OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18010769
	)
BRETT HELM AND TRACY HELM	) Date Issued: October 17, 2019
	)
	)
	)

OPINION

Representing the Parties:

For Appellants: Stuart M. Hurwitz

For Respondent: David Hunter, Tax Counsel IV

For Office of Tax Appeals: Tom Hudson, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, appellants[1] Brett Helm and Tracy Helm appeal from the action of respondent Franchise Tax Board (FTB) in denying their protest against the proposed assessment of $63,955 in additional tax, plus applicable interest, for the 2011 tax year.

Appellants waived their right to an oral hearing; therefore, this matter is being decided based on the written record.

ISSUE

Did appellant make a loan to his father in 2004 that qualifies as a bona fide debt for purposes of the nonbusiness bad debt deduction under Internal Revenue Code (IRC) section 166, and if so, did this debt become wholly worthless in 2011?

[1] Brett and Tracy Helm are both parties to this appeal. However, all references to "appellant" in this decision refer to Brett Helm because his actions are the subject of this dispute. "Appellants" will refer to both parties.

FACTUAL FINDINGS

1. Appellant loaned $646,421.38 to his retired father on December 27, 2004. An agreement dated December 27, 2004 states, *in its entirety*:

> This letter will confirm your personal loan to me on this date of a total of $626,421.38. I agree to repay this amount upon your demand, with accrued interest, at any time after December 27, 2005. Simple interest on this principal amount will accrue at the annual rate of 2.5 percent or the minimum annual rate required by IRS regulations for imputed interest, whichever is greater. Please indicate your agreement to these terms by signing below.[2]

2. Appellant's father deposited $646,421.38 into his account at West Star Credit Union on December 27, 2004.
3. Appellant executed and had notarized a Premarital Agreement dated January 8, 2008, that includes a Personal Financial Disclosure Statement listing a note receivable for $650,000 from appellant's father.
4. Appellant's father invested the loan proceeds into three real estate investment trusts (REITs): Desert Capital Real Estate Investment Trust, Inc. (Desert Capital); Centennial Meadows, LLC (Centennial); and CM MIDBAR 1-458, LLC (CM MIDBAR).
5. On December 16, 2010, Desert Capital informed its owners that the value of each share of common stock was $0.00 as of September 30, 2010, due to "the impact of recent adverse trends in the economy and the real estate industry."
6. On December 28, 2010, Centennial informed its owners that they had "received two payments totaling an approximate 13.1 percent Member net principal return. Additional sales proceeds will be forthcoming in early 2011 upon the sale of the remaining joint venture assets."
7. On June 16, 2011, CM MIDBAR sent a letter to its owners indicating that it would be dissolved and its owners would receive approximately 3.71 percent of the amount they had invested.
8. Appellant argues that his father made three repayments of principal totaling $26,883.38. However, in support of this statement, appellant provides only one check made to

[2] We note this agreement states the amount of $626,421.38, but appellant has stated and the bank statements confirm that the amount of the loan in dispute is $646,421.38 (a $20,000 discrepancy).

appellant by his father from the Bank of Nevada, in the amount of $1,385.17, dated September 20, 2011.

9. No interest was paid on the loan.

10. Appellant stated that he believed the loan became worthless in 2011.

11. Appellants reported a non-business bad debt deduction for 2011 in the amount of $620,918, which is $25,503.38 less than the loan principal of $646,421.38.[3]

12. FTB audited appellants' tax return and disallowed the entire deduction. FTB issued a Notice of Proposed Assessment (NPA) dated March 13, 2015, proposing additional tax of $63,955.

13. Appellants protested the NPA.

14. On September 29, 2016, FTB issued a Notice of Action that affirmed the NPA. This timely appeal followed.

DISCUSSION

Income tax deductions are a matter of legislative grace; the taxpayer bears the burden of establishing entitlement to the deductions claimed. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) To meet this burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Robert Telles* (86-SBE-061) 1986 WL 22792.)

