

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
ESTATE OF LEWIS HAVENS AVERY, DECEASED )

Appearances:

For Appellant: **Jared C. Avery**  
**Attorney at Law**

For Respondent: Kathleen M. Morris  
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of Lewis Havens Avery, Deceased, against a proposed assessment of additional personal income tax in the amount of **\$1,944.45** for the year 1971.

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The **issue presented** is whether certain bad debt losses sustained by appellant were business or nonbusiness bad debt losses.

Lewis Avery (hereinafter referred to as "Avery") was born on July 18, 1902, and was employed in the advertising field from 1926 until 1945. In 1945 he established his own advertising agency. In 1962 Avery, at age 60, retired from his company and with four others purchased, a radio station in San Francisco in which he apparently had an active management role. After four years, he and his partners sold the radio station. Avery continued to work for the new owner of the radio station, Avco Broadcasting Corporation ("**Avco**"), for six months until his services were terminated by Avco because of his uncertain health and certain personality conflicts with **Avco's** management.

After a short period during which Avery was not gainfully employed, he became involved with two FM radio stations in California. Avery advanced substantial sums to these stations even though he was not actively employed by either radio station. Avery did, however, from time to time, provide consulting services to the two stations.

In July 1969, at the age of 67 and a year and a half from the date of the termination of his last full-time salaried position, Avery became interested in Pocoh Industries, Inc; (hereinafter "**Pocoh**"), a company which manufactured novelty items. On December 11, 1969, he entered into an agreement which provided, in essence, that he would: (i) guarantee a \$25,000 loan to be made to Pocoh; (ii) be elected president of Pocoh and receive a salary of \$12,000 per annum to be deferred until the corporation had achieved a profit position and could afford to pay the salary, but payable in any event upon the termination of his employment; and (iii) have the option to acquire between 10 and 15 percent of **Pocoh's** capital stock for the same price as originally paid by the initial investors of Pocoh.

In February 1970, Avery guaranteed another \$25,000 loan to Pocoh, and sometime later he guaranteed still another \$25,000 loan. Additionally, he made a **direct loan** to Pocoh of \$50,000. This loan was evidenced by an unsecured promissory note made payable to Avery. From time to time, Avery advanced additional sums totaling \$18,000 in cash to Pocoh. On or about July 20, 1970, he became the chief executive officer in addition to

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being the president of Poch and, at that time, acquired 39 shares of Poch stock. After becoming the chief executive officer, Avery apparently determined that Poch was insolvent. In June 1971, he caused the corporation to file a petition in federal bankruptcy court for the involuntary dissolution of Poch. Approximately two months later, Avery, who had long been in uncertain health, learned he had terminal cancer. He died on November 25, 1971.

The amount of the losses to appellant as a result of Avery's advances to Poch is not in question, nor is the fact that appellant did suffer such a loss. The Franchise Tax Board (hereinafter "respondent") determined, however, that appellant's losses were nonbusiness bad debts rather than business bad debts. Consequently, respondent determined that the debts were deductible only to the extent of \$1,000 per year.

Revenue and Taxation Code section 17207 provides, in pertinent part, that a taxpayer can deduct a bad debt in full, in the year in which it becomes worthless, only if it is created or acquired in connection with, or if **the loss therefrom is incurred in, the taxpayer's trade or business.** Respondent's regulations provide the test to be applied in resolving the issue of whether a loss is incurred in a trade or business. (Cal. Admin. Code, tit. 18, reg. 17207(e), subd. (2) **(B).**) That regulation reads, in pertinent part, as follows:

For **purposes** of Section 17207 and this regulation, a nonbusiness debt is any debt other than (i) [a] debt which is **created, or** acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or (ii) [a] debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The determination of whether losses are business bad debts is a question of fact. (Oddee Smith, 457 F.2d 797 (5th Cir. 1972); Isidor Jaffee, ¶ 67,215 P-H Memo. T.C. (1967) .)

The proper standard to be applied in **ascertaining** whether the loss was incurred in connection with the taxpayer's trade or business is "dominant motivation." (United States v. Generes, 405 U.S. 93 [31 L. Ed. 2d 621 (1972) .) Appellant concedes that the correct standard

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to be applied is that of "dominant motivation" and argues that Avery's dominant motive in making the loans and guaranties was to obtain and continue a lifetime of gainful employment, and not for investment purposes.

