BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 85R-310-PR
CIRCLE METALS )

For Appellant: Gregg W. Ritchie
Certified Public Accountant

For Respondent: Paul J. Petrozzi
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 Circle Metals for refund of franchise tax in the amounts of $11,559, and $73,209 fur the income years ended May 31, 1980, and December 31, 1981, respectively, and in the amount of $5,852 for the short period ended December 31, 1980.

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.

Appeal of Circle Metals

The first issue presented by this appeal is whether appellant is entitled to bad debt deductions claimed for certain of its accounts 'receivable. In the alternative, appellant claims ordinary and necessary business expense deductions for the same accounts receivable. The short period claim arose because appellant changed from fiscal year to calendar year accounting periods, That change is not an issue in this appeal.

Appellant is a California corporation engaged in the business of manufacturing metal and aluminum parts. Sometime after the periods at issue, appellant determined that certain of its accounts receivable had become partially or wholly worthless during those periods, Appellant filed amended returns for those periods claiming bad debt deductions and consequent. claims for refund. The following is a listing of the bad debts claimed listed by account name in each of the periods.

| Account | Tax Year Ended 12/31/81 | 12/31/80 | 5/31/80 |
|---|---|---|---|
| Interpart | $304,421 | $436,387 | $261,693.. |
| Arval | 46,040 | 74,551 | 5,034 |
| Calif. Art | 372 | | |
| Micro Bus | 3,014 | | |
| Tri Metal Tab | 10,288 | | |
| Universal Metal | 16,244 | | |
| Western Tech Systems | 4,735 | | |
| TOTAL | $385,114 | $450,938 | $266,727 |

Upon audit, respondent discovered that the debtors on those accounts receivable had continued in business and appellant had continued selling them parts although it had limited certain debtors to COD deliveries. Appellant applied any money received from those debtors to the older past-due amounts owed by them rather than to the amounts which became due for the COD deliveries. Some of the "bad debt" debtors were still in business when appellant filed its claims for refund, Respondent disallowed the deductions and denied the claims for refund on the ground that appellant had not demonstrated that the claimed accounts. had become wholly or partially worthless during the periods for which the bad. debts were claimed. This appeal followed. Since

then, respondent reviewed the file and the information provided by appellant and determinkd that the California Art, Micro Bus, and Western Technical Systems accounts became bad debts properly claimable during the income year ended December 31, 1981. Respondent is now prepared to allow those deductions and the consequent amounts claimed for refund for that year.

Section 24348, subdivision. (a), provides, in part, that

> There shall be allowed as a deduction debts which become worthless within the income year; . . . When satisfied that a debt is recoverable in part only the Franchise Tax Board may allow such debt, in an amount not in excess of the part charged off within the income year, as a deduction; ...

Deductions, however, are a matter of legislative grace and the burden is on appellant to prove that it is entitled to each deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 43.5 [78 L.Ed. 1348] (-1934); Mayes v. Commissioner, 21' T.C. 286 (1953).) Section 24348 is substantially identical to section 166 of the Internal Revenue Code of 1954. Accordingly, federal case law is 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 far a wholly worthless 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 . 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 af the year and that it became worthless during that year. (Cittadini v. Commissioner, 139 F.2d 29 (4th Cir. 1943); Appeal of Knollwood West Convalescent Fiospitals, 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 in the period for which the deduction is claimed which furnishes 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.)

A deduction for partial worthlessness is allowable only to the extent that the taxpayer is able to demonstrate to the satisfaction of the tax administrator that a part of a debt is not recoverable. (Findley v. Commissioner, 25 T.C. 311 (1955), affd. per curiam, 236 F.2d 959 (3rd Cir. 1956); Bullock v. Commissioner., 26 T.C. 276 (1956), affd. per curiam, 253 F.2d 715 (2nd Cir. 1958).) The use of the word "may" in this section gives the administrator a certain amount of discretion in making his determinations and those determinations should not be disturbed unless they are plainly arbitrary or unreasonable. (Findley v. Commissioner, supra; Bullock v. Commissioner, supra.)

