

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of                  )  
  )  
ESTATE OF ROBERT P. McCULLOCH,                  )  
DECEASED, AND BARBARA B. McCULLOCH )

For Appellants: Donald W. Bauman

For Respondent: Carl G. Knopke  
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 Estate of Robert P. McCulloch, deceased, and Barbara B. McCulloch against a proposed assessment of additional personal income tax in the amount of **\$1,982.17** for the year 1976.

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Deceased. and Barbara **B. McCulloch**

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In 1974, Robert P. McCulloch loaned \$25,000 to Aero Resources, Inc. Of this amount, \$5,000 was repaid to his estate and the remaining \$20,000 is the amount claimed as a bad debt.

During the time of the loan, Robert P. McCulloch, hereafter referred to individually as appellant, and McCulloch Aircraft Corporation, the predecessor of Aero Resources, Inc., were embroiled in several stockholder derivative suits that included cross-complaints between Aero Resources, Inc. and appellant. On June 20, 1975, a memorandum of settlement concerning various pending actions was entered into which included claims between appellant and Aero Resources, Inc. The memorandum stated that "[a]ll parties whose counsel are signatories to this agreement shall execute mutual releases of any claims that any of them may have against the others." The referred to mutual release agreement was entered into by appellant and Aero Resources, Inc. on May 4, 1977, and included among its provisions a waiver of Civil Code section 1542, which specifically precludes the inclusion in a release of unknown or not yet existing claims between the affected parties.

After the due date of the \$20,000 note, appellant's **attorney advised him that collection was not** possible because the mutual release precluded such legal action between the parties. Since the debt could not be collected, the estate of appellant deducted it as a bad debt loss. Respondent disallowed the deduction and issued a proposed assessment of additional tax in the amount of **\$1,982.17**. This appeal followed.

The issue presented for determination is whether appellants are entitled to a worthless debt deduction in the amount of \$20,000 for the 1976 taxable year.

Section 17207, subdivision (a)(1), of the Revenue and Taxation Code provides that "**[t]here** shall be allowed as a deduction any debt which becomes worthless within the taxable year." This section is the counterpart of section 166 of the Internal Revenue Code of 1954. Two tests must be satisfied in order for the taxpayer to take a bad **debt deduction**. First, a bona fide debt must exist. (Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3).) Secondly, the debt must have become worthless in the taxable year for which the deduction is claimed. (Redman v. Commissioner, 155 F.2d

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**319** (1st Cir. **1946**); Appeal of Grace Bros. Brewing Co.,  
Cal. St. Bd. of Equal., June 28, 1966; Appeal of Isadore  
Teacher. Cal. St. Bd. of Equal., April 4, 1961.) The  
**taxpayer** has the burden of proving that both of these  
tests have been satisfied. (Appeal of Andrew J. and  
Frances Rands, Cal. St. Bd. of Equal., Nov. 6, 1967.)

Whether or not a bad debt existed in this case turns on the effect of the mutual release signed by appellant and McCulloch Aircraft Corporation on June **20**, 1975. Cases have held that where a mutual agreement of settlement is present, all the considerations moving between the parties must be viewed, and when the agreement provides for the release of a debt for satisfactory consideration, as respondent contends is the situation here, there is no support for a bad debt deduction.

(See Northwest Equipment Co. v. Commissioner, 34 B.T.A. 371 (1936) and First Nat. Bank and Trust Co. v. United States, 115 F.2d 194 (5th Cir. **1940**).) Appellant, on the other hand, urges that the \$20,000 debt at issue here was not part of the dissident stockholder's suit and, consequently, not part of the consideration for the mutual release between the parties.

Appellant's argument would have merit if the provisions of Civil Code section 1542 were operative, as the purpose of this section is to limit a release to the scope for which it was negotiated. However, the benefit of Civil Code section 1542 was specifically waived by appellant, and such a waiver is valid and enforceable in the commercial context. (Larsen v. Johannes, **7 Cal. App. 3d 491 [86 Cal. Rptr. 744] (1971)**.) We must agree with respondent that, without the benefit of section 1542, appellant's **debt** must be taken as part of the consideration for the mutual release, and appellant is subject to the full force and effect of its terms.

In any event, even if the transactions involved were considered as amounting to a deductible bad debt, the debt would have become worthless in 1977, the date the mutual release was signed, rather than the claimed year of **1976**. Therefore, it is clear that appellant has not met its burden of satisfying either of the two tests for worthlessness.

In view of this, we must sustain respondent's action in disallowing the deduction.

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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 18595 of the **Revenue** and Taxation Code, that the action of the Franchise Tax Board on the protest of Estate of Robert P. McCulloch, deceased, and Barbara B. McCulloch against, a proposed assessment of additional personal income tax. in the amount of **\$1,982.17** for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of September, **1980**, by the State Board of Equalization.

Dick Hein, Chairman

Paul J. Donnburg, Member

William B. Reed, Member

Frank Feltz, Member

                  , Member