The courts have taken the position that care must be taken to determine the character of the loss where the taxpayer, as in this case, is a creditor-stockholder who is also an employee of the debtor-corporation. In Whipple v. Commissioner, 373 U.S. 193 [10 L. Ed. 2d 2881 (1963)], the United States Supreme Court held that absent substantial additional evidence, furnishing management and other services to corporations does not ensure a business bad debt loss. (See also Donald C. Niblock, Jr., ¶ 68,260 P-H Memo. T.C. (1968); Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416] (1940); Burnet v. Clark, 287 U.S. 410 [77 L. Ed. 397] (1932); Dalton v. Bowers, 287 U.S. 404 [77 L. Ed. 389] (1932); Appeal of Walter E. and Pearl Robertson, et al., Cal. St. Bd. of Equal., June 2, 1969.) These cases make clear that where loans are made merely in connection with or for the purpose of protecting the stockholder's investment in his corporation, they may not be regarded as "business" loans of the stockholder.

It is equally clear, on the other hand, that being an employee of a corporation may constitute a trade or business, so that if a stockholder-employee's loan to his corporation is made in order to protect his job or is otherwise proximately related thereto, the resulting debt is a "business" debt. (Trent v. Commissioner, 291 F.2d 669 (2nd Cir. 1961); Weddle v. Commissioner, 325 F.2d 849 (2nd Cir. 1963); Kelly v. Patterson, 331 F.2d 753 (5th Cir. 1964).)

The facts in the instant appeal indicate that Avery necessarily concluded that the initial \$25,000 loan guarantee was necessary to obtain employment with Pocoh. The very terms of the agreement he executed on December 11, 1969, provided that he would obtain employment with Pocoh conditioned upon his making the loan guarantee. The agreement did not require him to make further loans to Pocoh, and the record reveals that, as to this first \$25,000 loan guarantee, he was prompted by the dominant motivation of gainful employment. Avery was, for all practical purposes, incapable of securing employment elsewhere due to his advanced age and uncertain health, and was desirous of augmenting his annual income. The record is undisputed that Avery would not have been employed at all unless the sum of \$25,000 was guaranteed by him. This initial \$25,000 loan guarantee, which ultimately resulted in a business bad debt of a like amount,

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cannot be defined as a nonbusiness bad debt since it was created in the course of Avery's trade or business. (Cal. Admin. Code, tit. 18, reg. 17207(e), subd. (2)(B)(i).) Consequently, it may be deducted as a business bad debt. (Weddle, supra.)

The same cannot be said of the remaining **\$118,052.46** advanced or guaranteed by Avery. As noted above, the courts have held that care must be taken to distinguish bad debt losses arising from the taxpayer's own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of his corporate business. (Whipple, supra.) The record here does not sustain appellant's contention that Avery's guarantee and advancement of the remaining **\$118,052.46** to Pocoh should be treated as a business bad debt and, therefore, differently from that of an ordinary investor in that corporation. There is no evidence to indicate that Avery felt it necessary to provide the additional loan guarantees and advancements to keep his job or that they were proximately related to maintaining his trade or business as an employee. (Donald C. Niblock, Jr., supra.) When he extended the additional **\$118,052.46 in loans** and guarantees, Avery was 67 years old and in ill health. While the record is somewhat unclear on this point, it seems inconceivable that he viewed his employment at Pocoh as anything other than short-term. It is clearly evident that the additional advancements and loan guarantees of this substantial sum were made not to secure his job, with a promised annual salary of only \$12,000; but rather for the purpose of -protecting his investment in Pocoh. Therefore, they may not be regarded as "business" loans.' (Donald C. Niblock, Jr., supra.) Consequently, we must conclude that the **remaining \$118,052.46** in loans and guarantees were in the nature of nonbusiness bad debts.

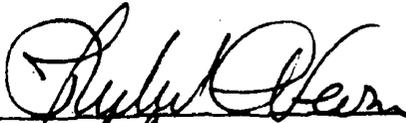
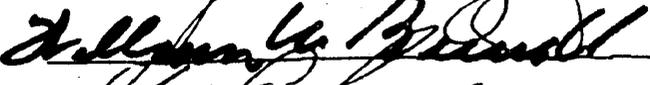
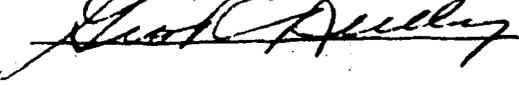
O R D E R

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 Estate of Lewis Havens Avery, Deceased, against a proposed assessment of additional personal income tax in the amount of \$1,944.45 for the year 1971, be and the same is hereby modified to allow a business bad debt deduction of \$25,000. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 30th day of June, 1980, by the State Board of Equalization.

	Chairman
	Member
	Member
	Member
_____	Member