Appellant simply argues that it knew that Interpart had become financially distressed because it was forced to recall and replace $6 million dollars worth of defective sun roofs it had manufactured and shipped to European customers, and that Arval, which sold metals to Mexican customers, had become insolvent because of the decrease in the Mexican peso's value and that company's poor management. But these stated views of appellant's provide us with no evidence which we may review and upon which we may come to a reasonable conclusion that the claimed bad debts had value at the beginning of a period and that identifiable events occurred during the period which formed a reasonable basis for abandoning hope of collecting on the outstanding accounts receivable. Indeed, the fact appellant did not determine that certain of the debts in question were bad until its review, after the periods in question, implies that no such events were apparent during those periods.

Nor does appellant's belief in Interpart's financial distress or Arval's insolvency constitute such clear evidence of the partial worthlessness of their debts that respondent's disallowance of the deductions taken by appellant constituted an abuse of the discretion conferred upon respondent by section 24348.

Appellant also argues that its claims for refund should be allowed and refunds granted because the Internal Revenue Service granted refunds based upon amended federal returns claiming the identical amounts of bad debts. Respondent's examination of the federal

refund documents submitted by appellant indicate that the federal refunds arose out of the IRS allowance of certain net operating loss carrybacks and that there was no reference in those documents to any bad debt claims. California law has no provision for net operating loss carrybacks. Thus, the federal action on those refunds appears irrelevant to the bad debt issue before this board.

Appellant argues, in the alternative, that, to the extent its claimed deductions are not allowable for the appeal periods as bad debt deductions, they are allowable for those periods as business expense deductions,

Section 24343, subdivision (a), provides, in part, that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the income year in carrying on any trade or business, . .." Like other tax deductions, business expense deductions are a matter of legislative grace, and, as noted above, the burden of proof is on the taxpayer to show entitlement to the deductions.

Apparently, appellant argues that its sales of the metals to the "bad debt" companies allowed those companies to make resales to others and thus stay out of bankruptcy longer and maintain the possibility that they would eventually be able to pay their overdue accounts with appellant.

We know of no authority for the proposition that ordinary credit sales to a poor credit risk buyer who is already a debtor of the seller may be deducted as an ordinary and necessary business expense by that seller. The two cases cited by appellant are quite distinguishable and are not persuasive authority for that argument, In United States v. E. L. Bruce Co., 180 F.2d 846 (6th Cir. 1950), the taxpayer purchased the tangible business assets of a corporation which had held the license to sell "Terminix," a process for the control of termites and other pests. The taxpayer purchased the license to sell "Terminix" from another unrelated corporation, Later, the taxpayer spent maney to reinspect and re-treat property of customers who had unbonded and unguaranteed "Terminix" contracts with the previous license holder. The taxpayer was under no legal liability to reinspect and re-treat those customers of its predecessor. However, the court ruled that those expenditures were ordinary and necessary business

expenses of that taxpayer to protect its investment and its continuance in the "Terminix" business. In contrast, the appellant's sales were not to protect its investment in its own business but to extend its hope of collecting some debts.

In Lucas v. Ox Fibre Brush Co., 281 U.S. 115 [74 L.Ed. 733] (1930), the taxpayer's board of directors had voted extra compensation in 1920 to be paid to its president and its treasurer for their services to the corporation in preceding years, At issue was the corporation's deduction of the payments in 1920 under section 234, subdivision (a), of the Revenue Act of 1919, which section read in pertinent part exactly as does the equivalent portion of section 24343, subdivision (a). There was no issue that the payments were not ordinary and necessary expenses as reasonable payments for personal services, although the corporation had been under no previous legal obligation to make those payments. At issue was whether the deduction could be taken by the corporation in 1920 or whether payment of the expense was attributable to the preceding years of service to the corporation by its president and its treasurer, Although the court concluded that the payments were deductible in the year paid, the case is no help to appellant since it is factually inappropriate. In contrast, the appellant's transfers of metals were credit sales to its ordinary customers and not money payments to its employees for extraordinary services.

For the above reasons, we cannot find that appellant has demonstrated to this board that it is entitled to the claimed deductions at issue. Therefore, we must sustain respondent's denial of appellant's claims for refund except to the extent of respondent's concession.

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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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Circle Metals for refund of franchise tax in the amounts of $11,559 and $13,209 for the income years ended May 37, 1980, and December 35, 1981, respectively, and in the amount of $5,852 for the short period ended December 31, 1980, be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained,

Done at Sacramento, California, this 19th day of November , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9