



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
LAMBERT-CALIFORNIA CORPORATION)

Appearances:

For Appellant: Fred A. **Lambert**
President
Donald R. Villee
Certified Public Accountant
For Respondent: Claudia K. Land
Counsel

O P I N I O N

This appeal is made pursuant to section 25666" of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Lambert-California Corporation against proposed assessments of additional franchise tax in the amounts of **\$3,719.06** and \$907.82 for the income years ended September 30, 1972, and September 30, 1973, respectively.

1/ All statutory references are to the Revenue and Taxation Code.

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The appeal **presents two issues:** (1) 'whether appellant's shareholding interest in its subsidiary became totally worthless during the first appeal year, thereby entitling appellant to treat such worthlessness as a loss sustained during that period; and (2) whether an amount paid **by appellant**, as guarantor of a liability of its subsidiary, resulted in a worthless bad debt during the second appeal year.

On October 1, **1969**, appellant acquired, at a cost of **\$73,536.14**, approximately 88 percent of the stock issued by **Lambert Towing Equipment, Inc.** ("Towing"). Towing's principal business was the assembly of towing vehicles. Appellant's principal activity is the rental of property. While Towing realized net income during its first year of operation, it incurred substantial net losses in subsequent years and its financial position declined. Appellant has furnished the following information concerning **Towing's book** values and financial condition during its first five years of operation:

<u>Fiscal Year</u> <u>Ended</u>	<u>Gross Sales</u>	<u>Net Income</u>	<u>Stockholders'</u> <u>Equity</u>
9/30/70	\$1,444,496.00	\$ 41,780.21	\$215,191.61
9/30/71	1,059,215.00	(118,165.31)	34,651.27
9/30/72	946,373.00	(147,581.70)	(138,778.65)
9/30/73	--	(124,347.87)	(291,400.00)
9/30/74	--	(35,762.37)	(306,771.00)

The record in this appeal does not clearly indicate whether the declining sales figures **for Towing** were for chronological years or fiscal years. As indicated; gross sales figures were not provided in all instances.

By September 30, 1972, Towing's credit was poor; moreover, the calling of a bank loan further limited Towing's viability. During 1972, the towing industry sustained substantial losses in Southern California. According to appellant, the market value of Towing's assets did not exceed the above book values and, consequently, the negative stockholders' equities reflected on Towing's books, above, are accurate. Thus, appellant alleges that there was no market for Towing's shares by September 30, 1972.

Appellant reported on its return for **the** income year ended September 30, 1972, that its **share-**holding interest in Towing had become worthless during

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that period and, **consequently**, deducted its investment of **\$73,536.14** as a loss sustained in that income year. The subsidiary nevertheless continued in business in subsequent years, and appellant sold its shareholding interest in Towing in 1975.

Appellant had executed continuing guarantees to creditors of Towing. The principal such creditor was C.I.T. Corporation which, pursuant to its agreement with Towing, had 'discounted the notes and contracts of Towing's customers, **but** had retained the right of recourse against appellant's subsidiary in the event the customers failed to pay. Appellant guaranteed payment of Towing's contingent liability to C.I.T. Many of Towing's customers became delinquent.

The amount of appellant's outstanding guarantees to C.I.T. and others (and thus appellant's total potential liability) as of September 30, 1972, was as follows:

1. Guarantees made to C.I.T., as described above.	\$ 875,107.49
2. Additional guaranty to C.I.T. with respect to a note.	\$ 165.57
3. To Ernest Holmes Co., Inc. to guarantee Towing account balance.	\$ 23,218.00
4. To Ernest Holmes Co., Inc. and/or American National Bank to guarantee Towing installment note.	\$ 21,280.00
5. To Dr. J. Harper Edmiston to guarantee other Towing notes.	\$ 98,000.00
6. To United California Bank to guarantee Towing note.	\$ <u>5,000.00</u>
Total outstanding guarantees	\$1,022,771.06

Appellant asserts that when it became aware of Towing's poor financial condition, it was precluded from immediately liquidating Towing because it needed to maintain the subsidiary as a going business in an effort to limit the amount of actual losses that appellant would sustain because of the aforementioned outstanding guarantees. Appellant explains that Towing, though continuing in business, took steps to facilitate the sale of its business or liquidation at the earliest possible

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time when its contingent liabilities would be small enough to be absorbed by appellant or transferred. These steps included reducing inventory and receivables, ceasing sales that required a sales contract with recourse, and selling Towing's subsidiary, Lambert Truck Body and Equipment, Inc.

