86-SBE-161

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81R-1148-SW
MERIDIAN EXPORT, INC.)

For Appellant: James B. Hearden
Certified Public Accountant

For Respondent: Grace Lawson
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Meridian Export, Inc., for refund of franchise tax in the amounts of $1,063.80 and $3,032.56 for the income years 1977 and 1978, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The issue presented in this appeal is whether appellant is entitled to bad debt deductions for the income years in issue.

Appellant is a California-based corporation engaged in the worldwide distribution of sexually explicit literature. It uses the direct chargeoff method of accouriting for its bad debts. *For* its 1977 income year, appellant deducted a bad debt from Universal Enterprises, Ltd. (Universal), Tokyo, Japan. The last charge Universal made on its. account with appellant was March 11, 1974. In April of 1976, Universal returned some merchandise for a credit, reducing its outstanding balance to **$37,451.22.** By February 1977, appellant's statement of account to Universal had been returned with a postal service stamp on the envelope indicating that Universal was no longer at the designated address. Appellant's calls to Universal allegedly resulted *in* notice that the service had been disconnected and no new number was listed.

During the income year 1978, appellant deducted a debt of $5,433 for the account of Interdiffusione. On January 18, 1978, Interdiffusione paid its outstanding balance and then on April 26, 1978, it charged an additional **$6,205.20.** The last statement issued to Interdiffusione by appellant was dated December 25, 1978. Appellant alleges that this statement was returned by mail authorities and that attempts to call Inter-diffusione resulted in notice of disconnection with no new listing. **Also,** during the income year 1978, appellant deducted a debt of **$32,709.58** for the Love Boutique. On November 3, 1976, Love Boutique had an outstanding balance of **$32,709.58.** Two payments totalling $5,040 were made in late 1977; however, in early January of 1978, an identical charge of $5,040. *was* made. There **was no** further activity on the account. Appellant contends that the last statement dated December 25, 1978, was returned by mail authorities and that calls to Love Boutique resulted in notice of disconnected service.

On April 4, 1979, appellant entered into an agreement with Mr. Mamoru Oyama to collect the amounts owed by Universal and Love Boutique. Mr. Oyama was to be paid 50 percent of any amount collected. There is no evidence that any amounts were collected by Oyama or remitted to appellant.

Respondent disallowed the claimed bad debt deductions and appellant paid the additional assessments. A claim for refund was filed and denial of this claim by respondent resulted in this timely appeal by appellant.

Section 24340, subdivision (a), provides that a corporate taxpayer may deduct all debts which become worthless within the income year. Deductions, however, are a matter of legislative grace and the burden is on appellant to prove that it is entitled to such deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Mayes v. Commissioner, 21 T.C. 286 (1953).)

Initially, we note that section 24348 is substantively identical to section 166 of the Internal Revenue Code of 1954. Accordingly, federal case law is highly persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

In order to be entitled to a deduction for a business bad debt, appellant must demonstrate that the debt became totally worthless during the income year. Whether a debt is totally worthless within a particular year is a question of fact. (Perry v. Commissioner, 22 T.C. 968 (1954); Mellen v. Commissioner, ¶ 68,094 T.C.M. (P-H) (1968).) The burden is on appellant to prove that the debt for which the deduction is claimed had some value at the beginning of the year in which the deduction is claimed, and that it became worthless during that year. (Cittadini v. Commissioner, 139 F.2d 29 (4th Cir. 1943); Appeal of Knollwood West Convalescent Hospitals, Inc., Cal. St. Bd. of Equal., Mar. 3, 1982.) The standard for the determination of worthlessness is an objective test of actual worthlessness. (Appeal of Parabam, Inc., Cal. St. Bd. of Equal., June 29, 1982.) The time for worthlessness must be fixed by an identifiable event or events in the period in which the deduction is claimed which furnish a reasonable basis for abandoning any hope of future recovery. (United States v. White Dental Mfg. Co., 274 U.S. 398 (71 L.Ed. 1120] (1927); Appeal of B & C Welding, Inc., Cal. St. Bd, of Equal., Oct. 26, 1983.)

The first debt to be discussed involves the amount owed by Universal. Universal made its last payment to appellant in 1975. In April of 1976, Universal received a returned-merchandise credit but no further activity on the account occurred during 1976. It

is well established that appellant must prove that at the beginning of the income year in question, the debt from Universal had some value. (See Appeal of Knollwood West Convalescent Hospitals, Inc., supra.) A bad debt deduction is not allowed if the debt became worthless in a year prior to the year for which the deduction is claimed. (Appeal of Real Estate Buy Keller, Cal. St. Bd. of Equal;, Nov. 13, 1973.) Appellant has presented no evidence that the debt owed by Universal had any value on January 1, 1977. No payments had been made on the account since 1975 and the only activity on the account in 1976 was a credit for returned merchandise. In the absence of specific evidence that appellant had a reasonable basis for believing that the account would eventually be paid, we cannot conclude that appellant has shown that the debt with Universal had any value at the beginning of 1977.

The second debt involves the Interdiffusione account. In January of 1978, Interdiffusione paid its outstanding balance and then, in April, charged a like amount. In January of 1979, the statement issued on December 25, 1978, was returned by mail authorities and attempts by appellant to contact Interdiffusione by telephone were unsuccessful. As we have previously stated, appellant has the burden of-proving not only that the debt had value at the beginning of 1978, but that the debt was worthless by the end of 1978. (Appeal of Grace Brothers Brewing Co., Cal. St. Bd. of Equal., June 28, 1966.) while there is evidence of the debt having value in January, there is no evidence that it became worthless before the end of 1978. 'In April of 1978, Interdiffusione was still charging on its account and it was not until January of 1979 that the statement to Interdiffusione was returned. Appellant has not shown by any identifiable event or events that the Interdiffusione account became worthless in 1978. In the absence of any evidence as to Lnterdiffusione's change in financial condition in 1978, we must conclude that respondent's action in denying the deduction is correct.

The *final* debt involves Love Boutique. This debtor made payments in late 1977, and made its final charge in January of 1978. The December 1978 billing was returned in early 1979 and attempts to contact Love Boutique personnel by mail or telephone allegedly failed. The services of a collection service were retained on April 4, 1979. Mr. Mamoru Oyama was to receive 50 percent of any amounts he collected. As was discussed above, we must conclude that appellant has not presented

any evidence that the debt by Love Boutique became worthless in 1978. (See Appalachian Trail Co. v. Commissioner, ¶ 73,119 T.C.M. (P-H) (1973).) It was not until the early part of 1979 that the statements were returned by postal authorities or that a collection agency was retained. As appellant has not met its burden of proof, the action of respondent must be sustained.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Meridian Export, Inc., for refund of franchise tax in the amounts of $1,063.80 and $3,032.56 for the income years 1977 and 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of September, 1986, by the. State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*-, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9