



**TERRITORY OF HAWAII**  
**DEPARTMENT OF THE ATTORNEY GENERAL**  
**HONOLULU**

OPINION NO. 1811

45

April 6, 1942

TAXATION, NET INCOME TAX:

Deductions from Income.

In a case of surrender of a bond partially worthless upon receipt of a new bond in a lesser amount, or upon the receipt of partial payment, a bad debt deduction may be enjoyed where there is compliance with the statutory conditions applicable to bad debt deductions.

Honorable William Borthwick  
Tax Commissioner  
Territory of Hawaii  
Honolulu, T.H.

Dear Sir:

The question involved relates to paragraphs (a) and (g) of subsection 1, section 2034, R.L. 1935, relating to deductions from gross income for net income tax purposes. The law provides:

"Sec. 2034. 1. Gross income; deductions from.

In computing net income there shall be allowed as deductions:

"(a) Bad debts. Debts ascertained to be worthless and charged off on the books of the taxpayer within the taxable year (or in the discretion of the commissioner a reasonable addition to a reserve for bad debts); provided that when satisfied that a debt is recoverable only in part, the commissioner may allow such

debt to be charged off in part;

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"(g) Losses. Losses sustained during the taxable year if incurred in the trade or business or in any transaction entered into for profit though not connected with such trade or business, except that capital losses of an individual or corporation resulting from the purchase, sale, exchange or other acquisition or disposition of real property, stocks, bonds, notes or other like securities shall not be allowed as deductions;

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You state that in a certain instance there were two group of bondholders, one group secured by a first mortgage and the other by a second mortgage on the same property. The holders of the second mortgage agreed to surrender their bonds in return for a small cash payment, and claimed partial bad debt deductions on account of their losses. You also inquire as to a partial bad debt deduction claimed by a bondholder secured by the first mortgage who surrendered his bonds and received bonds in a less amount secured by a new mortgage on the property.

For the purposes of this opinion it is assumed that these taxpayers have complied with all of the conditions requisite for partial bad debt deductions and that the facts support such deductions if paragraph (a) may be relied upon by taxpayers in such situations. Your question is: should such deductions be disallowed as

capital losses under paragraph (g)?

Debts evidenced by bonds or other securities are nevertheless debts within the meaning of the bad debt provision. Commonwealth Commercial State Bank v. Lucas, 41 F. (2d) 111 (Ct. Ap. D.C. 1930); Op. Let. Atty. Gen. (January 14, 1935) F. 45. Release or cancellation of a part of the debt when such action is taken as part of the ascertainment of worthlessness is consistent with the theory of a partial bad debt deduction. Deeds v. Commissioner, 45 F. (2d) 695 (C.C.A. 6, 1931); W.F. Taylor Co. 38 B.T.A. 551; Lana P. Wheeler, 40 B.T.A. 92; of First National Bank of Durant, Oklahoma, 6 B.T.A. 545, 548. The bad debt provision is a provision governing a special type of loss, and in the absence of any provision indicating the contrary, a deduction claimed on account of worthlessness of a debt, in whole or in part, is to be judged under the bad debt provision and not under the loss provision. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189. When, however, Congress introduced into the federal statute provisions showing its intention that in certain situations deductions on account of worthlessness of debts were to be treated as losses, the Supreme Court held that bad debt deductions could not be had. McClain v. Commissioner,

311 U.S. 527; see also Rockford Dairy, Inc., 26 B.T.A. 501.

The present question therefore turns upon this point: Does the capital losses provision contained in paragraph (g) manifest an intention that no deductions may be claimed by these taxpayers under the bad debt provision? In the federal cases above cited there was a provision so broad as to prohibit any loss claim in the particular situation, or to compel treatment of the claim in a particular manner no matter under what provision the deduction might be claimed by the taxpayer. Such a provision would be present here if it read: "No loss shall be recognized on account of a capital loss resulting from the purchase, sale, exchange or other acquisition or disposition of real property, stocks, bonds, notes or other like securities." Instead, the capital loss provision is framed as an exception to the type of deduction allowed by paragraph (g), and hence is applicable only to deductions claimed under paragraph (g). 2 Lewis' Sutherland Statutory Construction, 2d Ed., Sec. 352, p. 673.

Respectfully,

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Rhoda V. Lewis  
Deputy Attorney General

APPROVED:

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Attorney General