



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CROCKER-ANGLO NATIONAL BANK)

Appearances:

For Appellant: Valentine Brookes, Attorney at Law;
George E. Oefinger, Certified Public
Accountant

For Respondent: F. Edward Caine, Associate Tax Counsel;
James Hamilton, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 27 of the Bank and Corporation Franchise Tax Act (now Section 26077 of the Revenue and Taxation Code) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) in denying the claim of the Anglo California National Bank of San Francisco, whose corporate name now is Cracker-Anglo National Bank, for refund of franchise tax in the amount of **\$67,755.39** for the income year 1941.

The Franchise Tax Board has allowed a separate claim for refund, based on a separate ground, in the amount of **\$20,898.89** for the income year involved. Appellant paid a total of only **\$67,755.39** for that income year. Thus, the amount actually in dispute is **\$46,856.50**. The sole remaining issue is whether Appellant is entitled to a bad debt deduction in 1941 based on an unsecured note of Pacific Coast Cannery, Inc., hereinafter referred to as the Company.

In 1926 Appellant acquired bonds of the Company in the principal amount of \$750,000. These bonds, together with an undisclosed number of other bonds, were a first mortgage on the Company's physical assets. In 1929 the Company suspended its operations and leased out its facilities to other operators. By June 30, 1932, the Company became further indebted to Appellant on unsecured loans evidenced by notes in the total amount of **\$1,400,000**. The notes at that time were among a group of assets held in trust for Appellant in connection with a merger.

By the end of 1936 the Company had redeemed a part of its outstanding bonds and had made cash payments on the notes. The outstanding bonds then amounted to \$715,000 and the balance due on the notes then totaled **\$1,370,000**. On December 28, 1936,

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bank examiners ordered Appellant to write down the value of the Company's bonds and notes in the amounts of \$143,000 and \$470,000, respectively. Appellant accordingly deducted those amounts as bad debts for the income year 1936 in its California franchise tax return,

In 1937 the above-mentioned trust was terminated and the trust assets, including the notes, were distributed to Appellant. The notes then were entered in Appellant's account titled "non-ledger assets.⁹⁹ Items in this account were reflected in Appellant's balance sheet at a nominal value of \$1.00. Appellant itself describes the function of the account as follows:

"Every bank continues to keep a record of notes written off as worthless. This record is necessary in order to make the proper entries when there are later recoveries, partial or complete, as a credit record in case the debtor ever asks for another loan, and for other purposes. For this reason normally Appellant refers to former ledger assets which have been written off as non-ledger assets ..."

By 1939 the lessees of the Company's canneries had failed and rental income had fallen to a level insufficient to meet taxes and other cash requirements. The Company's bonded indebtedness, amounted to approximately \$900,000 and its obligation on the unsecured notes amounted to approximately \$1,400,000.

On February 15, 1939, Appellant's officers ordered the removal of the amount of the unsecured notes from the non-ledger asset account and the transfer of the notes to Appellant's trust department "for permanent safekeeping." The notes accordingly were transferred and Appellant's contemporary record of the transaction expressly described the notes as being "uncollectible." To apply against current liabilities totaling almost \$2,000,000, exclusive of the principal amount of its bonds, the Company had current assets consisting of cash of \$44,348 and miscellaneous receivables of about \$8,600 on February 28, 1939. Its mortgaged properties had an appraised value of around \$450,000, which was scarcely half the amount then due on its outstanding bonds.

In November, 1939, an official of Appellant who had been assigned to review the situation made a recommendation that the Company be allowed to remain in possession of its properties until a purchaser could be found. The recommendation was made in the hope that the real estate market would improve. In the succeeding month it was further recommended that this policy be observed so long as the Company's cash on deposit with Appellant lasted.

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Appellant received a tentative balance sheet of the Company as of February 29, 1940, which showed that, while the book value of its depreciated assets was almost \$1,000,000, including cash of \$31,628.26 on deposit with Appellant, it had outstanding debts, including accumulated interest to date, of over \$2,700,000. Furthermore, in the previous 12 months its cash disbursements had exceeded its cash receipts by \$14,484.40. By the middle of 1940 Appellant's credit department had concluded as follows:

"The Company is clearly insolvent and without prospects of again having sufficient income to meet even part of its obligations The heavy involvement of the Company eliminates any possibility of any equity remaining.... If a purchaser for all or part of the properties can be located, an ultimate recovery of up to 50 cents on the dollar on the bonds may be possible. If the Company is allowed to continue to own the properties it could carry then for a considerable period with the cash it now holds."

In October of 1940 Appellant purchased at a cost of \$250 two more notes of the Company, having an aggregate face value of \$15,283.22. Appellant entered these notes in the non-ledger asset account, and promptly adjusted their value down to \$2.00. Also, in 1940 Appellant became the sole holder of the Company's bonds as a result of purchasing the interest of minority bondholders for \$5,000. On December 1, 1940, Appellant had the Company execute a new unsecured note in the amount of \$1,445,000, representing the unrecovered balance on the notes earlier transferred to Appellant's trust department for safekeeping. The new note, however, was then entered in Appellant's non-ledger asset account.

In 1941 Appellant, as the sole bondholder, started foreclosure proceedings against the Company, and in the same year obtained a judgment resulting in the sale of the Company's assets at a loss of \$264,878.24 on the outstanding bonds. Appellant also froze the Company's remaining cash on deposit, amounting to \$7,150, and applied that money by way of setoff against the unsecured note for \$1,445,000. The Company then was dissolved.

