BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WILLIAM S. AND BETTY V. JACK)

For Appellants: Higgs, Fletcher & Mack and Frederick G. Tellam, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; James W. Hamilton, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of William S. and Betty V. Jack to proposed assessments of additional personal income tax in the amounts of $192.26, $431.54, $153.12 and $358.23 for the years 1951, 1952, 1953 and 1954, respectively.

Appellants have been residents of California since, and including, the year 1948. They were residents of Ohio during the years 1946 and 1947. In 1950 the United States Internal Revenue Service proposed a deficiency for the tax years 1946 and 194'7. The deficiency was alleged to have existed because of the sale of an Ohio corporation whose stock was owned entirely by Appellant William S. Jack, hereinafter referred to as Appellant, and another. The United States Internal Revenue Service contended that the proceeds of the transaction should be taxed as ordinary income. Appellant contended that the transaction was a true sale and that his gain was a capital one. Appellant engaged attorneys in 1951 to resist the assessment. The Tax Court of the United States entered a decision for Appellant in 1955.

During the years 1951 through 1954 the Appellant paid the following amounts for legal fees and expenses to resist the assessment of additional tax:

Year	Legal fees and expenses
1951	$11,340.63
1952	17,152.02
1953	13,167.10
1954	10,562.16

In 1948 Aero Industries, Inc., hereafter referred to as Aero, was incorporated in Cleveland, Ohio. Appellant, for the amount of $25,000, acquired 250 shzres of the capital stock of

Aero, representing a one-third interest. His son also acquired a one-third interest and apparently a third party or parties acquired the other one-third interest. The total amount of $75,000 was used to acquire equipment and machinery. In addition, Appellant advanced Aero the sum of $25,000 to be used for temporary working capital. This amount was not represented by a note nor did it bear interest.

Aero proved to be unprofitable and on April 1, 1950, it cancelled its lease and moved into smaller quarters where, until July, 1952, it was engaged exclusively in research on a nonlinear potentiometer. On April 1, 1950, it also transferred all its heavier machine tools to the Bill Jack Scientific Instrument Company, a company of which Appellant was substantially sole owner, for the sum of $10,325.60. That amount was then transferred to Appellant. The value of the machinery has not been established. After transfer of the heavy equipment the remaining equipment was acquired by Appellant's son. The son also acquired the remaining one-third interest in the capital stock of Aero. The son then leased to Aero the equipment he had acquired.

In 1952 the potentiometer development was discontinued. It was decided that Aero should be dissolved but, since the son had an opportunity to get into a new operation, he retained the corporation name and used the corporate property. Appellant surrendered his stock and waived any claim on his unpaid advance. Appellant charged off, in 1952, the remainder of the amount advanced to Aero but did not deduct the amount on his income tax return for that year. No evidence has been shown as to the assets and liabilities of Aero other than statements by Appellant that the obligation had become worthless. The son supplied funds for the new operation of Aero. As far as is known Aero is still in operation although its financial condition is unknown.

After being advised by the Franchise Tax Board that the expenses for the year 1952 were being disallowed, Appellant claimed a deduction of $14,674.40 as a bad debt for the year 1952. This amount represents the $25,000 advanced by Appellant to Aero as temporary working capital less the amount received by Appellant from the sale of the heavy machinery owned by Aero.

Appellant deducted $1,831.45 in the year 1952 as interest expense. The interest was on a deficiency in federal income taxes accrued prior to the time Appellant became a resident of this State.

Respondent disallowed the deduction of all legal fees and expenses, $1,761.93 of the interest expense and the sum of $14,674.40 claimed as a bad debt for the year 1952.

Respondent asserts that the legal fees and expenses and the interest expense are non-deductible because attributable to

classes of income exempt from tax, since they relate to income earned before Appellant became a California resident. Respondent further contends that the deductions accrued prior to the time Appellant became a resident of this State and are therefore non-deductible. Respondent also asserts that Appellant has failed to show that the debt to Aero became worthless in the year in which it was deducted. In addition, Respondent asserts that the cancellation of the debt was either a gift or a contribution to the capital of Aero.

Appellant contends that the legal fees and expenses and interest expense were not incurred until after Appellant became a resident of this State and are, therefore, deductible. His theory is that the expenses were incurred in the management and conservation of property held for the production of income. Appellant also contends that the debt to Aero became worthless in 1952.

We have recently held that no deduction may be taken for legal fees and other expenses incurred in contesting a federal tax on income derived before the taxpayer became a California resident and that no deduction may be taken for interest paid upon a federal tax with respect to such income. (Appeal of Bernard B. and Dorothy Howard, Cal. St. Bd. of Equal., March 7, 1961, 3 CCH Cal. Tax Cas. Par, 201-694, 3 P-H State & Local Tax Serv. Cal. Par. 58185.) This conclusion was based upon Sections 17351(e) and 17304 (now 17285 and 17203) of the Revenue and Taxation Code, which prohibit deductions for amounts that are related to exempt income, and upon federal authorities interpreting comparable federal provisions (James F. Curtis, 3 T.C. 648; George W. P. Heffelfinger, 5 T.C. 985; Nary A. Marsman, 18 T.C. 1, aff'd 205 F.2d 335, 216 F.2d 77, cert. denied 348 U.S. 943). The conclusion is also supported by Rev. Rul. 61-86, 1961-1 Cum. Bull. 41 and Rev. Rul. 62-9, 1962-4 Int. Rev. Bull. 11.

As in the Howard appeal, the legal expenses and interest here involved were related to exempt income, income derived before Appellant became a California resident, and thus they are not deductible.

The next issue to be decided is whether Appellant may deduct the money advanced to Aero as a bad debt during the year 1952. Our statute provides that in computing taxable income there shall be allowed as a deduction debts which become worthless within the taxable year. (Rev. & Tax. Code § 17207 [formerly § 17310].)

The burden of proof is on the Appellant to show not only that the debt was worthless but also that it became worthless during the taxable year in question. A presumption of correctness attaches to the action of Respondent in determining that the debt did not become worthless in 1952. (Appeal of Reginald C. Stoner

and Laura P. Stoner, Cal. St. Bd. of Equal., April 17, 1947, 3 P-H State and Local Tax Serv. Cal. Par. 58007.)

Appellant has not submitted evidence sufficient to show that the debt due from Aero became worthless in 1952. He merely alleges that it became worthless and that nothing would have been recovered had Appellant retained the obligation. No showing was made of the financial condition of kero nor of any attempt by Appellant to collect the amount due. We hold that Appellant has failed to meet the burden of proof as to worthlessness and Respondent's action in disallowing the deduction must be upheld.

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 protests of William S. and Betty V. Jack to proposed assessments of additional personal income tax in the amounts of $192.26, $431.54, $153.12 and $358.23 for the years 1951, 1952, 1953 and 1954, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of May, 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary