

1 QUESTION: Whether appellant has satisfied its burden of proving that the debts at issue
2 became worthless in 2002.

3 HEARING SUMMARY

4 Background

5 Appellant is a California magazine distributor. It receives magazines from various
6 publishers, with return privileges for unsold magazines. Appellant then distributes the magazines to
7 retailers who, typically by oral agreement, also have the right to return unsold magazines to appellant.
8 After distribution of magazines to a retailer, appellant sends an invoice to the retailer for the delivered
9 magazines, less any returns. Appellant is an accrual basis taxpayer and allegedly treats the mailing of an
10 invoice to a retailer as the point of recognition of appellant's income with regard to the magazines. If
11 appellant does not receive payment from a retailer, it first contacts the retailer and, failing to obtain
12 payment at that time, will often engage an attorney or collection service to collect the account.

13 Appellant filed a California tax return for 2002 on April 15, 2004. Appellant's return for
14 that year was due on March 15, 2003. After reviewing appellant's 2002 return, respondent issued a
15 Notice of Proposed Assessment (NPA) for 2002 on which respondent disallowed bad debt deductions
16 claimed by appellant in the amount of \$208,868. Respondent also imposed a late filing penalty.
17 Appellant states that, during meetings between appellant and respondent's auditors regarding appellant's
18 returns for 2002 and 2003, respondent and appellant agreed that appellant's previous accountants
19 inaccurately advised appellant that it was proper to report bad debt deductions for those years by making
20 reasonable additions to a reserve for bad debts.⁵ Respondent and appellant further agreed that appellant
21 would employ what it characterized as the "direct write-off method" for deducting its bad debts for 2002
22 and 2003, as well as for all subsequent years.

23 Appellant protested respondent's NPA for 2002, as well as a Notice of Adjusted
24 Carryover Amount issued against appellant for 2003. In its protest letter (App. Br., Exhibit E), appellant
25 stated that, apparently as a result of its meetings with respondent's auditors, it revised its method for
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27 ⁵ Apparently, appellant's previous accountants were unaware of the changes to Internal Revenue Code (IRC) section 166 that
28 resulted from the Tax Reform Act of 1986 (TRA 1986) (see P. L. 99-514 (TRA 1986), section 805, for those changes) and
related changes to R&TC section 24348.

1 deducting bad debts from a reasonable addition to a reserve for bad debts method to the direct write-off
2 method. Appellant further stated it wanted to file amended returns for 2002 and 2003 to reflect that
3 revision but one of respondent's auditors reviewed the schedule of bad debts that allegedly incorporated
4 appellant's revision and concluded the schedule did not provide additional information that warranted a
5 change in respondent's position. Appellant then gave examples of bad debts it regarded as deductible in
6 2002 but the auditor disallowed. Finally, appellant reiterated its desire to file amended returns for 2002
7 and 2003.

8 In her denial letter of January 28, 2009 (App. Br., Exhibit D), respondent's protest officer
9 stated that appellant provided at audit a schedule of allegedly deductible bad debts for 2002 in the total
10 amount of \$128,682, appellant's comments regarding why it regarded the items on the schedule as
11 uncollectible, and a written narrative of its procedures for identifying and writing off bad debts. The
12 protest officer then stated that appellant took the position at protest that the amount of deductible bad
13 debts for 2002 should be reduced from \$208,868 to \$170,951 and the amount of deductible bad debts for
14 2003 should be revised from \$15,014 to \$41,975. The protest officer further stated that a sample of 16
15 alleged bad debts was selected to verify the deductibility of the claimed bad debts and the same sample
16 was used for verification purposes at audit.

17 With regard to the selected sample, the protest officer asserted that appellant had not
18 provided documentation supporting that appellant made efforts to collect the debts in the sample despite
19 respondent's requests for the documentation at both audit and protest. The protest officer stated that the
20 only evidence appellant provided by the time of her denial letter was a ledger provided at audit which
21 showed that appellant continued transacting significant business with nine of the 16 debtors in the
22 sample after 2002. Relying upon the *Appeal of Circle Metals (Circle Metals)* (86-SBE-176), decided by
23 the Board on Nov. 19, 1986, the protest officer took the position that case law established that continued
24 business relations by a taxpayer with a debtor precluded the treatment of the taxpayer's receivables of
25 the debtor as bad debts because no reasonable businessperson would continue to do business with a
26 customer if the businessperson knew that it was unlikely the customer's debt would be collected. The
27 protest officer also asserted that while appellant argued at protest that some of the debts at issue became
28 worthless in 2003 rather than in 2002, the worthlessness of the debts had not been substantiated for any

1 year.

2 Citing *Circle Metals*, the protest officer observed that a taxpayer has the burden of
3 proving that the debt for which a deduction is claimed had some value at the beginning of the taxable
4 year and became worthless during the taxable year. She acknowledged that the debts at issue had value
5 at the beginning of an unspecified taxable year but concluded that appellant had not shown that those
6 debts became worthless in either 2002 or 2003. As a result, she further concluded that the bad debts
7 claimed as deductible on appellant's returns for 2002 and 2003 should be disallowed and recommended
8 that respondent issue NOA's affirming its NPA for 2002 and Notice of Adjusted Carryover Amount for
9 2003.

10 Respondent issued an NOA on March 27, 2009, affirming its NPA for 2002. Respondent
11 also issued an NOA on March 19, 2009, affirming its Notice of Adjusted Carryover Amount for 2003.
12 Appellant timely appealed the 2002 NOA, but not the 2003 Notice of Adjusted Carryover Amount.

13 Contentions

14 In its appeal letter, appellant again stated that it wished to file amended returns for 2002
15 and 2003. Appellant also acknowledged again that the method used for deducting bad debts for those
16 years by its previous accountants was inappropriate. In addition, appellant alleged that, of the bad debt
17 deductions of \$208,868 claimed on its 2002 return, \$192,413 remained unrecovered and named a
18 number of agents that appellant engaged to collect the latter amount.

19 In its opening brief, appellant stated its contention that the amount of \$128,681.71 was
20 properly deductible as bad debt in 2002 and that the amount of \$32,599.42 was properly deductible as
21 bad debt in 2003. Appellant further stated that its protest letter and the schedules attached to its brief at
22 Exhibit E collectively support its contention. One of the two schedules attached at Exhibit E is
23 comprised of statements of law regarding bad debt deductions and a chart (designated "Tested
24 Statement"), which were apparently prepared by respondent, listing 16 of appellant's customers and
25 providing information about those customers under such categories as "Activity After 2002 Tax Year,"
26 while the other schedule is comprised of a list of the same 16 customers with information about those
27 customers for 2002 under such categories as "Date of Last Delivery" and "Comment."

28 Respondent contends that appellant may not prevail here because appellant has not

1 satisfied its burden of proving the debts under consideration here became worthless in either 2002 or
2 2003. Respondent alleges that, at both audit and protest, appellant has not provided supporting
3 documentary evidence of collection efforts with respect to the disallowed amounts of alleged bad debt or
4 any other acceptable evidence of worthlessness regarding the sample of debt selected for testing.
5 Respondent further alleges the only evidence regarding worthlessness that appellant provided were
6 accounts receivable ledgers and what respondent characterized as “account details.”

7 Applicable Law

8 R&TC section 24348, subdivision (a)(1), provides that there shall be allowed as a
9 deduction debts that become worthless within the taxable year in an amount not in excess of the part
10 charged off within that taxable year. R&TC section 24348, subdivision (a)(2), limits a reasonable
11 addition to a reserve for bad debts as an alternative method for deducting bad debts, which was
12 essentially available to taxpayers like appellant before 2002, to banks and similar financial institutions in
13 respondent’s discretion. R&TC section 24348, subdivision (b), provides, in pertinent part, that when
14 satisfied that a debt is recoverable in part only, respondent may allow that debt, in an amount not in
15 excess of the part charged off within the taxable year, as a deduction. R&TC section 24348, subdivision
16 (c)(1), provides that “[t]he amendments to this section made by the act adding this subdivision shall
17 apply only to taxable year beginning on or after January 1, 2002.”

