



67-SBE-021

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
HANS KLEGER)

Appearances:

For Appellant: W. Harold Jeffrey and
H. A. Sherda
Certified Public Accountants

For Respondent: Lawrence C. Counts
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 1859¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Hans Kleger against proposed assessments of additional personal income tax in the amounts of \$1,241.66 and \$459.93 for the years 1959 and 1960, respectively.

The issue presented is whether appellant Hans Kleger was entitled to certain bad debt deductions claimed in his personal income tax returns for the years in question.

Hans Kleger (hereafter referred to as "appellant") was the sole stockholder or controlling stockholder of Kleger Specialty Products Co. (hereafter "Specialty Co."), Kleger Corporation (hereafter "Klego"), and Kleger Machine Co. (hereafter "Machine Co."). Appellant advanced funds to these corporations from time to time, after their formation, and the corporate books indicated these corporations were indebted to appellant during the years on appeal.

On July 1, 1957, Sterilizer Products Co., a partnership, was created to engage in the business of investments. The partners were the three corporations mentioned above. During the partnership's taxable year ended December 31, 1957,

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the partners contributed partnership capital totalling \$66,173.75. Of that total Specialty Co. contributed \$10,000, Klego contributed \$27,593.75, which had been advanced to it by appellant, and Machine Co. contributed \$28,580.

Sterilizer products Co., in turn, invested these donations to capital in another partnership, Universal Sterilizer Co. (hereafter "Universal"), thereby becoming one of Universal's two partners. Universal's operations in 1957 and 1958 resulted in partnership losses of \$70,642.19 and \$80,001.39, respectively, and it was taken over by its creditors early in 1958.

During 1958 all of Universal's equipment and inventory were sold for one hundred dollars to American Plating Co., an unrelated company. American Plating Co. agreed to take over Universal's operations and, after two years had elapsed, to assign 5 percent of any royalties received from sales of sterilizers to the creditors of Universal. Despite the fact that American Plating Co. invested over \$250,000 in Universal's operations over the next two years, production was still not profitable and no creditors' royalties were forthcoming. On September 27, 1961, a final creditors' conference was held and the matter was closed,

As a result of Universal's losses Klego and Machine Co. two of the partners of Sterilizer products Co., reported losses in their franchise tax returns for income years ended in 1958 and 1959. Specialty Co., the third partner in Sterilizer products Co., had no income in 1959 or 1960. It had been suspended on November 1, 1958, for failure to pay franchise taxes, and was never revived thereafter. In his personal income tax return for 1958, appellant indicated that his Specialty Co. stock was worthless in that year.

Within this factual framework, two series of transactions gave rise to the bad debt deduction claimed by appellant for 1959:

1. On September 27, 1957, Klego advanced \$10,500 to Specialty Co., on the alleged condition that appellant personally guarantee that Klego would suffer no loss as a result of the advance. (\$10,000 of this advance was then transferred to Sterilizer products Co., as Specialty Co.'s contribution to partnership capital.) Promissory notes payable to Klego in the amounts of \$5,879.04 and \$1,063.96,

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which were executed by Specialty Co. at the time of Klego's advance, were transferred to appellant on August 1, 1959, and there was a corresponding reduction in the amount of Klego's indebtedness to appellant.

2. During the years 1957 and 1958 Machine Co. made credit sales of goods to Universal, which resulted in an account receivable in the amount of \$10,794.90. In 1959 Machine Co. transferred that account receivable to Specialty Co., in return for Specialty Co.'s note in that amount. This transaction also allegedly was conditioned on appellant's personal guarantee that Machine Co. would not suffer any loss as a result of the transfer. On August 1, 1959, Machine Co. transferred Specialty Co.'s note to appellant, and the amount owed to appellant by Machine Co. was correspondingly reduced.

In his 1959 return appellant claimed a bad debt deduction of \$17,737.90, attributable to the three Specialty Co. notes which he held in the amounts of \$10,794.90, \$5,879.04, and \$1,063.96.

In his 1960 return appellant claimed a bad debt deduction in the amount of \$11,872.88, allegedly resulting from unrecoverable payroll advances to Universal in 1960 and payments on that partnership's notes which had been personally guaranteed by appellant.

Appellant argues that he is entitled to the bad debt deductions claimed for 1959 and 1960, since those deductions represent amounts which he was obliged to pay under guarantees and salary advances made to Universal which could not be recovered. Respondent disallowed these bad debt deductions on the ground that appellant had failed to establish his right to them.

During the years in question section 17207 of the Revenue and Taxation Code provided generally for the deduction of debts which became worthless during the taxable year. It is well established that deductions are a matter of legislative grace, and the taxpayer seeking a deduction has the burden of proving that he comes within the provisions of the deduction statute. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348].)

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It is also settled that a guarantor who is required to pay the debt of his principal under a valid guaranty contract may take a bad debt deduction. (Putnam v. Commissioner, 352 U.S. 82 [1 L. Ed. 2d 144].) The fact of payment gives rise to the guarantor's claim against the principal debtor, creating the necessary debtor-creditor relationship between them. (Cushman v. United States, 148 F. Supp. 880.) Again, however, the taxpayer has the burden of proving that a guaranty contract existed (Alexander N. Lukorsky, T.C. Memo., Dkt. No. 90286, Aug. 3, 1965; Suzanne Von Mandel, T.C. Memo., Dkt. No. 85514, Jan. 17, 1962), and that his claim against the primary debtor was worthless. (Morris Sass, 17 B.T.A. 261.)

In the instant case appellant has failed to produce evidence to substantiate the existence of the "personal guarantees" on his part which allegedly gave rise to the major portion of the bad debt deductions claimed. Appellant has similarly failed to prove that he in fact made the alleged payroll advances to Universal, or any other advances.

Even assuming that appellant did execute valid guaranties and that the advances were made as contended, appellant has not shown that his claims against Specialty Co. and Universal actually became worthless in 1959 and 1960, the years on appeal. The only events in the record which constitute any evidence of worthlessness are the suspension of Specialty Co. in 1958 for failure to pay franchise taxes, the taking over of Universal's operations by its creditors in 1958, and the decision of Universal's creditors on September 27, 1961, to discontinue further attempts to make Universal's operations profitable. These events lend no support to a claim of worthlessness in 1959 or 1960.

Respondent's disallowance of the deductions claimed by appellant carries with it a presumption of correctness. (Appeal of William S. and Betty Jack, Cal. St. Bd. of Equal., May 17, 1962; Appeal of Reginald C. and Laura P. Stoner, Cal. St. Bd. of Equal., April 17, 1947.) After careful review of the entire record in this case we conclude that appellant has failed to submit evidence to overcome this presumption of correctness. That being so, respondent's determination on this issue must be sustained.

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,

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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 Hans Kleger against proposed assessments of additional personal income tax in the amounts of \$1,241.66 and \$459.93 for the years 1959 and 1960, respectively, be and the same is hereby sustained,

Done at Sacramento, California, this 24th day
of April, 1967, by the State Board of Equalization.

Paul R. Reese, Chairman
John W. Lynch, Member
J. Richard Olsen, Member
Bob K. Green, Member
_____, Member

ATTEST:

[Signature], Secretary