



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
KEYSTONE DRUG COMPANY )

Appearances:

For Appellant: H. D. Jenkins, its Auditor

For Respondent: J. Brereton, on behalf of the Franchise  
Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Stats. 1929, Chapter 13, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Keystone Drug Company, a corporation, against a proposed assessment of additional tax.

Apparently, during the years from 1916 to 1929, inclusive, the Appellant, Keystone Drug Company, made what it terms an investment in the Keystone Hall of Music, an organization claimed by Appellant to have been operated separately and apart from the Keystone Drug Company; The total of the investment over the entire period was \$24,565.07.

In 1929, Keystone Hall of Music discontinued business. Due to mismanagement, and misappropriation of funds (as charged by Appellant), Appellant's investment in the Keystone Hall of Music dwindled to practically nothing. On the discontinuance of Keystone Hall of Music, the Appellant, as a partial salvage, took over its contract accounts in the amount of \$2,950.62, thus reducing Appellant's loss from its investment to \$21,613.45.

In its return for the taxable year ended December 31, 1929, Appellant deducted in computing its net income for said year, the sum of \$21,835.49. This item apparently included the above item of \$21,613.45 a bad check item of \$19.09 and an item of \$202.95, expense incurred in closing out the Keystone Hall of Music, although the method by which the total of \$21,835.49 was reached, was not made to appear. Appellant also deducted the sum of \$322.95 on account of dividends received..

The Commissioner disallowed as deductions both of the above items. The item of \$21,835.49 was disallowed, apparently, because the Commissioner considered it as a deduction on account of bad debts and consequently evidence should have been given as to name of debtor, date account was acquired, method by which determined to be worthless, et cetera, whereas no such evidence was given. The dividend item was disallowed due to failure on the part of Appellant to submit a schedule showing the corporations from which the dividends were received, and the amount.

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received from each.

As a result of disallowance of the above deductions, the Commissioner proposed an assessment of additional tax in the sum of 4717.49. This proposed assessment was duly protested by the Appellant, and, pursuant to a request of the Appellant, was reconsidered by the Commissioner. On reconsideration, the Commissioner segregated the item of \$21,835.49 into bad debts which were in existence on or prior to January 1, 1928, and into bad debts not in existence on or prior to January 1, 1928. As a result of this segregation, the Commissioner allowed as a deduction the sum of \$722.73 as being debts not in existence on or prior to January 1, 1928. This sum included the bad check item of \$19.09, but did not include the item of \$202.95 expense incurred in closing out the Keystone Hall of Music.

The sum of \$21,112.76 being the difference between the sum of \$722.73 allowed as a deduction and the sum of \$21,835.49, originally disallowed, was allocated to bad debts in existence on or prior to January 1, 1928. The deduction of this item was disallowed because no evidence was submitted as to the fair market value of the debts on January 1, 1928.

As a result of allowing as a deduction the sum of \$722.73, the Commissioner reduced the proposed assessment from \$717.49 to \$788.58. It is the correctness of this latter sum that is involved in this appeal.

At the time the Appellant protested the proposed assessment of additional tax in the sum of \$717.49, Appellant furnished the schedule which its original failure to furnish had caused the Commissioner to disallow as a deduction dividends received in the amount of 8322.95. However, the Commissioner inadvertently omitted to deduct this sum in computing the revised proposed assessment. In his brief filed in this appeal, the Commissioner concedes his error in neglecting to allow the dividend deduction. In view of this, we are convinced that the deduction should be allowed.

Hence, there remains for our consideration only the question as to whether the sum of \$21,112.76 should or should not have been allowed as a deduction,

It is to be noticed that, apparently, the sum of \$202.95 expense incurred by Appellant in closing out the Keystone Hall of Music was not at any time allowed as a deduction by the Commissioner. Inasmuch as this item was expended during the taxable year ended December 31, 1930, and inasmuch as we think it can be regarded as a legitimate business expense, we are of the opinion that the sum of \$202.95 should be deducted under Section 8a of the Act in computing Appellant's income for the taxable year ended December 31, 1930.

However, we are of the opinion that the balance of the sum of \$21,112.76, namely, \$20,909.81 attributed to a loss sustained by Appellant as a result of its transactions with

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the Keystone Hall of Music, during the years 1916 to 1927, inclusive, was properly disallowed as a deduction.

As above noted, the Commissioner considered that the above item represented a loss from debts in existence on or prior to January 1, 1928. If the Commissioner was correct in this, then, unquestionably, evidence should have been submitted as to the value of the debts on January 1, 1928. Section 8e of the Act provides for the deduction of debts ascertained to be worthless and charged off within the taxable year, but specifies that

"In the case of a debt existing on the date fixed by section 19 hereof for the ascertainment of a gain or loss on the part of the taxpayer, no more than its fair market value on that date shall be deducted."

The date fixed by Section 19 is January 1, 1928, Consequently, neither the Commissioner nor this Board could allow as a deduction any loss sustained from debts in existence on or prior to January 1, 1928, in the absence of evidence as to the value of the debts on January 1, 1928, inasmuch as such value controls the amount of the deduction allowable.

Appellant contends that the loss sustained by it as a result of its transactions with the Keystone Hall of Music during the years 1916 to 1929 should be regarded as a loss from a bad investment. We do not believe it is necessary to decide this point. In this connection, it is to be noted that Section 19 of the Act provides:

"For the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed \* \* \* acquired prior to January 1, 1928, and disposed thereafter, the basis shall be the fair market value thereof as of said date."

Hence, conceding that the loss was sustained as a result of a bad investment rather than as a result of bad debts, it is necessary, in view of the above quoted provision, that evidence of the value of the investment on January 1, 1928 be submitted inasmuch as the investment was made prior to, and was in existence on January 1, 1928.

At a hearing duly held in this appeal, the necessity of submitting evidence as to January 1, 1928 values was explained to Appellant's representative and Appellant was allowed a continuance of sixty days in which to obtain and submit such evidence. This, the Appellant has not done. Consequently, we are of the opinion that we are justified in sustaining the action of the Commissioner in disallowing as a deduction the item of \$20,909.81 attributable to a loss sustained by Appellant as a result of its transactions with the Keystone Hall of Music prior to January 1, 1928.

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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, that the action of the Franchise Tax Commissioner in overruling the protest of Keystone Drug Company, a corporation, against a proposed assessment of an additional tax in the amount of \$688.58, based upon the net income of said corporation for the period ended December 31, 1929, be and the same is hereby modified. Said action is reversed insofar as the Commissioner disallowed as a deduction the sum of \$322.95 received as dividends and the sum of \$202.9 expended in closing out the Keystone Hall of Music. In all other respects, said action is sustained. The correct amount of the tax to be assessed to the Keystone Drug Company is hereby determined as the amount produced by means of a computation which will include the allowance as a deduction of the above amounts in the calculation thereof. The Commissioner is hereby directed to proceed in conformity with this order and to send the said Keystone Drug Company a notice of assessment revised in accordance therewith.

Done at Sacramento, California, this 10th day of May, 1932, by the State Board of Equalization.

R. E. Collins, Chairman  
Fred E. Stewart, Member  
H. G. Cattell, Member  
Jno. C. Corbett, Member

ATTEST: Dixwell L. Pierce, Secretary