

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MEDICAL ARTS PRESCRIPTION PHARMACY, INC.)

Appearances:

For Appellant: Arthur A. Mayhew, Jr.
Secretary and Certified Public Accountant

For Respondent: Richard C. Creeggan
Counsel

OPINION

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 Medical Arts Prescription Pharmacy, Inc. , against proposed assessments of additional franchise tax in the amounts of \$567.91 and \$846.19 for the income years ended June 30, 1966 and 1967, respectively.

Appellant, a California corporation, operates a pharmacy in Lynwood. From 1964 until 1967 appellant owned one percent of the

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capital stock of Cerritos Rexall Drugs, Inc. (hereinafter Cerritos) . During those years Cerritos experienced steadily declining sales and continuing losses which resulted in a deficit that increased from \$46,445 in 1964 to \$100,972 in 1967. As a result of its unprofitable operations Cerritos was finally dissolved on October 19, 1967, when its assets were sold for less than their book value.

During appellant's four income years ended June 30, 1964 through June 30, 1967, it made substantial cash and merchandise advances to Cerritos on an open book account. Appellant never received any material repayment of these advances. On its federal and state tax returns for those years, appellant charged off the advances as bad debts in the following amounts:

| <u>Income Year Ended</u> | <u>Bad Debt Deduction</u> |
|--------------------------|---------------------------|
| June 30, 1964 | \$ 14,719.66 |
| June 30, 1965 | 16,444.00 |
| June 30, 1966 | 15,164.00 |
| June 30, 1967 | <u>62,641.00</u> |
| Total | \$108,968.66 |

The Internal Revenue Service audited appellant's federal returns for those years, and in an audit report dated November 7, 1967, disallowed the claimed bad debts on the basis that the advances were contributions to capital rather than loans. In 1969, a federal settlement statement was issued by the Internal Revenue Service allowing all the bad debt deductions for the income years ended June 30, 1964 and 1965, and a portion of the deduction claimed for the income year ended June 30, 1966. The disallowance of the entire bad debt deduction for the income year ended June 30, 1967, remained unchanged.

Originally, respondent proposed assessments of additional franchise tax based on the 1967 federal audit report. However, appellant protested that determination and respondent issued notices of action revising the proposed assessments in accordance with the final federal settlement. It is the propriety of respondent's action in this matter which is the sole issue for determination.

It is well established that a deficiency assessment which is based upon a federal determination is presumed to be correct, and the taxpayer must show wherein it is erroneous. (Fodd . McColgan, 89 Cal. App. 2d 509 [201 P. 2d 414]; Appeal of Henrietta Swimmer,

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Cal. St. Bd. of Equal. , Dec. 10, 1963.)

Appellant does not challenge the amount of the federal adjustments; however, it maintains that the final federal determination is not inconsistent with allowing the claimed deductions for purposes of the California franchise tax. Specifically, appellant argues that the Internal Revenue Service determined that the portions of the claimed bad debt deductions which were disallowed were contributions to capital and, therefore, capital losses. However, the federal law limits the deductibility of capital losses for corporations to the extent of the corporation's capital gains. (Int. Rev. Code of 1954, §1211(a).) Since appellant had no capital gains for the years in question it could not avail itself of the capital loss deductions at the federal level. Appellant concludes that, since California law has no such limitations on the deductibility of a corporation's capital losses, the claimed deductions should be allowed in full pursuant to section 24347 of the Revenue and Taxation Code,

Initially, we note that the federal settlement statement did not state the basis upon which the final figures were arrived at. Rather, it merely showed the mathematical results of the allowance of the entire bad debt deduction claimed for each of the income years ended June 30, 1964 and June 30, 1965, a partial allowance of the bad debt deduction claimed for the income year ended June 30, 1966, and the complete disallowance of the bad debt deduction claimed for the income year ended June 30, 1967. The deductions in question were originally disallowed by the Internal Revenue Service on the basis that they were contributions to capital rather than bad debts. If, as maintained by appellant, this theory had been upheld in the final federal settlement, then no part of the deductions would have been allowable since appellant had no capital gains during the years in question. (See Int. Rev. Code of 1954, § 1211(a) .) However, the Internal Revenue Service did allow the full deduction claimed for two of the years, and a partial deduction for the third year. Therefore, we find appellant's argument that the federal adjustments are not inconsistent with allowing the claimed deduction for state purposes, unconvincing.

Next, we turn to the question whether, regardless of the federal determination, the claimed deductions were, in fact, deductible capital losses.

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It is true that deductions are allowed for any loss sustained during the income year and not compensated for by insurance or otherwise. (Rev. & Tax. Code, § 24347, subd. (a) .) Securities which become worthless during the income year are treated as losses pursuant to section 24347, subdivision (d), of the Revenue and Taxation Code; and advances which are capital contributions are included within the statutory definition of a security. (Phil Kalech, 23 T.C. 672; Cal. Admin. Code, tit. 18, reg. 24347, subd. (e)(1).) However, in order to be deductible, 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. 11201; Cal. Admin. Code, tit. 18, reg. 24347(a), subd. (2).) Therefore, even if we assume that the advances were contributions to capital, appellant must establish that the securities became worthless in the years for which the deductions were claimed. In order to do this appellant must show that the securities had value at the beginning of the year in question and that some identifiable event occurred during the year rendering the securities worthless by the end of that year. (United States v. White Dental Mfg. c o . , supra.)

In support of its position, appellant submitted the unaudited balance sheets of Cerritos for the years in question. The balance sheets indicated that liabilities substantially exceeded assets. This, appellant concluded, established an identifiable event evidencing the worthlessness of the securities. However, mere insolvency, without more, does not establish that a security is worthless. (Trinco Industries, Inc., 22 T.C. 959; Robert D. Marshall, T.C. Memo., Dec. 30, 1960.) There is no doubt that the balance sheets portrayed a dismal financial future for Cerritos. Nevertheless, the corporation continued in business until its dissolution in October 1967, well after the close of the years in question. It would appear that the securities became worthless, if at all, at the time of dissolution and not during either of the years in question.

We conclude that appellant has failed to establish that respondent's determination in this matter was erroneous. Accordingly, respondent's action must be sustained.

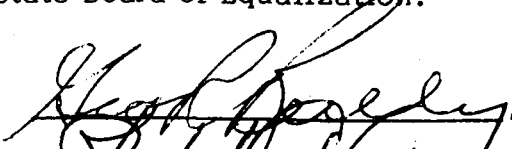
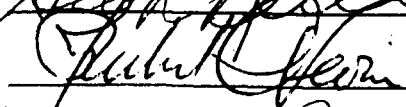
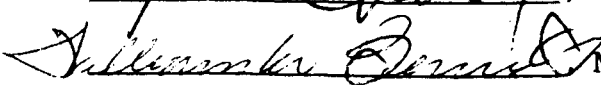
ORDER

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 section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Medical Arts Prescription Pharmacy, Inc. , against proposed assessments of additional franchise tax in the amounts of \$567.91 and \$846.19 for the income years ended June 30, 1966 and 1967, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 13th day of June, 1974, by the State Board of Equalization.

 Chairman
 Member
 Member

_____, Member

_____, Member

ATTEST:  Secretary