In 1942 Appellant recovered \$762 which it applied against the unpaid balance of the unsecured note. In 1943 it similarly recovered and applied \$1,234. In 1945 the note was transferred to Appellant's trust department for safekeeping.

On July 1, 1947, Appellant filed a claim for refund for the income year 1941. It contends that it incurred a loss in that year on the Company's unsecured note in the amount of \$892,850,

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taking into account the **amounts previously recovered** and the amount taken as a bad debt deduction in 1936.

Proceedings in this appeal have been deferred pending the settlement in court of questions related to the taxation of Appellant for prior years, including a question as to the proper basis for the assets received by Appellant from the aforementioned trust. Among other things, the court concluded that Appellant had a net loss of **\$119,06.50** for the year 1939. (Anglo-California National Bank v. Franchise Tax Board, Sacramento County Superior Court, No. 81630.) Appellant contends that this amount must be considered as the entire loss for 1939 and that the Franchise Tax Board is collaterally estopped from arguing that the Bad debt based on the unsecured obligation of the Company should have been deducted in that year. This contention is without merit, since the issue of the bad debt was not actually litigated and determined by the court. (United States v. Int'l Bldg. Co., 345 U.S. 502; Commissioner v. Sunnen, 333 U.S. 591; 29 Cal. Jr. 2d Judgments §§ 237, et seq.) **The precise question**, which still remains for **us to decide**, is whether Appellant is entitled to a bad debt deduction in **the year 1941** for the unrecovered balance of **\$892,850** on the Company's unsecured note.

The law applicable to this appeal is contained in Section 8(e) of the Bank and Corporation Franchise Tax Act which, during the years 1937 through 1941, allowed deductions of "**Debts** ascertained to be worthless within the income year and charged off" Substantially the same allowance was given in Section 23(k)(1) of the Internal Revenue Code of 1939. (The test of deductibility provided in the applicable law differs from the present test, that of actual worthlessness, contained in Section 24348 of the Revenue and Taxation Code.)

Under the above-quoted statutory language, it is well established that a taxpayer is entitled to a bad debt deduction for a particular year only if the debt is both ascertained to be worthless and charged off within that year. (Malden Trust Co. v. Commissioner, 110 F. 2d 751.) If in fact then, the **Company's** unsecured note was ascertained to be wholly worthless in a year prior to 1941, it cannot be made the basis of a bad debt deduction for the income year 1941. The burden is on Appellant to prove that the note was ascertained to be worthless in 1941. (Malden Trust Co. v. Commissioner, supra.)

As early as 1937 Appellant treated the company's notes as a non-ledger asset with a book value of \$1.00 or less. Not later than 1939 Appellant concluded that the notes were uncollectible and stored them away "**for permanent safekeeping.**" By 1940 Appellant recognized that the most it was likely to recover from the insolvent Company was **50 percent** of the bonded indebtedness, and

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this was contingent upon Appellant's carrying the Company (i.e., permitting the Company to draw out its remaining cash on deposit) until a purchaser of the Company's properties could be found. In 1940 it valued newly acquired notes of the Company at \$2.00, notwithstanding the fact that they had a face value in excess of \$15,000.

In the years 1939 and 1940 the cash on deposit with Appellant was allowed to drain out while an attempt was made to salvage as much as possible of the Company's bonded indebtedness. The cash residue was applied against the note only after Appellant decided to foreclose upon the Company's properties and minimize its loss on the outstanding bonds. Under these circumstances, the setting off of the cash residue against the unsecured note in 1941 had as little significance in Appellant's ascertainment of the note's worthlessness as the setting off of other small sums recovered in the years 1942 and 1943.

In our opinion, the unsecured debt was ascertained to be wholly worthless prior to 1941. The small sums later set off against the note constituted only subsequent recoveries on a debt already ascertained to be worthless and, as such, had no effect on the original ascertainment of worthlessness. (See Richards & Hirschfeld, Inc., 24 B.T.A. 1289, 1294; 29 Calif. L. Rev. 198.)

We are also of the opinion that the unsecured debt was "charged off" prior to 1941. If the debt was not "charged off" in 1937 by placing the notes in the non-ledger assets account, then, having officially labeled the notes as uncollectible on February 15, 1939, Appellant's removal of the amount of the notes from the non-ledger assets account, and transfer of the notes to its trust department "for permanent safekeeping" certainly constituted a charge off. (See Cammack v. United States, 113 F. 2d 547; 130 A.L.R. 212.) Although it was stated in the course of oral argument that the notes were recalled from the trust department later in 1939, the facts did not indicate that any such action was based on a conclusion that the notes had gained value. The condition of the Company obviously became worse rather than better after February 15, 1939. Nothing occurred later in that year which might have affected Appellant's original estimate of the debt's worthlessness. (Cf. In re Elaborated Ready Roofing Co., 78 F. 2d 75.)

Appellant argues, nevertheless, that Regulation 24121f(3), in Title 18 of the California Administrative Code, holds that debts become worthless at the time the creditor sells the debtor's property leaving a balance due. In answer, it is sufficient to observe that this regulation does not refer to the worthlessness of a debt unsecured by property.

