Memorandum

To: Mr. Michael Kitchen
Audit Review and Refunds Unit

From: David H. Levine
Tax Counsel

Subject: [K]

This is in response to your mini memo dated March 5, 1990. [K] sold equipment to [T] for $2,100,000. [T] paid [K] $600,000 and executed a promissory note for $1,500,000 secured by the equipment. [K] reported sales tax on this transaction. Thereafter, [T] defaulted on its obligations. [T] then filed a proceeding in bankruptcy, and the automatic stay prevented [K] from proceeding against [T] on the security interest held by [K]. The parties entered into a stipulation in the bankruptcy proceeding which provided that if the terms of the stipulation were violated, the stay would be lifted. The terms of the stipulation were violated and, with the stay lifted, [K] sold the equipment to [C] as authorized by California Commercial Code section 9504, applying the proceeds against the debt of [T].

In a letter dated October 10, 1989, [K] provided a brief description of these transactions and asked how to formally apply for a refund. This letter was accepted as a claim for refund, and you asked [K] to compute its net “repossession loss” pursuant to subdivision (f) of Regulation 1642. In a letter dated December 1, 1989, a CPA for [K] again provided a brief description of the transaction and stated that the equipment which was security for [T]’s debt was sold to a third party pursuant to California Commercial Code section 9504 on behalf of the original buyer and that [K] did not take title to the equipment. The CPA then stated that [K] will experience a bad debt of approximately $1,500,000 as a result of these transactions. You ask:

“At face value this appears to be a default on a promissory note and a repossession by the seller. Please advise if the sale by [K] (seller) to [C] was a sale by [K] or a sale by [T] (buyer) pursuant to the order of the bankruptcy court.”

Initially, I note that [K] would not be entitled to a bad debt deduction until the debt was found worthless and charged off for income tax purposes or, if [K] was not required to file income tax returns, charged off in accordance with generally accepted accounting principles. (Rev. & Tax. Code § 6055, Reg. 1642(a).) The amount of the bad debt deduction can be no more than the amount charged off for income tax purposes or charged off in accordance with generally accepted accounting principles. (Actually, the amount charged off is usually greater than the amount allowable as a bad-debt deduction under the Sales and Use Law, as discussed in section 419.03 of the audit manual.)
You ask whether the sale to [C] was pursuant to the bankruptcy court order. No, the bankruptcy court did not order the sale. Rather, upon the filing of a bankruptcy petition, an automatic stay attaches to prevent collection activities by persons such as [K]. The stipulation and order in the bankruptcy court provided that if it were violated, the automatic stay would be lifted. Since the terms of the stipulation were violated, the automatic stay was lifted and [K] was thereby permitted to proceed with its remedies pursuant to state law.

Assuming [K] charged off the bad debt, it is entitled to a bad-debt deduction. That deduction can be no more than actually charged off. Further, as you correctly concluded, the amount allowable as a deduction must be computed as specified in Regulation 1642.

If you have further questions, feel free to write again.

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cc: Oakland District Administrator