On September 26, 1973, appellant paid **\$25,132.39** to Ernest Holmes Company, Inc., when called upon to honor its guaranty after Towing defaulted on a demand made upon it. On its return for that income year, appellant deducted as a bad debt Towing's resulting obligation to pay that sum to it. As a consequence of keeping Towing in business through that income year, appellant's potential loss from its guarantees was reduced by **\$448,420.06**, i.e., from **\$1,022,771.06** to **\$574,351.00**. Included therein were the guarantees to C.I.T., relating to the recourse contracts: potential losses therefrom were reduced from **\$875,107.49** to **\$439,157.00**.

In the fiscal year ended September 30, 1974, appellant advanced **\$55,000.00** to Towing to maintain that corporation as a going concern. Appellant treated those advances as a debt which became worthless in that income year. During the fiscal year ended September 30, 1975, appellant acquired additional shares of Towing's stock in an effort to expedite the transfer of its shares, of that corporation to a buyer interested in Towing's inventories and equipment. Appellant thereafter was able to transfer all of its stock in Towing (virtually all of Towing's shares) to that buyer for **\$50,000.00**, but only after appellant agreed to assume a net of **\$397,954.69** of Towing's liabilities. Without the assumption of these liabilities, allegedly the stock would not have been marketable. Appellant claimed as a loss for the income year ended September 30, 1975, a bad debt write-off of **\$236,894.55** and a **\$59,170.21** capital loss on the transfer of the stock. Appellant had reduced its potential losses from the **\$1,022,771.06** outstanding guarantees, existing as of September 30, 1972, to **\$425,892.44** by the end of the fiscal year ended September 30, 1975.

Appellant has also claimed bad debt losses of **\$6,381.07** and **\$16,000.00**, respectively, for its income years ended in 1976 and 1977, as a consequence of payments made pursuant to the guarantees.

The disallowance of the **\$73,536.14** stock loss deduction claimed the first appeal year and of the

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\$25,132.39 bad debt deduction claimed the second appeal year, however, are the only subjects of this appeal.

We first turn to the question whether appellant's Towing stock became totally worthless during the income year ended in 1972, and thereby resulted in a deductible loss for that year.

Deductions are allowed for any loss sustained during the income year and not compensated for by insurance or otherwise. (**§ 24347**, subd. (a).) Securities which become worthless during the income year are treated as losses pursuant to section 24347, subdivision (d). In order to qualify for the deduction, the loss must be evidenced by closed and completed transactions, and fixed by identifiable events. (United States v. White Dental Mfg. Co., 274 U.S. 398 [71 L.Ed. 1120] (1927); Cal. Admin. Code, tit. 18, reg. 24347(a), subds. (2) & (4).) The burden is on the taxpayer to establish that the securities became totally worthless during the year for which the deduction is claimed. (Mahler v. Commissioner, 119 F.2d 869 (2d Cir. 1941), cert. den., 314 U.S. 660 [86 L.Ed. 5291 (1941)]; Appeal of Harry E. and Mildred J. Aine, Cal. St. Bd. of Equal., April 22, 1975.)

Stock will not be considered as worthless so long as there is a reasonable hope and expectation that it will become valuable at some future time. In order to establish that hope and expectation is foreclosed, it is necessary for the taxpayer to show the occurrence of an identifiable event or events during the year which have destroyed not only the present liquidating value of the stock, but the potential value of the stock as well. (See generally Sterling Morton, 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940); Cooley Butler, 45 B.T.A. 593 (1941).) Appellant has offered a number of factors which, it maintains, constituted identifiable events establishing that the stock became totally worthless during the income year ended September 30, 1972. First, appellant particularly stresses the negative shareholder's equity as of September 30, 1972, as reflected in book values. It also emphasizes the decline in sales, the calling in of the bank loan, and the substantial losses in the towing industry generally in the area at that time.

