or business, if the loss arises from fires, storm, shipwreck, or other casualty, or from theft."

The Commissioner contends, on the other hand, that the bad debt provisions of Section 8(f) relate specifically to the deductibility of losses due to the worthlessness of bonds and that those provisions preclude the deductibility of the loss under any other portion of the Act. Subdivisions (2.) and(3) of Section 8(f) read as follows:

"(2) If any securities (as defined graph (3) of this subsection) are ascertained to be worthless within the taxable year and are charged off and are capital assets, the loss resulting shall be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

"(3) As used in this subsection, the term 'securities' means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation. .."

The courts have recognized a distinction between losses debts under provisions in the Federal Income Tax Acts similar to the provisions of the California Act involved herein. In Spring City Foundry Company v. Commissioner of Internal Revenue, 292 U. S. 182, the court denied a deduction for a bad debt under Section 234(a)(4) of the Revenue Act of 1918 providing for the deduction of "Losses sustained during the taxable year and not compensated for by insurance or otherwise," since Section 234(a)(5) of the Act provided for bad debt deductions. The Court stated that the specific provision as to debts indicates that these were to be considered as a special class and that losses on debts were not to be regarded as falling under the preceding general provision for losses. The Court stated that debts which were excluded from deduction under subdivision (5) as bad debts could not be deducted under subdivision (4) as losses. Accordingly, since bonds are debts, losses from worthless bonds are deductible only under the Section relating to bed debts, Section 8(f) of the Personal Income Tax Act, and not under the general loss provision, Section 8(d) of the Act.

The Appellants also contend that the bonds in question were not "worthless" in 1941 and for that reason did not then fall within Section 8(f). There was then no evidence that the assets of the Tokio Electric Co., Ltd., were seized by the Japanese Government or destroyed in the course of the war. it is the Appellant's contention that the declaration of war and its instant application of the Trading With The Enemy Act of 1917, (40 U.S. stats., Chap. 106,: as amended) did not make the bonds worthless in and of themselves but that it made them a deductible loss to the Appellants in that it precluded the Appellants from

selling, exchanging or in any other way exercising property rights in the bonds. A similar situation was involved in Hector Fezandie, Executor, 12 B. T.A.1325. In that case certain debts were owing to taxpayers in this country by German nationals at the outbreak of World War I. The debts were not worthless in that it did not appear that the debtors were insolvent and the debts were not confiscated by the German alien property custodian. Direct payment of the debts by the debtors was prohibited, however, by the German Government so that they were in a state of suspension. The Board held that, still being debts, they were deductible under the bad debt provision, if proved worthless to the taxpayers.

The Commissioner does not contend that the bonds were not properly ascertained to have become worthless to the Appellants in. 1941. In fact, he has conceded that they did then become worthless to them inasmuch as he allowed a deduction with respect to the bonds but limited that deduction to $2000.00 in accordance with Sections 8(f) and 9.4(d). Since the Appellants concede that the bonds were capital assets, the action of the Commissioner in so limiting the amount of the deduction must be sustained.

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, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of Chas. J, McColgan, Franchise Tax Commissioner, on the protest of F. T. and Funiko Mitsuuchi to a proposed assessment of additional personal income tax in the amount of $2, 010.61 for the year 1941 be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of January, 1949, by the State Board of Equalization.

Km. G. Bonelli, Chairman
J. H. Quinn, Member
J. L. Seawell, Member
G. R. Reilly, Member

ATTEST : Dixwell L. Pierce, Secretary