BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DAHLQUISI' DRILLING, INC.)

For Appellant: Donald D. Dahlquist
President

For Respondent: Crawford H. Thomas
Chief Counsel

Richard A. Watson
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 Dahlquist Drilling, Inc. , against a proposed assessment of additional franchise tax in the amount of $1,358.04 for the income year ended March 31, 1968.

The question presented is whether, for the income year in question, appellant is entitled to a greater casualty loss deduction than was allowed by respondent.

Appellant is a California corporation engaged in rendering mining, oil, and gas field services. At all relevant times, appellant's insurance representative was Insurance Incorporated. On January 23, 1967, Donald Dahlquist, appellant's president, asked Fritz Klemm, secretary of Insurance Incorporated, to add a newly acquired drilling rig to appellant's existing insurance policy covering another rig. This policy was underwritten by Hartford Fire Insurance Company. Klemm advised Dahlquist that the second rig would be added to the Hartford policy and that the rig was covered as' of that date (January 23, 1967).

Since Insurance Incorporated had no written agency agreement with Hartford, it had placed the original insurance with Hartford through the Gene Whitlock Agency, an authorized Hartford agent. Therefore, after his discussion with Dahlquist, Klemm instructed one of Insurance Incorporated's employees to contact the Gene Whitlock Agency to add coverage of the second rig to the existing policy. Since Mr. Whitlock was not in his office, the employee mailed a written order to him, which Whitlock saw for the first time on January 25, 1967. Sometime on January 24, the second rig was destroyed in a windstorm.

Appellant's existing Hartford policy had no provision for the immediate coverage of newly acquired equipment; consequently, sometime on or after January 25, Whitlock and Hartford refused coverage of the already destroyed rig. As a result of that refusal, appellant filed suit against Hartford, Klemm, and Insurance Incorporated, among others, on December 5, 1967. The principal thrust of the complaint was that appellant had a contractual basis for recovery against all of the defendants because Klemm and Insurance Incorporated were either actual or ostensible agents of Hartford, with authority to bind that company. Secondarily, the complaint alleged that; notwithstanding the oral agreement between Dahlquist and Klemm, the defendants negligently failed to place the promised insurance coverage. On March 13, 1970, the trial court ruled against appellant on its contract claims. The court rendered judgment against Klemm and Insurance Incorporated, however, on the ground that they had negligently purported to issue appellant a

Hartford insurance policy, when they had no authority to do so. In an unpublished opinion dated April 21, 1972, the District Court of Appeal reversed the trial court's decision on the negligence issue. The basis for the reversal was that Klemm and Insurance Incorporated had been held liable for negligent misrepresentation, a tort that appellant had neither pleaded nor proved.

On its franchise tax return for the fiscal year ended March 31, 1968, the fiscal year following that of the physical casualty, appellant claimed a casualty loss deduction of $18,702.88, representing the drilling. rig's adjusted basis minus its salvage value. Respondent disallowed $15,000 1/ of the loss on the ground that to that extent the loss had not been sustained during this income year. The correctness of that determination is the only issue we must resolve.

Section 24347, subdivision (a), of the Revenue and Taxation Code allows as a deduction "any loss sustained during the income year and not compensated for by insurance or otherwise." This section is virtually identical to section 165 of the Internal Revenue Code. Respondent's regulation 24347(a), 2/ which is based on section 1.165-1 of the Treasury Regulations, describes the proper year for taking a loss deduction as follows:

1/ $15,000 is the amount of insurance proceeds appellant would have received if the second rig had been covered under appellant's existing Hartford policy.

2/ Although this regulation was promulgated subsequent to the year in issue, it is automatically retroactive and applicable as of the enactment of section 24347 in 1955. (Appeal of Wilhelm S. and Geneva B. Everett, Cal. St. Bd. of Equal., Nov. 13, 1973.)

> (4) Year of deduction. (A) A loss shall be allowed as a deduction under Section 24347(a) only for the income year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the income year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such income year.
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> (B) (i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of Section 24347, until it can be ascertained with reasonable certainty whether or not, such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim.. .. (Cal. Admin. Code, tit. 18, reg. 24347(a), subd. (4).)

Respondent's position is that appellant did not sustain $15,000 of the alleged loss during the income year in question, since appellant had a claim for reimbursement in that amount as to which there was a reasonable prospect of recovery. If that is correct, then this portion of the total loss was not "sustained," for purposes of section 24347, until the adverse decision of the appellate court made it clear that appellant would not receive any reimbursement for its loss.

In order to overturn respondent's action in this matter, appellant must show that its prospect for recovery was no longer reasonable as of the end of the income year in issue. (Louis Gale, 41 T. C. 269.) This it has failed to do. Appellant argues that during that year it reasonably concluded that it had no reasonable chance

to recoup its loss because Hartford, Insurance Incorporated, and Klemm denied all liability for the loss. Although such denials may certainly be considered in evaluating a taxpayer's prospects for recovery, they are not enough, standing alone, to constitute the decisive. factor in appellant's favor. (Louis Gale, supra.) Of equal or greater significance is appellant's prosecution of its lawsuit despite the defendants' denials of liability. At the least such conduct casts doubt on the assertion that appellant believed it had no reasonable chance of recovery. (Cf. Ramsay Scarlett & Co. , 61 T. C. 795, 813, n. 12, appeal docketed, 4th Cir. , June 6, 1974.) Moreover, the appellate court finding that appellant had not proved negligence because no evidence was offered on the drilling rig's insurability does not mean that appellant's chances of proving negligence were hopeless from the outset. Appellant's allegation on brief that it could not have produced such evidence in the trial court is insufficient, by itself, to establish either that the rig was uninsurable or that it was insurable only through Klemm and Insurance Incorporated because of time limitations.

On the sketchy record before us, we cannot find that appellant lacked a reasonable prospect of recovery at least from its own insurance man, who promised insurance coverage that he and his agency could not and did not provide. (See Graddon v. Knight, 138 Cal. App. 2d 577 [292 P. 2d 632].) Accordingly, respondent properly denied the deduction in question, since the loss was not sustained, within the meaning of subdivision (a) of section 24347, during appellant's income year ended March 31, 1968.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Dahlquist Drilling, Inc.

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 Dahlquist Drilling, Inc. , against a proposed assessment of additional franchise tax in the amount of $1,358.04 for the income year ended March 31, 1968, be and the same is hereby sustained.

Done at Sacramento, California, this 19 day of August 1975, by the State Board of Equalization.

John W. Lynch, Chairman

Member

Member

Member

Member

ATTEST: W. W. Dunlap, Executive Secretary