The factors upon which appellant relies show that Towing was beset with economic difficulties. We are not persuaded, however, that they constituted identifiable events which clearly established that the stock

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became worthless during the year in question. There are several reasons for our conclusion.

First, no independent evidence has been presented supporting the contention that the book values truly reflected actual values. Nevertheless, even assuming they did so, an excess of liabilities over assets is **not conclusive** evidence that stock is worthless. (See Mahler v. Commissioner, supra.) As we have indicated, **the potential** value of the stock must also be shown to be destroyed. (See Cooley v. Butler, supra; Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408 (5th Cir. 1943); Appeal of Medical Arts Prescription Pharmacy, Inc., Cal. St. Bd. of Equal., June 13, 1974.)

Appellant contends that because of the condition of the towing industry and Towing's financial condition, it was apparent by September 30, 1972, that there was no recovery possible of any portion of the investment in the future. We do not agree. Assuming book values reflected actual values, the year in question marked the first year that the stock had no present liquidating value. It was also only the second year in which net losses were incurred. Moreover, there is nothing of significance in the record to indicate that, as of September 30, 1972, a reasonably **prudent business-**man would have concluded that conditions in the towing industry were so adverse, and Towing's financial condition so poor, that the **stock** did not have at least a partial potential value. It is the situation as it reasonably appeared **at that time that** is significant, not that which may have later developed. (See Mahler v. Commissioner, supra.) The adverse conditions in **the** industry could well have been temporary. The change in Towing's method of operation could have improved the subsidiary's financial condition, at least to the extent of resulting in some value to the stock. Furthermore, it has frequently been held that such factors as deficits, operating losses, poor business conditions and similar circumstances are insufficient in themselves to establish the worthlessness of stock. (See, e.g., Joseph C. Lincoln, 24 T.C. 669 (1955), affd. on other grounds, 242 F.2d 748 (6th Cir. 1957); Anthony P. Miller Inc., 7 T.C. 729 (1946), affd., 164 F.2d 268 (3d Cir. 1947).)

Where a business does continue, we believe that the circumstances must be exceptional before we are induced to hold that the shares are devoid of any potential future worth. (See Bullard v. United States,

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146 F.2d 386 (2nd Cir. 1944); Miami Beach Bay Shore Co. v. Commissioner, supra; see also Duncan M. Fort, ¶ 55,261 P-H Memo. T.C. (1955.) Appellant simply has not established that this is one of **those exceptional** cases where the liabilities of a corporation so greatly exceeded its assets at a particular time as to compel a conclusion that the stock became worthless during the previous income year. (Compare and contrast the extreme disparity existing in Sterling Morton, supra.)

We **next** turn to the question of the **\$25,132.39** bad debt deduction claimed for the period of the second appeal year.

Section 24348 allows a deduction for debts which become worthless within the income year. The factors considered in determining when and whether a debt becomes totally worthless are similar to those associated with the determination of deductible 'losses from securities. Again, the burden, is imposed upon the taxpayer to show that the debt became totally worthless during the year for which the deduction is claimed. (Appeal of William C. and Lois B. Hayward, Cal. St. Bd. of Equal., Oct. 2, 1963.) When considering the worth of the debt in **question**, the fact that Towing's liabilities exceeded its assets as of September 30, 1973, simply does not, of itself, establish that the Holmes debt was then totally worthless. Mere insolvency, without more, does not establish that fact; it merely indicates that a debt is only partially recoverable. (Trinco Industries, Inc., 22 T.C. 959 (1954); Robert D. Marshall, ¶ 60,288 P-H Memo. T.C. (1960).)

While losing money and **apparently insolvent** to the extent that its liabilities exceeded its assets, as of September 30, 1973, Towing continued to engage actively in business thereafter. Appellant has not shown that, as of that date, Towing's liabilities were so greatly **in excess** of its assets as to preclude the possibility that at least some portion of the debt would be recoverable.

Moreover, while section 24348 also provides, under certain conditions, for deduction of partially worthless bad debts, appellant has neither alleged nor proved the amount of any such partial worthlessness.

For the foregoing reasons, we must sustain respondent's action.