IRC section 166, as incorporated into California law by R&TC section 17201, allows a deduction for bad debts that become worthless during the tax year. Pursuant to IRC section 166, subdivision (d), a nonbusiness bad debt is debt that was not created or acquired in connection with the taxpayer's trade or business. It is deductible as if it were a short-term capital loss. Treasury Regulation section 1.166-1(c) specifies that "[o]nly a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." The existence of a promissory note that may be legally enforceable is not conclusive of the existence of a bona fide debt. (*Estate of Van Anda v. Commissioner* (1949) 12 T.C. 1158.) Purported loans between family members are subject to rigid scrutiny and are presumed to be

[3] Appellant argues that $25,503 represents the total of two repayments ($5,937 and $19,146) appellant's father received from the REITs, which appellant claims were subsequently paid to him. There is no evidence of these payments anywhere in the record.

gifts. (*Id.* at p. 1162). This presumption can be rebutted by proving that, at the time of the transaction, there existed a real expectation of repayment, an intent to enforce collection, and that intention comported with the economic reality of creating a debtor-creditor relationship. (*Calumet Industries, Inc. v. Commissioner* (1990) 95 T.C. 257).

The factors used to determine whether a bona fide debt existed are: (1) the promise to repay was evidenced by a note or other instrument; (2) interest was charged; (3) a fixed schedule for repayments was established; (4) collateral was given to secure payment; (5) repayments were made; (6) the borrower had a reasonable prospect of repaying the loan, and the lender had sufficient funds to advance the loan; and (7) the parties conducted themselves as if the transaction was a loan. (*Welch v. Commissioner* (9th Cir. 2000) 204 F.3d 1228; *Todd v. Commissioner*, T.C. Memo. 2011-123, affd. (5th Cir. 2012) 486 Fed. Appx. 423.) We will discuss these factors below.

Appellant has provided a copy of a short promissory note signed by appellant and his father. Appellant contends that the promissory note meets the requirement that the obligation be evidenced by a note or other instrument. The written statement of Craig S. Andrews, the attorney who drafted that note, provides further evidence of the existence of a formal loan agreement. Therefore, this factor favors the existence of a bona fide debt.

As for whether interest was charged, the promissory note itself specifies an annual interest rate of 2.5 percent ("or the minimum annual rate required by IRS regulations for imputed interest, whichever is greater").[4] The note called for interest .02 percent higher than the lowest Applicable Federal Rate (2.48 percent in December 2004), which was the lowest rate that would not cause the IRS to impute interest to appellant. What is critical here, however, is that there is no evidence that interest was ever demanded by appellant or paid by his father. Appellant has not shown that he reported any interest from the note, imputed or otherwise, on his tax returns. The lack of evidence that interest was ever paid or demanded favors a finding that no bona fide debt existed.

As for establishing a fixed repayment schedule, the loan agreement specified that it was to be repaid "upon demand" after December 27, 2005. However, there is no evidence as to when, if ever, appellant demanded repayment of the loan. The promissory note does not specify

[4] Imputed interest is interest income that can be imputed to a taxpayer who has made a loan at interest below the Applicable Federal Rate.

a repayment schedule or any details concerning the procedures for repayment. The lack of a fixed repayment schedule favors a finding that no bona fide debt existed.

As for whether collateral was given to secure payment, appellant asserts that he and his father agreed that the REIT investments would serve as the collateral for appellant's loan of $646,421.38. However, their oral agreement did not provide appellant with a security interest in the REIT investments. The lack of a true security arrangement concerning the purported collateral for the loan of $646,421.38 tends to indicate that there was no bona fide debt.

Appellant argues that his father made principal repayments under the loan agreement, which totaled $26,883.38. However, the only documentary evidence of repayment consists of a single check for $1,385.17, dated September 20, 2011, from appellant's father to appellant. While even a token repayment provides some evidence that the borrower was expected to repay the loan, in this instance the alleged repayment was so small relative to the amount of the loan that it is insignificant. (*See Geftman v. Commissioner* (3d Cir. 1998) 154 F.3d 61, 71.) In this case, appellant claims that he received $26,883.38 on a debt of $646,421.38 or approximately 4.16 percent of the funds he claims he lent his father. We only have evidence that one payment of $1,385.17 was made, meaning approximately .214 percent of the funds were repaid. This factor favors a finding that no bona fide debt existed.

