



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal
of
RAY R. AND DOROTHY D. ANDERSON

Appearances:

For Appellants: Earl W. Dufton, Public Accountant
For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, 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 Board on the protest of Ray R. and Dorothy D. Anderson to proposed assessments of additional personal income tax in the amounts of \$153.20, jointly, for the year 1948 and \$319.79 and \$35.00, respectively, for the year 1944.

Appellants are husband and wife. They filed a joint personal income tax return for 1948, and separate returns for 1949, computing their income on the cash basis.

Mr. Anderson and George S. Humphrey, who were associated in an automobile agency, organized Tube-Craft Products, Inc., a California corporation, in June, 1946, and became its president and secretary, respectively. The enterprise was unsuccessful and the corporation filed a petition in bankruptcy on December 31, 1947. The bankruptcy proceedings were completed June 14, 1949.

During the years 1946 and 1947, Anderson and Humphrey had loaned Tube-Craft a total of \$119,882.38 in an attempt to keep that company's business in operation. For the loans the corporation gave interest bearing demand notes. Anderson and Humphrey obtained the funds for making the loans by borrowing from a bank on notes executed by them as individuals. Because Tube-Craft failed, they were compelled to repay the bank with dividends withdrawn from their automobile agency,

Appellants claimed bad debt deductions on account of loans to Tube-Craft in the amounts of \$13,412.93, \$27,153.07, and \$12,674.57 for the years 1947, 1948, and 1949 respectively, or a total of \$53,240.57. These sums represent the amounts

Appeal of Ray R. and Dorothy D. Anderson

repaid by the Appellants to the bank during such years. Humphrey and his wife claimed bad debt deductions in the same amounts, so that the total claimed by the Andersons and the Humphreys was \$106,481.14. The Franchise Tax Board determined that the deduction on account of the unrecoverable debt due Appellants from Tube-Craft was allowable only in the year 1947, and disallowed the deductions claimed in the years 1948 and 1949,

Section 17310 (now Section 17207) of the Revenue and Taxation Code, as it read during the years involved in this appeal, provided in part:

"In computing net income there shall be allowed as a deduction debts which become worthless within the taxable year ~~and~~* & When satisfied that a debt is recoverable only in part, the commissioner may allow the debt as a deduction in an amount not in excess of the part charged off within the taxable year as a deduction."

Appellants contend that, because they report on the cash basis, they may claim the bad debt deduction in each of the years in which they were required to satisfy their notes to the bank; that only as they repaid money to the bank did the bad debt occur; and that the circumstances of this case come within the partial worthlessness provisions of the statute. As we view the matter, this is not at all a case of partial worthlessness. For reasons hereinafter noted, the debt became wholly worthless prior to 1948. Where the debt is determined to be totally worthless the taxpayer may not take a partial deduction and save the balance for a succeeding year, Malden Trust Co., 39 B.T.A. 190, aff'd. 110 F. 2d 751. The statute does not constitute the source of the funds with which the loan is made a determining factor between debts which become wholly or only partially worthless. Neither does the statute contain any condition that before a lender realizes worthlessness, either partial or total, he must repay the funds which he borrowed to use in making the loan. Appellants' theory would have merit only if Appellants were guarantors of a debt of Tube-Products to the bank. In such a situation the debt arises when the guarantor is compelled to make payment following default by the principal on the note. See D. W. Pierce, 41 B.T.A. 1261; and Leo L. Pollak, 20 T.C. 376.

Appellants have questioned whether the debt, under any theory, had become totally worthless in the year 1947. The Franchise Tax Board determined that the debt became worthless prior to 1948. In support of its position are the facts that Tube-Craft filed a petition in bankruptcy on December 31, 1947,

Appeal of Ray R. and Dorothy D. Anderson

and that the liabilities greatly exceeded the assets at that time, One of the Appellants, as president of Tube-Craft, was in a position to know intimately the financial condition and prospects of Tube-Craft, but has offered nothing to show that the debt had any value as of January 1, 1948. Appellants support the deductions as claimed in 1948 and 1949 with the contention that the debt did not become totally worthless until the completion of the bankruptcy proceedings on June 14, 1949. On this point Regulations 17310-17312(a), title 18, California Administrative Code, are pertinent and provide in part:

"Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. In bankruptcy cases a debt may become worthless before settlement in some instances and in others only when a settlement in bankruptcy shall have been had, In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year."

The date of the final settlement of the bankruptcy proceedings is not conclusive as to the worthlessness of a debt, but all factors bearing on the worthlessness of the debt must be **considered**. Patten and Davies Lumber Co. v. Commissioner, 45 Fed. 2d 556; W. A. Dallmeyer, 14 T.C. 1282. The debt may become worthless upon the filing of the petition in bankruptcy, Richard Downing, 43 B.T.A. 1147. Appellants have failed to present facts which would justify deferring the deduction beyond the year 1947. Curry v. Commissioner, 117 Fed. 2d 307.

Appellants assert that the Internal Revenue Bureau allowed deductions in each of the three years, 1947, 1948 and 1949, and submitted revenue agents' reports purportedly in support of that statement. However the report for the year 1947 shows that the bad debt deduction allowed for that year to Anderson was increased from \$13,412.93 to \$26,450.84. A similar increase was allowed for the separate returns of the Humphrey family, making a combined bad debt allowance of \$52,901.68 for Anderson and the Humphreys in that year. The 1947 report also states that during the period from October, 1946, to December, 1947, Mr. Anderson and Mr. Humphrey loaned a total of \$52,901.67 to the corporation. The reports for the years 1948 and 1949 state only that the returns are accepted as filed, and we are not shown any amount of bad debt deduction claimed. The bad debt deduction claimed for the year 1947 by Anderson and the Humphreys on their California tax returns was the amount claimed before the

Appeal of Ray R. and Dorothy D. Anderson

adjustment made by the revenue agent's report. Appellants make no attempt to explain the adjustment by the revenue agent or the statement regarding the total amount loaned.

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 the Franchise Tax Board on the protest of Ray R. and Dorothy D. Anderson to proposed assessments of additional tax in **the amounts** of **\$153.20** for the year 1948, and \$319.79 and **\$35.00**, respectively, for the year 1949, be and the same is hereby sustained,

Done at Sacramento, California, this 9th day of August, 1956, by the State Board of Equalization,

Paul R. Leake, **Chairman**

Robert E. McDavid, Member

J. H. Quinn, Member

_____, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary