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Income Tax--Deductions for Worthless Debt--Good Faith of Taxpayer in Ascertaining Worthlessness (In re Charles C. Huitt, as Executor of Finley J. Shepard, deceased v. Carroll E. Mealey, et al., 292 N.Y. 52 (1944))

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INCOME TAX—DEDUCTION FOR WORTHLESS DEBT—GOOD FAITH OF TAXPAYER IN ASCERTAINING WORTHLESSNESS.—In 1928 taxpayer purchased $100,000 worth of six percent gold debentures issued to finance the construction of a hotel. The hotel corporation had also issued first mortgage leasehold sinking fund bonds, senior in every respect to those debentures issued to the taxpayer and which were the first and only lien on the hotel property. The sole security back of taxpayer's bonds were those assets of the corporation which were not covered by the security given for the senior bond issue. In 1931, upon default in interest payments, a mortgage bondholder's committee was organized and foreclosure proceedings were instituted by the trustee named in the mortgage. In March of 1942 the corporation filed a voluntary petition in bankruptcy. In June of the same year a plan of reorganization was proposed, forming a new corporation to purchase the hotel. Bondholders of the taxpayer's class were invited to participate by investing new capital up to ten percent of their previous investment in exchange for certain securities. The taxpayer never entered into this reorganization plan but kept his debentures. When a substantial deficiency resulted, following court approval of the plan and confirmation of the referee's report of the foreclosure sale in 1933, he entered the purchase price of the bonds in his 1933 income tax return as a deduction for a worthless debt. The State Tax Commission disallowed the deduction on the ground that the debt had become worthless during the previous year or following the judgment of foreclosure and sale. *Held,* order of the Appellate Division reversed; determination of the State Tax Commission annulled. Under Section 360, subdivision 7,[1] of the Tax Law, it is the taxpayer provided he acted in good faith, and not the Tax Commission, who may ascertain whether a debt has become worthless and when it is to be charged off.[2] It was apparent that taxpayer had not conclusively lost all chance to recoup until court approval of the plan of reorganization and confirmation of the referee's report of sale in 1933. Further, there was evidence tending to show taxpayer's good faith in discussing with his financial adviser the possibility of including the item in his 1932 return, and deciding to wait for the final word of the court on the reorganization plan before charging off the debt. In re *Charles C. Huitt, as executor of Finley J. Shepard, deceased v. Carroll E. Mealey,* et al., 292 N. Y. 52 (1944).

In interpreting the worthless debt clause of the New York State Income Tax Law, the court has followed rulings of the federal courts in construing similar federal statutes. The "good faith" requirement of the statute allowing deduction for bad debts is satisfied as long

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[1] N. Y. Laws 1921, c. 214, § 1, says that in computing net income there shall be allowed as deductions: ". . . Debts ascertained to be worthless and charged off within the taxable year."

[2] People *ex rel.* Central Union Trust Co. v. Loughman, 249 N. Y. 409, 164 N. E. 333 (1928).

as it sufficiently appears that taxpayer did not act with a view to defeat the intent and purposes of the tax law.[3] It has been held that the test of the good faith of the taxpayer is whether a prudent business man would have acted as the taxpayer did in ascertaining the worthlessness of the debt.[4] Although the debt must be deducted in the year in which the taxpayer ascertains it to be worthless, the law does not impose upon the taxpayer the absolute risk of selecting the year when it actually becomes so.[5] The real question is not when did the debt become worthless, but when did the taxpayer ascertain it to be worthless.[6] In answering that question the taxpayer must be allowed a fair degree of latitude.[7]

J. L. G.

LIMITATIONS—INTERSTATE COMMERCE ACT—INVALIDITY OF AGREEMENT BY SHIPPER NOT TO PLEAD.—Respondent, carrier, sued to recover the amount of freight charges on twenty-one carloads shipped by petitioner over its own and connecting carriers' lines. The issue is whether the action was brought in time under Section 16(3)(a) of the Interstate Commerce Act which provided: "All actions at law by carriers subject to this Act for recovery of their charges, or any part thereof, shall be begun within three years from the time the cause of action accrues, and not after." Three days before the expiration of the term allowed, the petitioner agreed not to plead in any suit the defense of any general or special statute of limitations in consideration of respondent's forbearance to sue for a specified time. Two months later, respondent brought this action. Petitioner contends that the statute prohibits maintenance of the action notwithstanding its agreement. Respondent insists that the act has merely modified its common-law contractual right and that the provision may be waived, and it attempts to distinguish between cases like this one and others in which the shipper sues the carrier to recover excess charges paid or damages for the charging of unreasonable rates.[1] *Held,* the agreement is invalid as being contrary to the intent and effect of the section and the Act. The primary intention

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[3] Moore v. Commissioner of Internal Revenue, 101 F. (2d) 704 (C. C. A. 2d, 1939).

[4] Peyton Du-Pont Securities Co. v. Com'r, 66 F. (2d) 718 (C. C. A. 2d, 1933).

[5] Rosenthal v. Helvering, 124 F. (2d) 474 (C. C. A. 2d, 1941).

[6] Jones v. Com'r, 38 F. (2d) 550 (C. C. A. 7th, 1930).

[7] Blair v. Com'r, 91 F. (2d) 992 (C. C. A. 2d, 1937).

[1] A. J. Phillips Co. v. Grand Trunk Western Ry., 236 U. S. 662, 35 Sup. Ct. 444 (1915). There the Court held that the objection to the timeliness of the shipper's suit was properly raised by demurrer and said: "the lapse of time . . . destroys the liability." *See* Galveston H. & S. Ry. v. Webster, 27 F. (2d) 765, 124 P. (2d) 906 (1928); Kansas City Southern R. R. v. Wolf, 261 U. S. 133, 43 Sup. Ct. 259 (1923).