As to whether appellant's father had a reasonable prospect of repaying the loan, we look to whether there was a reasonable expectation of repayment in light of the economic realities of the situation at the time the funds were advanced. (*Welch v. Commissioner*, *supra*, 204 F.3d at p. 1067.) Here, appellant's father borrowed the money to invest in real estate. Appellant states that he thought his father's plan to invest in REITs was a good idea because the real estate market was booming when he made the purported loan, and he expected repayment from the return his father received on his investment. However, appellant's loans went to fund investments that were speculative in nature and there is no evidence that appellant's father had the resources to repay the loan if the investments lost their value. This factor favors a finding that no bona fide debt existed.

As for whether the conduct of the parties was consistent with the existence of a bona fide debt, we find that, in some respects, appellant and his father conducted themselves as if there was a bona fide debt. They executed a simple promissory note that had been drafted by an attorney; appellant provided funds to his father and, six years later, his father repaid a small

amount. Significantly, appellant disclosed the transaction as a loan that was reflected as an asset in the Premarital Agreement that he had notarized on January 8, 2008. On the other hand, both parties agree that appellant's father did not report the cancellation of debt income on his own tax return when appellant says that he determined the debt was worthless in 2011. Appellant asserts that his father did not report his investment losses, either, which allegedly would have offset the cancellation of debt income. There is no evidence that appellant obtained a security interest in the purported collateral for the loan. There is no evidence that appellant sought to collect the debt; appellant acknowledges that he made no collection efforts. On balance, we find that this factor favors a finding that no bona fide debt existed.

"A purported loan between family members is always subject to close scrutiny . . . . The presumption, for tax purposes at least, is that a transfer between family members is a gift." (*Perry v. Commissioner* (1989) 92 T.C. 470, 481 (citations omitted).) Although some factors suggest that a bona fide debt was created (there was a promissory note and the prospects for repayment might have seemed reasonable at the outset), overall, the factors weigh heavily against finding a bona fide debt existed. There is no evidence that interest was demanded or paid; there is no evidence of a repayment schedule; there was no written agreement concerning the purported collateral or a security interest; the alleged repayments were insignificant compared to the amount borrowed; and there was no demand for repayment. Thus, we conclude that appellant has not met his burden of establishing the existence of a bona fide debt.

Even if we were to determine that the loan was a bona fide debt, appellant would need to show that the loan had become totally worthless during the year at issue before it may be deducted. (Treas. Reg. § 1.166-5(a)(2); s*ee also Stanley v. Commissioner*, T.C. Memo. 1999-20). "Mere nonpayment of a debt does not prove its worthlessness and the . . . . failure to take reasonable steps to enforce collection of the debt, regardless of the motive for the failure, does not justify a bad debt deduction unless there is proof that those steps would have been futile." (*Appeal of Myron E. and Daisy I. Miller* (79-SBE-106) 1979 WL 4148 [citations omitted].) To establish that a debt is worthless, "taxpayers must exhaust the usual and reasonable means of collection before they are entitled to a deduction." (*Newman v. Commissioner*, T.C. Memo. 2000-345.)

Appellant states that he met with the promoters of the REITs before their dissolution during 2011 and "at that point in time, it became crystal clear to [him] that his earlier loan would

not be repaid; the collateral had failed and [his father's] only asset, his home in Las Vegas, literally had no equity." Appellant's opinion about the potential value of his father's investments and appellant's potential ability to collect from his father is unsupported by documentary evidence. We have no evidence that appellant took any steps to enforce collection of the debt owed to him by his father, even though his father had assets, including a rental property in Nevada. Since appellant's father had some ability to make payment, and no collection efforts were initiated, appellant has not established that the debt became worthless in 2011. Furthermore, FTB provided evidence showing that the Desert Capital REIT still had over $600,000 in assets as of its Chapter 11 Bankruptcy Post Confirmation Report filed on February 19, 2016. Thus, even if the loan were bona fide, appellant has not established that it became worthless during 2011.

HOLDING

Appellant's loan to his father in 2004 does not qualify as a bona fide debt that became worthless during 2011.

DISPOSITION

Respondent's action is sustained.

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

DocuSigned by:
Michael F Geary
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Michael F. Geary
Administrative Law Judge

DocuSigned by:
Jeffrey I Margolis
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Jeffrey I. Margolis
Administrative Law Judge