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65-SBE-034

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
KUHN ENTERPRISES, INC. }

Appearances:

For Appellant: Paul W. McComish, Attorney at Law,
and Thomas A. Gianella, Certified
Public Accountant

For Respondent:, Peter S. Pierson,
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Kuhn Enterprises, Inc., against a proposed assessment of additional franchise tax in the amount of \$5,818.89 for the income year ended June 30, 1959.

Appellant, a California corporation, was formed in June 1954, and adopted a fiscal year ending June 30. Its principal activity was the development of real estate. It was controlled by B. W. Kuhn, who also controlled a number of other corporations which he formed to engage in real estate development projects. These corporations included Linton Builders, Inc., Robar, Inc., Starco Development Co., Mervco Corporation, Mira Costa Constructors, John Marshall Corporation, and Dragline Rentals, Inc. Various intercompany accounts were created between appellant and the other corporations.

For the income year ended June 30, 1958, appellant wrote off on its books the following amounts, due from its affiliates: Starco Development Co., \$9,363.85; Linton Builders, Inc., \$1,878.06; Robar, Inc., \$3,647.65; and Dragline Rentals, Inc., \$19,097.34. The journal entries writing off these accounts were made on October 31, 1958, with the following notation: "To write off accounts. Companys are broke and out of business."

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On October 23, 1958, *appellant acquired a tract of land known as 'Triplett Manor, which had been subdivided into five units with 60 lots in each unit, Unit 1 was conveyed by appellant to John Marshall Corporation, which proceeded to develop it with streets and houses, It was expected that other corporations affiliated with appellant would participate in the development of other units, By May 31, 1959, 'John Marshall Corporation had incurred a deficit of \$50,000. In addition, Mr. Kuhn's health began to fail, The development of unit 1 was ultimately completed, and that unit was sold at a date which has not been specified. No houses were built on the remaining units, which were sold in December 1959, with the understanding that appellant was to install **streets** and sidewalks, **Mr. Kuhn's** health continued to decline and he died in September 1961.

In its franchise tax return for the income **year** ended June 30, 1959, 'appellant deducted as bad debts the amount of \$122,502.97, which represented **advances** it had made to Mira Costa Constructors, Linton Builders, Inc., Mervco Corporation, Robar, Inc., and Starco Development Co.

Respondent disallowed the deductions on the ground that the debts had become worthless prior to the year in which they were claimed. It allowed the bad debts as deductions for the income year ended June 30, 1958.

Section 24348 of the Revenue and Taxation Code permits a deduction for "debts which become worthless within the income year," The burden is upon the taxpayer to establish that a debt became worthless in the year for which he claims it as a deduction. (Redman v. Commissioner, 155 F.2d 319; Seaboard Commercial Corp., 28 T.C. 1034, 1053.)

Aside from the entry in appellant's books indicating that Starco Development Co., Linton Builders, Inc., and Robar, Inc., were "broke and out of business" as of June 30, 1958, the only evidence of the financial condition of the debtors consists of (1) a trial balance sheet showing that Robar, Inc., had a deficit of \$4,601.01 as of September 30, 1957, (2) a balance sheet showing that Mervco Corporation had a deficit of \$23,530.22 as of November 30, 1957, and (3) a trial balance sheet showing that Mira Costa Constructors had a surplus, .of \$4,906.24 as of July 31, 1958. The assets listed in arriving at this surplus include a loan of \$6,843.62 due from Mervco Corporation, which, -on the available evidence, was insolvent. .

Appellant argues, nevertheless, that its accountant erred in writing off any of the debts as of June 30, 1958. It attempts to establish that one of the corporations, Dragline Rentals, Inc., which was listed in the journal entry, was not "broke and out of business" on that date and asks us to infer that the entry as to the other corporations was therefore erroneous.

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The evidence submitted by appellant shows that Mr. Kuhn assigned a certain joint construction contract to Dragline Rentals in August 1957 and that in August 1958 there was approximately \$11,000 in a joint bank account in the name of Dragline Rentals and another, unrelated, company engaged in the construction project. There is no evidence of the liabilities of Dragline Rentals at any time. A letter of February 15, 1960, from an accountant to appellant's attorney, moreover, indicates that Mr. Kuhn, rather than Dragline Rentals, was engaged in the venture, and that he was entitled to deduct on his individual returns extensive losses which were incurred in the venture,,

The accountant, as of June 30, 1958, wrote off only a portion of the debts which appellant claims were owed by the corporations specified in the journal entry. The reason for this does not appear., Whatever the explanation for that may be, it has not been established that the entry was erroneous insofar as it reflected a determination that debts owed by the companies listed therein were worthless as of June 30; 1958.

We cannot find from the record before us that, immediately prior to the year in question, appellant's debtors were able to pay their debts. Although their prospects apparently improved during that year, the journal entry previously, referred to indicates that those prospects did not exist at the beginning of the year, and there is no evidence to the contrary. Even if we were to assume that the debts had value at the beginning of the year we could not find that they became worthless during the year without evidence of the debtors' financial condition in that period.

Appellant suggests that objective evidence of the financial condition or prospects of its debtors is unnecessary because their destinies were controlled entirely by Mr. Kuhn and his subjective determination alone fixed the worthlessness of the debts, But objective evidence of worthlessness is at least as desirable in the case of corporations controlled by their creditors as it is in the case of independent debtors. Under appellant's view, the creditor would be completely free to defer or accelerate his deductions into a year when it is most advantageous to him from a tax standpoint.

Since the objective evidence does not establish that the debts in question had value at the beginning of the year in which appellant deducted them, or that they became worthless during that year,, the deductions cannot be allowed.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Kuhn Enterprises, Inc., against a proposed assessment of additional franchise tax in the amount of \$5,818.89 for the income year ended June 30, 1959, be and the same is hereby sustained.

Done at Sacramento, California, this 3d day of August, 1965, by the State Board of Equalization.

John W. Lynch, Chairman
Paul R. Leate, Member
Richard H. ..., Member
..., Member
..., Member

Attest ... Secretary