



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
WILLIAM C. AND LOIS B. HAYWARD )

For Appellants: William Harold Jeffrey  
Certified Public Accountant

For Respondent: Crawford H. Thomas  
Chief Counsel

Lawrence C. Counts  
Tax Counsel

O P I N I O N

This appeal is made pursuant to sections 18594 and 19359 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of William C. and Lois B. Hayward against a proposed assessment of additional personal income tax in the amount of \$636.68 for the year 1959, and from the action of the Franchise Tax Board in denying the claim for refund of William C. and Lois B. Hayward in the amount of \$55.46 for the year 1960.

The questions presented are whether appellants were entitled to deductions for worthless stock and for a bad debt in either 1959 or 1960.

On February 4, 1957, Hayward and Smyth Co., a California corporation incorporated in 1955, issued 2500 shares of its stock to William C. Hayward (hereafter referred to as "appellant") as partial consideration for the assignment to it of a business and certain assets. The corporation engaged in the general contracting business and built apartment houses and residences. The corporation's books also reflected that during 1959, \$1,954 was transferred to the corporation by appellant as paid-in-capital.

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The formal balance sheets of Hayward and Smyth Co. indicate that the first time liabilities exceeded assets was in the fiscal year ended March 31, 1959. Total assets and liabilities for years ended March 31, 1956 through March 31, 1961, inclusive, were as follows:

<u>Fiscal Year</u> <u>Ended</u>	<u>Assets</u>	<u>Liabilities</u>
3-31-56	No activity	
3-31-57	\$138,989.59	\$121,727.81
3-31-58	156,274.68	153,593.42
3-31-59	429,545.93	451,864.67
3-31-60	554,043.06	575,591.16
3-31-61	346,386.88	373,767.65

The books of the corporation disclosed the following information:

<u>As f :</u>	<u>Inventory</u>	<u>Gross Sales</u>	<u>Net Income</u>	<u>Officer Wages</u> <u>to</u> <u>W. C. Hayward</u>
3-31-56	\$ -0-	\$ -0-	\$ -0-	\$ -0-
3-31-57	71,386.92	35,000	( 7,713.22)	1,600
3-31-58	151,452.02	134,000	(14,493.96)	-0-
3-31-59	333,202.94	117,300	(22,663.52)	-0-
3-31-60	504,487.73	657,201	856.98	12,500
3-31-61	306,864.54	425,060	( 3,717.31)	3,500
3-31-62	83,291.27	832,063	33,892.26	14,500
3-31-63	-0-	70,739	(36,470.74)	-0-

The books also revealed that as of March 31, 1959 appellant had loaned \$16,497 to the corporation, and that by the end of 1960 such loans had increased to \$28,790. The

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records also indicated that at the end of 1959 there was corporate indebtedness to banks of \$362,836 and to others of \$10,000. By the end of 1960 such indebtedness had increased to \$455,251 to banks and \$43,996 to others.

Appellants deducted a \$25,000 long-term capital loss on their 1959 return basing the deduction on the alleged worthlessness of the Hayward and Smyth Co. stock. Appellants also deducted \$1,954 as representing a loan to the corporation which allegedly had become worthless. Respondent Franchise Tax Board disallowed both deductions on the ground that appellants failed to establish worthlessness as occurring in 1959; and with respect to the bad debt deduction, respondent further questioned the existence of a bona fide debt. Appellants protested the proposed assessment which arose from the disallowance of the claimed deductions and appealed from respondent's action on their protest.

On the assumption that, in the alternative, the worthlessness of the stock and alleged debt occurred in 1960, appellants filed a protective claim for refund. The claim was also denied, respondent holding that its conclusions as to the year 1959 also applied to the year 1960.

Appellants contend that an identifiable event occurred during the fiscal year ended March 31, 1959, when the liabilities for the first time exceeded the assets, and that there was no prospect of improved conditions that would cause the stock to have any value,

Section 17206, subdivision (g) of the Revenue and Taxation Code provides that a loss from stock becoming worthless during the taxable year shall be treated as a loss from the sale of a capital asset. Section 17207 permits the deduction of a debt "which becomes worthless within the taxable year." Similar language is found in sections 165(g) and 166 of the 1954 Internal Revenue Code.

The burden is clearly upon appellants to establish that the shares of stock became totally worthless in the year for which the deduction is claimed, (Mahler v. Commissioner, 119 F.2d 869, cert. denied, 314 U.S. 660 [86 L. Ed. 529].) Appellants place great reliance upon the fact that the balance sheet as of March 31, 1959 showed that liabilities exceeded assets. Even if appellants had proven that the liabilities and assets were shown at their present value, the prospect of improved conditions gives otherwise worthless stock a potential value and no loss is recognizable for income tax purposes until that potential value has disappeared.

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(Nelson v. United States, 131 F.2d 301. See also Joseph C. Lincoln, 24 T.C. 669, aff'd, 242 F.2d 748; Cooley Butler, 45 B.T.A. 593; Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408.) For the years ended March 31, 1960 and March 31, 1962, the corporation realized a net income rather than a net loss. While there was an overall loss for the year ended March 31, 1961, it was considerably less than the net deficits for the years ended March 31, 1958 and 1959. Furthermore, the primary assets of the corporation consisted of residential homes and apartments in various stages of construction. Apparently, the extent of completion of these assets in 1959 was such that gross sales significantly increased in 1959 and were also substantial in 1960. Substantial loans were also made to the corporation by appellant and others in 1959 and 1960, a further indication that the stock had potential value.

In view of the above facts and authority, we must conclude that appellants have not established that the shares of Howard and Smyth Co, became worthless in 1959 or 1960 so as to allow a loss deduction in either of those years.

Because the corporate books reflected paid-in-capital of \$1,954, it is questionable whether the additional \$1,954 advanced by appellant constituted a loan. Assuming, however, without deciding that the advance created a bona fide debt, appellants have not established that any such debt actually became worthless in 1959 or 1960. Appellants again have the burden of proof and must show that some identifiable event occurred during 1959 or 1960 which formed a reasonable basis for abandoning any hope that the debt would be paid sometime in the future. (Redman v. Commissioner, 155 F.2d 319.) As was the case with the stock, appellants have failed to meet this burden. The advances made during 1959 and 1960, the fact that the alleged debtor remained a going concern during those years, the substantial gross sales, the profit for the years ended March 31, 1960, and March 31, 1962, and the relatively small loss for the year ended March 31, 1961, are all factors inconsistent with a claim of worthlessness. (Janet McBride, 23 T.C. 926; Miriam Coward Pierson, 27 T.C. 330, aff'd, 253 F.2d 928; Robert T. Ely, T.C. Memo., Dkt. No. 60483, May 13, 1958.) Accordingly, we find that respondent properly disallowed the bad debt deduction.

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,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to sections 18595 and 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of William C. and Lois B. Hayward against a proposed assessment of additional personal income tax in the amount of \$636.68 for the year 1959, and the action of the Franchise Tax Board in denying the claim for refund of William C. and Lois B. Hayward in the amount of \$55.46 for the year 1960, be and the same are hereby sustained,

Done at Sacramento, California, this 3rd day of October, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman  
John W. Kunch, Member  
J. B. ..., Member  
Robert ..., Member  
..., Member

ATTEST: [Signature], Secretary