BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ARTHUR AND KATE C. HEIMANN)

Appearances:

For Appellants: R. J. Swenson, Certified Public Accountant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenu and Taxation Code from the action of the Franchise Tax Board on the protest of Arthur and Kate C. Heimann against a proposed assessment of additional personal income tax in the amount of $571.03 for the year 1955.

The sole question before us relates to amounts deducted by Appellants as bad debt losses under the following circumstances The various amounts in question will be referred to as "advances" because whether they were in fact loans is one of the points at issue.

Appellants are the parents of John Heimann, who, at the times mentioned herein, was married and the father of four children.

Appellant's son enjoyed working with youth and hoped to make a profitable venture of it. Commencing in September 1948 the son operated a business called the Wakoda Lodge, which consisted of arranging for and conducting excursions and camps for boys. He experienced a net loss of $1,042.50 in 1949 and net profits of $1,400.06, $1,978.19 and $915.95 in 1950, 1951 and 1952, respectively. By the end of 1951, the business had a deficit of $10,531.81 and at the end of the year 1952, a deficit of $16,235.26. The liabilities at the end of 1952 totaled $20,537.66 against assets valued at $4,302.40.

From the start of the business in 1948 to April 1, 1950, Appellants advanced to their son more than $7,500. In April of 1950 they obtained from him a promissory note for the latter amount. They advanced additional amounts of $500.00, $1,853.68 and $838.33 in the years 1950, 1951 and 1952, respectively.

In September 1952 the son ceased operating the Wakoda Lodge and obtained employment as a private school athletic director

at a salary of $3,100 for a work-year of ten months. On a part-time basis, he conducted activities of the type he had carried on in operating Wakoda Lodge, There is no indication that these activities were profitable.

On October 8, 1952, Appellant Kate Heimann executed a will which stated in part that:

> I authorize my trustee or trustees, in his or their sole discretion, to grant extensions of time to any of my children who are the makers of promissory notes held by my trustee or trustees, to the end that said makers shall be expected to make reasonable payments upon said notes only after reasonable allowances for taxes and living expenses.

In 1953, Appellants advanced $4,016.61 to their son and paid $1,615.74 to a bank as guarantors of a note on which their son had defaulted. On their personal income tax return for that year Appellants deducted as a bad debt the amount which they had paid to the bank.

Further advances were made by Appellants to their son in 1954 and 1955 in the amounts of $1,453.13 and $1,221.10 for each year, respectively.

The son filed a voluntary petition in bankruptcy in 1955 and was discharged as a bankrupt in the same year. He listed his total debts as $26,176.05, including the amounts advanced by Appellants. The following statement appeared on the schedule with reference to the advances by Appellants:

> Loans from petitioner's father. These are in two categories: (1) from 1950 through 1953 petitioner's father assisted him in the payment of numerous business debts in the approximate amount of $15,425.44 on the understanding that if petitioner's business was ever sufficient to enable him to repay these amounts then he would do so. (2) In 1954 and 1955 petitioner's father has made loans in the amount of $2,674.23 on the understanding that these were to be repaid prorate along with other business indebtedness of petitioner.

The schedule listed assets in the amount of $4,313.74, consisting of household furniture subject to a mortgage and an automobile. None of the creditors, however, received any payments through the bankruptcy proceedings. The Appellants, who knew the financial condition of their son, did not file claims.

The son had never repaid any part of the advances made to him by Appellants and they have never made any effort to collect.

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On their personal income tax return for 1955, Appellants took a bad debt deduction in the amount of $17,382.85, representing sums they had advanced to their son up to and including the year 1955, exclusive of the deduction that they took for 1953.

Respondent disallowed the deduction on the grounds that no bona fide debt existed and that if there were such a debt it became worthless prior to 1955.

Section 17207 of the Revenue and Taxation Code provides that "There shall be allowed as a deduction any debt which becomes worthless within the taxable year ..." The benefits of the federal counterpart of this section are applied very sparingly to intra-family transactions, which are subject to especially rigid scrutiny. No deduction for a bad debt based upon such a transaction is allowed unless there is an affirmative showing that there existed at the time of the advance a real expectation of repayment and an intent to enforce collection. (E. J. Ellisberg, 9 T.C. 463; Evans Clark, 18 T.C. 780; Leonard Henly Bernheim, T.C. Memo., Dkt. No. 20117, Nov. 10, 1950.) The required showing is not met merely by exhibiting a promissory note, valid in form. (Estate of Van Anda, 12 T.C. 1158, aff'd, 192 F.2d 391.) And where repayment is contingent upon the occurrence of an event, such as the success of a venture, no debt arises unless the event occurs. (Evans Clark, supra; Julius Schmutz, T.C. Memo., Dkt. No. 109555, March 27, 1943, aff'd, 139 F.2d 701; Bercaw v. Commissioner, 165 F.2d 521; Alexander & Baldwin, Ltd. v. Kanne, 190 F.2d 153.)

The previously quoted excerpt from Mrs. Heimann's will was introduced in an effort to show that Appellants intended to collect the advances. The will stated that any of Mrs. Heimann's children who are makers of notes held by her trustee shall be expected to make reasonable payments only after reasonable allowance for taxes and living expenses. Not only does this show a conditional obligation in itself, but there is nothing to establish that the one note here in question was, or that it was contemplated that it would be, "held by her trustee."

Assuming that the advances made in the early stages of the operation of the Wakoda Lodge were made with a real expectation of repayment, it is nevertheless apparent that repayment was intended to be contingent upon the success of the business. That this contingency existed is manifested by the statement in the schedule of debts filed in the bankruptcy proceedings that the advances were "on the understanding that if petitioner's business was ever sufficient to enable him to repay these amounts then he would do so." There is no testimony or other satisfactory evidence contradicting the statement and it is supported by the fact that Appellants never sought repayment,

After the business had been operated for a time, it became evident that it was not going to be successful. The business

did not show more than a nominal profit in any year. By the end of 1951, a deficit of more than $10,000 had accumulated and the deficit increased to over $16,000 by the end of 1952. At that time Appellants' son obtained a position at a salary that was hardly sufficient to support himself, his wife and his four children, aside from the possibility of paying many thousands of dollars in debts, His financial condition did not improve after 1952 and there were no reasonable prospects that it would. Appellants themselves demonstrated a recognition of the hopelessness of the situation by deducting as a bad debt in 1953 the amount which they had paid to a bank as guarantors of their son's note.

Viewed objectively and realistically, the facts and circumstances of this case lead to the conclusion that with respect to all of the advances, repayment was either not truly expected or was conditioned upon events that never occurred. It follows that no deduction may be permitted.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protest of Arthur and Kate C. Heimann against a proposed assessment of additional personal income tax in the amount of $571.03 for the year 1955 be and the same is hereby sustained.

Done at Pasadena, California, this 26th day of February, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary