

Appeal of Roy E. and Evelyn B. Klotz

The issue presented is whether a nonbusiness bad debt became totally worthless in the year 1971, thereby **entitling appellants** to a capital loss deduction for that year.

During 1971 and **prior** thereto, Roy E. Klotz (hereafter "appellant") was one of the principal stockholders of Anadite Corporation ("**Anadite**"), a manufacturer and processor of metal products primarily for the aerospace industry. William **E.** Riley, a key executive of Anadite, became financially distressed prior to 1971. To assist Riley, appellant and Glenn E. Boehmer, another large stockholder, cosigned and guaranteed Riley's \$700,000 note. This enabled Riley to renew a loan in that sum from Continental National Bank of Fort Worth ("**Continental**") in 1970. Riley pledged 35,000 shares of Anadite common stock as security for the loan.

Because of an economic decline in the aerospace industry, the market value of Anadite common stock declined from \$44.75 per share during 1969 to a low of \$2.75 in April of **1971**. As a consequence, Continental insisted upon being paid \$600,000. Riley could not comply, **and appellant** had to pay \$225,000 in 1971 pursuant to his guaranty, while Foehmer paid \$375,000.

Riley resigned as president of Anadite in July of 1971 and terminated all relationships with the corporation in December of **1971**. He became seriously ill during 1971. Because of declining health, he was thereafter unable to obtain meaningful employment. The following personal balance sheet was prepared by Riley in 1973:

Schedule of Assets and Liabilities
December 31, 1971

Assets

Cash in banks:	\$	2,150.00
Note receivable - Donald Pentecost		100,000.00
Investments at estimated market values:		
Stocks:		
87,000 shares, Anadite, Inc.		174,000.00
307 shares, State Bank of East Fort Worth		21,490.00
51 shares, Nor-Tex Agency		10,000.00
Real Estate:		
2/3 interest Highway 81 property		160,000.00
1/3 interest 420 acres San Antonio		36,000.00
Residence (homestead)		75,000.00
	\$	<u>578,640.00</u>

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Liabilities

Account payable - Nor-Tex Agency	\$ 74,900.00
Notes Payable:	
Continental National Bank	700,000.00
State Bank of. East Fort Worth	120,000.00
Walter P. Camp	76,000.00
Borg-Warner Acceptance Corp.	91,000.00
Income tax deficiencies:	
1965, 1968, 1969, 1970	<u>28,100.00</u>
	<u>\$1,090,000.00</u>

The above balance sheet is subject to certain modifications. It should have indicated that \$225,000 was owed to appellant, \$375,000 to Boehmer, and \$100,000, not \$700,000, was owed to Continental. Moreover, any value given to the Pentecost note, dated July 1, 1970, was doubtful. It **should** be noted also that as of December 31, **1971**, **all** of Riley's Anadite stock was pledged to creditors. In addition to the 35,000 shares pledged to Continental, Riley's other 52,000 shares were pledged to the East Fort Worth bank as security for the \$120,000 obligation. **It also** appears that in **1971** Riley did not own any shares of East Fort Worth bank stock. Furthermore, Riley apparently only held a one-third interest in the Highway 81 property (hereinafter the "81 property") as of December 31, 1971. As evidenced by a subsequent appraisal, a one-third interest in that property would have had a reasonable fair market value of **\$96,666.67**. However, the property allegedly was not merchantable at that time because of several pending lawsuits and existing liens. Moreover, the property in San Antonio was also apparently then involved in litigation, and under applicable provisions of Texas homestead law, Riley's residence was not attachable.

In addition to the assets listed on the balance sheet, Riley had also been awarded a judgment in a United States District Court, dated November 16, 1971, for **\$81,763.77** against Richard M. Jones, Charles Owen and Continental. Furthermore, Nor-Tex Agency, Inc., of which Riley was then a 50 percent stockholder, had obtained a judgment in the same action in the amount of **\$356,981.64**.

