

Appeal of Roy G. and Cynthia A. Carr

Appellants filed a joint California personal income tax return for 1978 claiming a bad debt deduction in the amount of \$5,276. Respondent's inquiry into the nature of the claimed debt revealed the following information. Mrs. Carr, who had been married previously, was divorced in 1976. As a result of the divorce, Mrs. Carr's ex-husband agreed to pay her \$5,276 as a settlement. Her ex-husband failed to make the payment and became disabled in 1978. Appellants concluded that these payments would never be collected and claimed the bad debt deduction in issue. Respondent disallowed the deduction on the basis that the uncollectibility of the obligation did not give rise to a deductible bad debt. After appellant's protest of the resulting proposed deficiency was denied, this appeal followed.

In this appeal we are not concerned with whether the obligation of the ex-husband became worthless during the taxable year. The more fundamental question presented is whether the uncollectible obligation was a deductible bad debt under section 17207 of the Revenue and Taxation Code.

It is well settled that a cash basis taxpayer may not take a bad debt deduction for an uncollectible item which has never been reported as income; the deduction of a bad debt is limited to debts created by advances out of capital or out of income previously taxed or exempted. (See, e.g., Dale A. Swenson, 43 T.C. 897 (1965); W. Thomas Menefee, 8 T.C. 309 (1947); Pearl A. Long, 35 B.T.A. 479 (1937), affd. on other grounds, 96 F.2d 270 (9th Cir.), cert. den., 305 U.S. 616 [83 L.Ed. 392] (1938).) This principle has been articulated by the courts in the following language:

The taxing statute, as has often been said, is concerned with realized gains and losses. This, it seems to us, is the proper test to be applied in these cases. The taxpayer was not out of pocket anything as the result of the promisor's failure to comply with his agreement. There was no realization either as a gain or loss at any time. There was no outlay of cash or property by the petitioner in the taxable year, or any other year, by which to measure a loss. She merely failed to receive something promised, which is vastly different from the loss of something once reduced to possession. (Pearl A. Long, supra, 35 B.T.A. at 481.)

