BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE J. AND COLLEEN M. NICHOLAS)

For Appellants: George J. Nicholas
Attorney at Law

For Respondent: Claudia K. Land
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 George J. and Colleen M. Nicholas against a proposed assessment of additional personal income tax in the amount of **$2,730.94** for the year 1973. Since Colleen M. Nicholas is included in this appeal solely because appellants filed a joint return, "appellant" herein shall refer to George J. Nicholas.

Appellant is a practicing attorney. From 1967 through 1973 he sought out financially troubled, publicly held corporations which he would attempt to revive by reorganizing management, putting the balance sheet in order, arranging for the issuance of securities to provide additional funds, and, sometimes, lending money to the corporation or guaranteeing corporate bank loans. Typically, he would acquire a minority interest in the corporation, apparently either by purchase or in consideration of his services.

In 1970 appellant was a 20 percent shareholder in North American Funding, Inc. (NAF), a company which he was trying to rejuvenate. Appellant arranged for a loan to NAF from Union Bank ("the bank"), which he personally guaranteed and secured in part with a $25,000 certificate of deposit.

Appellant was unable to obtain underwriting for a necessary securities issuance, however, and in 1972 he sold his NAF stock to outside investors ("the Woods group") for $1.00. The sale contract included the buyers' agreement to hold appellant harmless on his Union Bank loan obligation. In June 1973 NAF was insolvent and ceased doing business. The new stockholders divided NAF's remaining assets among themselves. The bank then brought suit against appellant and NAF on the corporate loan. Appellant cross-complained against the Woods group, alleging that the bank was threatening to cash his certificate of deposit which secured the loan and that the Woods group had breached the sale contract by not paying the bank. The bank evidently carried out its threat and cashed appellant's certificate of deposit, and appellant deducted the $25,000 as a business loss on his 1973 personal income tax return. In 1975 the bank won a judgment against all defendants. Appellant also won a judgment against the Woods group, but the parties reached a settlement on the cross-complaint, in which appellant received part of his $25,000 from the Woods group. The amount he received was reported as income on his personal income tax returns for 1975 and 1976.

Respondent audited appellant's 1973 return and disallowed the $25,000 business loss deduction. Appellant protested that the loss was incurred in his business as a promoter, stating that he had often "advanced monies to various corporations and other entities in which he had other investments for the purpose of promoting the investment and for the purpose of collecting

interest on monies advanced." Respondent affirmed its proposed assessment, asserting that investment was not a trade or business, that the loss was properly deductible only as a bad debt loss rather than an ordinary loss, and that, in any event, the loss was not deductible in 1973, since the worthlessness of the debt was not certain in that year.

The first issue to be determined is whether a business loss or a bad debt loss is involved. Business losses are deductible under Revenue and Taxation Code section 17206 and bad debt losses under section 17207. These two sections are substantially the same as sections 166 and 167, respectively, of the Internal Revenue Code, so federal case law and interpretations are highly persuasive as to the application of the California sections. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428] (1941); Meanly v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

It is clear that the provisions regarding business losses and bad debt losses are mutually exclusive. (Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 189 [78 L.Ed. 1200] (1934), rehg. den., 292 U.S. 613 [78 L.Ed. 1472] (1934).) We believe it is equally clear that where a stockholder guarantees a corporate loan, any loss he incurs upon payment pursuant to his guaranty is deductible, if at all, only as a bad debt loss. (Putnam v. Commissioner, 352 U.S. 82 [1 L.Ed.2d 1441 (1956).) Therefore, we find that appellant is not entitled to a business loss deduction, but may only take a bad debt loss deduction, provided he meets the criteria for such a deduction.

Revenue and Taxation Code section 17207(a)(1) allows a deduction for "any debt which becomes worthless within the taxable year. ..." In determining that a debt became worthless in a certain taxable year, the taxpayer bears the burden of showing that some identifiable event occurred during the taxable year which served as a reasonable basis for abandoning any hope for future recovery. (Appeal of Donald D. and Ann M. Duffy, Cal. St. Bd. of Equal., March 27, 1973.)

Appellant acquired the debt of NAF when the bank cashed the certificate of deposit which appellant had pledged in connection with his guaranty. Both appellant and respondent state that NAF was insolvent in June 1973, and it is apparently because of this insolvency that appellant claims his loss in that year.

A debtor's insolvency, by itself, however, will not establish the worthlessness of a debt. Liabilities may greatly exceed assets, but there may still be sufficient assets to partially pay the indebtedness. (Appeal of Samuel and Ruth Reisman, Cal. St. Bd. of Equal., March 22, 1971.) In the case of NAF, apparently there were assets existing at the time it ceased business which were distributed to the new shareholders. But whether or not the possibility of reimbursement from NAF existed, we find that the debt was not worthless in 1973 because of appellant's right to indemnification by the Woods group.

An indemnitor promises to reimburse any loss or damage which the indemnitee suffers in connection with the subject matter of the indemnity agreement. (Leatherby Ins. Co. v. City of Tustin, 76 Cal.App.3d 678, 687 [143 Cal.Rptr. 153] (1977); Sammer v. Ball, 12 Cal.App.3d 607, 610 [91 Cal.Rptr. 121] (1970).) A cause of action against the indemnitor arises, at the latest, when the indemnitee has suffered loss; i.e., when he has paid or performed on his obligation. (Alberts v. American Casualty Co., 88 Cal.App.2d 891, 898-899 [200 P.2d 37) (1948).) Even in the absence of an express contract, the law may imply an obligation to indemnify. Thus, an obligation is imposed on a principal to reimburse a surety who, pursuant to his agreement, has paid the indebtedness of the principal. (Aetna Life & Cas. co. v. Ford Motor Co., 50 Cal.App.3d 49, 52 [122 Cal. Rptr. 852) (1975); Berrington v. Williams, 244 Cal.App. 2d 130, 135 [52 Cal.Rptr. 772] (1966).)

Applying these principles to appellant's s'ituation, we see that he had, essentially, two parties who were obligated to reimburse him for his loss on his guaranty--NAF and the Woods group. Although NAF may be considered primarily liable for reimbursement, the Woods group was obligated to reimburse appellant on the same debt and in the same manner. Since he had a right to recover from the Woods group, and he acted to enforce that right as soon as his liability arose (and even before he had suffered actual loss), the debt could not be considered worthless in 1973, when there was not just a hope, but obviously a justifiable expectation, of recovery. The extent of the debt's worthlessness was not established until appellant recovered on his cross-complaint.

Finding that the debt was not worthless in 1973, we need not consider the issues raised as to the

character of the debt deduction, and respondent's action is therefore sustained. We note that respondent has conceded that this result entitles appellant to refunds of taxes paid on those amounts recovered, and reported as income, in 1975 and 1976.

ORDER

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 George J. and Colleen M. Nicholas against a proposed assessment of additional personal income tax in the amount of $2,730.94 for the year 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of January 1981, by the State Board of Equalization, with Member: Dronenburg, Bennett, Nevins and Reilly present.

Ernest J. Dronenburg, Jr., Chairman

William M. Bennett, Member

Richard Nevins, Member

George R. Reilly, Member

_____, Member