4 T.C. 806 (1945)

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A taxpayer can claim a bad debt deduction when collection efforts are reasonably deemed impractical due to legal defenses and debtor resistance, even if the debtor possesses the financial capacity to pay.

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Summary

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Robert Dennison sought a bad debt deduction for $12,000 related to unpaid promissory notes. The Tax Court addressed whether the debt was worthless in 1940, despite the debtors' solvency. Dennison had previously sued to collect the debt, but his attorneys advised him that success was unlikely, leading to dismissal of the suit. The court held that Dennison was entitled to the deduction because pursuing collection was impractical given the legal defenses available to the debtors and their clear intent to use those defenses, rendering the debt effectively worthless.

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Facts

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Between 1927 and 1932, Dennison loaned approximately $241,500 to Hedger Transportation Co., receiving promissory notes. These notes were largely paid, but a balance of $30,000 remained by 1933, secured by barges. After foreclosure, $12,000 remained unpaid. Hedger Transportation went bankrupt, and Dennison accepted new notes from W.E. Hedger, endorsed by Eben-Baxter-Harstedt Co. and its officers. Upon default, Dennison negotiated for supporting notes from the endorsers, but these were never fully executed. Legal action was initiated in 1936 to recover the amount but was later dismissed due to concerns about the likelihood of success.

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Procedural History

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Dennison claimed a bad debt deduction in 1936, which was initially disallowed. He then filed suit in New York State Supreme Court to collect the debt, but this case was dismissed with prejudice in 1940 based on advice from his attorney. The Commissioner of Internal Revenue then disallowed the deduction for 1940, leading to this case before the Tax Court.

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Issue(s)

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Whether Dennison was entitled to a bad debt deduction of $12,000 in 1940, considering the debtors' solvency but also the practical difficulties of enforcing collection.

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Holding

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Yes, because despite the debtors' solvency, the circumstances, including the dismissal of the prior suit and the likelihood of the debtors raising successful defenses, made the debt uncollectible and thus worthless in 1940.

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Court's Reasoning

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The court reasoned that the critical factor was not the debtors' ability to pay, but the practical impossibility of collection. Dennison had pursued legal action, but was advised that defenses such as usury and the statute of limitations would likely prevail. Although corporations cannot claim usury as a defense under New York law, the individual endorsers could potentially raise it. The court emphasized that the proposed renewal of the debt was never fully completed, so Dennison was entitled to rely on the original endorsed notes. The court noted, "The fact that the debtors were financially able to pay was of no moment in the circumstances. The debt became worthless in 1940 and constitutes an allowable deduction." The dismissal of the suit

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