Subsequently, Riley's financial situation improved. He was successful in the litigation involving the 81 property; his interest in that property increased in value; he sold his interest in the San Antonio property for \$30,000; he received \$10,000 for his Nor-Tex

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Agency, Inc. stock; and there was a gain in the value of his Anadite stock. As a result, he was able to satisfy certain liabilities and to have 12,640 shares of Anadite stock returned to him.

In 1972 appellant and Boehmer filed a lawsuit against Riley in an attempt to recover the money owed to them. This was settled in 1973 and resulted in a significant recovery by appellant. Specifically, in consideration for releasing him from all liability, Riley transferred to them his 12,640 shares of Anadite stock, which represented a total value of \$41,080, assigned the Pentecost note to them, and also assigned to them the rights to certain anticipated proceeds from collection of the judgments against Jones and from the sale of Riley's interest in the 81 property. As a result of this settlement, 'appellant received **\$16,432.00** worth of stock and net proceeds from the sale of the 81 property in the amount of **\$6,048.02**. The Pentecost note, however, apparently was totally worthless.

Concluding that **they** could properly regard Riley's \$225,000 debt to them as worthless, because of Riley's financial condition as of the close of 1971, appellants deducted it as a nonbusiness bad **debt on** their return for that year. Respondent concluded that the debt was not totally worthless and disallowed the deduction. In support of his contention that the debt was totally worthless by December 31, 1971, appellant points out that Riley was insolvent, the Pentecost note was worthless, and the value of the Anadite shares was less than the amount owed, by Riley to the banks. He also emphasizes the unavailability of Riley's house because of homesteading, the seemingly limited value and unavailability of the 81 property, and Riley's lack of employment prospects because of poor health.

Here both parties agree that the debt in question was a nonbusiness bad debt: consequently, total worthlessness in the taxable year must be established before any deduction is allowable. (Rev. & Tax. Code, § 17207, subds. (d)(1)(A) and (d)(1)(B); Miriam Coward Pierson, 27 T.C. 330 (1956), affd. on other grounds, 253 F.2d 928 (3d Cir. 1958); see W. A. Dallmeyer, 14 T.C. 1282 (1950).) Subdivision (d)(1)(B) of Revenue and Taxation Code section 17207 provides that where **any** nonbusiness debt becomes worthless within the taxable **year**, the loss resulting therefrom shall be considered a loss from the sale or exchange during the taxable year of a capital asset held for not more than one year. The

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taxpayer must establish that some identifiable event, or series of events, occurred during the taxable year which formed a reasonable basis for abandoning any hope that any portion of the debt would be paid in the future. (w. A. Dallmeyer, supra; Appeal of Harry B. and Maizie E. Breitman, Cal. St. Bd. of Equal., Feb. 18, 1964.) If the nonbusiness bad debt has some reasonably foreseeable potential value, the debt is not worthless. (Miriam Coward Pierson, supra.)

Applying these principles, we conclude that as of December 31, 1971, appellant did not have a reasonable basis for abandoning hope of a substantial recovery on Riley's debt. Here future conditions were uncertain. The stock pledged with the Fort Worth bank in December of 1971 had a market value only slightly less than Riley's debt to that bank. With only a slight increase in value, those shares represented a foreseeable source of some recovery. (Cf. Lbewi & Co. v. Commissioner, 232 F.2d 621 (7th Cir. 1956).) Moreover, there were two court judgments under appeal which awarded Riley large sums of money. Where substantial assets representing a possible source of recovery are the subject of litigation between the debtor and a third person, the final resolution of such litigation may be a condition precedent to the establishment of worthlessness. (J. Rogers Flannery, Jr., ¶ 46,103 P-H Memo. T.C. (1946).) We also are of the view that a moderate increase in the market value of the 81 property was foreseeable.

Under all these circumstances, we conclude that at the close of 1971 there was still a potential for a partial recovery on Riley's debt. Therefore, respondent properly disallowed the deduction claimed by appellants for 1971.