18 IRC section 166(a)(1) (incorporated by reference by R&TC 17201) provides that there
19 shall be allowed as a deduction any debt that becomes worthless within the taxable year. IRC section
20 166(a)(2) provides that when satisfied a debt is recoverable only in part, the Internal Revenue Service
21 may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a
22 deduction.

23 Treasury regulation section 1.166-2(a) provides that, in determining whether a debt is
24 wholly or partially worthless, all pertinent evidence, including the value of any collateral securing the
25 debt and the financial condition of the debtor, will be considered. Treasury regulation section 1.166-
26 2(b) provides that when the surrounding circumstances indicate that a debt is worthless and uncollectible
27 and that legal action to enforce payment would in all probability not result in the satisfaction of
28 execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the

1 debt for purposes of the deduction under IRC section 166. Treasury regulation section 1.166-2(c)(1)
2 provides that bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured
3 and unpreferred debt. Treasury regulation section 1.166-2(c)(2) provides, in pertinent part, that in
4 bankruptcy cases a debt may become worthless before settlement in some instances, and in others, only
5 when a settlement in bankruptcy has been reached.⁶

6 In order to be entitled to a deduction for a wholly worthless bad debt, a taxpayer must
7 demonstrate that the debt became wholly worthless within the taxable year. Whether a debt became
8 totally worthless within a particular year is a question of fact. The burden is on the taxpayer to prove
9 that the debt for which the deduction is claimed had some value at the beginning of the year and that it
10 became worthless during that year. The standard for the determination of worthlessness is an objective
11 test of actual worthlessness. The time for worthlessness must be fixed by an identifiable event in the
12 period for which the deduction is claimed that furnishes a reasonable basis for abandoning any hope of
13 future recovery. (*Appeal of Circle Metals, supra.*)

14 A deduction for partial worthlessness is allowable only to the extent that the taxpayer is
15 able to demonstrate to the satisfaction of the tax administrator that a part of a debt is not recoverable.
16 The use of the word “may” in IRC section 166(a)(2) gives the administrator a certain amount of
17 discretion in making his determinations, and those determinations should not be disturbed unless they
18 are plainly arbitrary or unreasonable. (*Appeal of Circle Metals, supra.*)

19 The Board has stated the rule that a failure of a party to introduce evidence that is within
20 his control gives rise to the presumption that, if provided, it would be unfavorable. In stating the rule,
21 the Board pointed out that to hold otherwise would establish skillful concealment as an invincible barrier
22 to the determination of tax liability. (*Appeal of Don A. Cookston, 83-SBE-048, Jan. 3, 1983.*)

23 STAFF COMMENTS

24 Appellant should be prepared at the hearing to clarify the exact amount of alleged bad
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27 ⁶ Staff notes that R&TC section 24348 is, in relevant respects here, substantially identical to IRC section 166. (*See Appeal of*
28 *Circle Metals, supra.*) In that regard, staff also notes that California Code of Regulations, title 18, section 19053 provides
that in the absence of regulations promulgated by respondent and unless specifically provided, in instances when the Bank
and Corporation Tax Law conforms to the IRC, regulations under the IRC shall, insofar as possible, govern the interpretation
of conforming California statutes, with due account for California terminology, California effective dates, and other obvious
differences between California and federal law.

1 debt that, in its view, was deductible for 2002. Appellant should also be prepared to clarify at the
2 hearing whether either one of the schedules attached to its opening brief at Exhibit E was the same
3 schedule of allegedly deductible bad debts for 2002 in the total amount of \$128,682 provided to
4 respondent at audit. In any event, appellant should mail within 14 days before the hearing in this matter
5 (with a copy to respondent) the schedule provided to respondent at audit, together with any associated
6 documentation provided at audit, and any other documentation (such as written requests for payment
7 from appellant's collection agents to appellant's debtors under consideration here or documents related
8 to bankruptcies of those debtors) that appellant wishes the Board to consider to:

9 Claudia Madrigal
10 State Board of Equalization
11 Board Proceedings Division
12 450 N Street, MIC:80
13 Sacramento, CA 95814

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17 ArmadilloTradingCo._cd

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