BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
DAVID B. HAAG AND ESTATE OF)
CAROL D. HAAG, DECEASED)

Appearances:

For Appellants: Walter Tribbey,
Attorney at Law

For Respondent: Brian W. Toman
Counsel

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of David B. Haag and Estate of Carol D. Haag, Deceased, against proposed assessments of additional personal income tax and penalties in the total amounts of $961, $4,762.42, and $1,363.31 for the years 1967, 1968, and 1969, respectively, and on the protests of David B. Haag against proposed assessments of additional personal income tax and penalties in the total amounts of $8,818.03 and $363.80 for the years 1971 and 1972, respectively.

Appeals of David B. Haag and
Estate of Carol D. Haag, Deceased

Appellants were husband and wife and filed joint returns for the years in question. The Estate of Carol D. Haag is a party to this matter solely because of joint filing; David B. Haag is hereafter referred to as appellant. Appellant is a dentist and at all times during the years in question practiced that profession full time.

In 1972, respondent discovered that appellant had not filed any California personal income tax returns for the years 4963 through 1971. Appellant was contacted and he responded by voluntarily filing returns for the years 1963 through 1972. Respondent reviewed these returns and disallowed various claimed deductions for 1967, 1968, 1969, 1971, and 1972. Appellant protested the following disallowances: an interest expense deduction of $12,135 for 1967; a repair deduction of $8,512 for 1968; a furniture replacement deduction of $4,987 in 1969; a casualty loss deduction of $1,133 for 1969; and a bad debt loss deduction of $62,004 for 1971.' After respondent upheld the disallowances, appellant brought this appeal. At the oral hearing in this matter, appellant withdrew his objection to the casualty loss disallowance for 1969. The facts as to the remaining issues are set forth below.

In 1967, appellant acquired certain improved property. The seller of that property had made prepaid interest payments to the original owner of the property in the total amount of $13,400. When appellant purchased the property, a portion of the prepaid amount was allocated as "used" by the seller prior to the close of escrow and the remainder of $12,138.22 became a charge to appellant.

In 1968, appellant purchased an apartment building. On his return for that year, appellant deducted $8,512 for "Repairs -- Carpenter, Electrical, Painting & Decorating, Plumbing, Roofing, Screens, Blinds & Hardware." In 1969, appellant deducted $4,987 for "furnishing replaced" in the apartment building. Respondent disallowed the respective deductions in part because they were unsubstantiated and in part because they represented expenditures for capital items. Subsequent to the initiation of this appeal, appellant submitted documents from Doud Realtors, who managed the apartments, which documents bore the title "DISBURSEMENT SCHEDULE," and which were offered as evidence of the claimed expenses associated with the apartments.

In '1970, appellant and three other individuals formed a corporation-named 'Pacer Consolidated Industries, Inc. (Pacer). Pacer was formed to develop and market motorcycle parts and accessories. Appellant was to own 40% of the Pacer stock and the others the remainder. Articles of incorporation were filed with the Secretary of State and appellant became Secretary and Treasurer of Pacer. However, no stock was issued and no other acts were taken to formalize the corporation. Pacer did, nonetheless, operate, developing and marketing a substantial number of motorcycle-related products. Appellant was involved in the development of some of Pacer's products. He devoted about 25-30 hours a week to Pacer activities but received no remuneration.

In the latter part of 1970, Pacer merged with Omega Plastics and one Roy Beightol became an employee as well as chairman of Pacer. At or about this same time, appellant was called upon to guarantee certain loans made to the business. In late 1971, after an unsuccessful year, internal strife arose within the corporation. All of the corporation's assets were ultimately taken by Roy Beightol. Pacer then defaulted on the various obligations appellant had guaranteed. Appellant paid these obligations which amounted to $62,004. He claimed this amount as a "partnership loss" on his 1971 return.

At the oral hearing in this matter, appellant testified extensively as to his history of motor vehicular interest - in modification, fabrication and racing. He explained how he shifted this interest into the area of motorcycle modification from street'to motocross, at a time when the production of motocross motorcycles was in its infancy. This is what led him to become involved in Pacer. He also testified that he worked for Pacer without a salary in order to give Pacer more financial leeway to become an ongoing viable entity. He further indicated that after Pacer's demise, he individually continued in the business of research and development on products related to motor vehicles.

The deductibility of a claimed interest expense is governed by section 17203 of the Revenue and Taxation Code. This particular statute is essentially the same as section 163(a) of the Internal Revenue Code (IRC). Therefore, federal law is persuasive as to the proper interpretation and application of the California provision. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941); Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d

45] (1942).) It is well established that the allowance of an interest expense 'requires that there should be an indebtedness, that there should 'be interest upon it, and that what is claimed as an interest deduction should have been paid or accrued within the year. (Old Colony R. Co. v. Commissioner, 284 U.S. 552 [76 L.Ed 484] (1932); Baltimore & Ohio Railroad Co., 29 B.T.A. 368, affd., 78 F.2d 460 (4th Cir. 1935).)

In the instant matter, appellant purchased property and as part of the transaction assumed indebtedness. Under normal circumstances, interest accrued on that indebtedness after the date of acquisition would be deductible by appellant. (Joell Co., 41 B.T.A. 825 (1940); Walter H. Rich, B.T.A. Memo., May 18, 1936.) However, the circumstances were other than normal since appellant assumed an indebtedness as to which interest had been prepaid. The contract stated that he was compensating his seller for the portion of the prepaid interest unaccrued as of the date the property was acquired by appellant. We have been asked whether a compensation of this sort results in a deductible interest expense for appellant. There appears to be no citable authority on the point. However; we are given some guidance by Robert F. Weyher, 66 T.C. 825 (1976). In that case, the taxpayer purchased some property and assumed an indebtedness as part of the transaction. The taxpayer agreed to prepay a substantial amount of interest on that indebtedness. When he sold the property a'short time later, a significant portion of the prepaid interest remained unaccrued. The new purchaser assumed the same indebtedness on the property and gave additional cash and a note. The court examined all the circumstances and found the sale price was not reflective of the market value of the property; instead, it equaled the sum of the taxpayer's purchase price plus the interest prepaid thereon. On the basis of this finding, the court determined that the unaccrued portion of the interest prepaid by the taxpayer and offset against gross income in determining his tax liability was subsequently recovered when he sold the property. Pursuant to the tax benefit rule, this amount was includable in the taxpayer's gross income in the year of recovery.

The above-cited case gives us some indication that an individual prepaying interest and subsequently receiving "compensation" for an unaccrued portion thereof must include such "compensation" in gross income.

Whether such compensation, once determined. to be includable. in gross income on, the receipt side, should be allowable as an expense on the disbursement side is the question appellant wishes to be resolved in the affirmative. However, that question need not be reached in the instant matter since appellant has not demonstrated that the price he paid for the property, exclusive of the specific amount designated as a reimbursement for unaccrued prepaid interest, was based on such property's fair market value. In the absence of such information, we cannot conclude that the "interest reimbursement" would be ordinary income to the party who sold appellant the property within the rule of the Weyher case. Without such showing, the question of whether appellant is entitled to the interest expense claimed cannot even be entertained. Accordingly, respondent's denial of that claim must be upheld.

The next issue for consideration is whether the bad debt incurred by appellant was a business or nonbusiness bad debt. Where a business debt is proven to exist and it is totally worthless, the debt, to the extent of worthlessness, is treated as an ordinary business loss and is totally deductible from income. (Rev. & Tax. Code, § 17207, subd. (a).) Where a nonbusiness bad debt is proven to exist and it is totally worthless, it is treated as a loss from the sale of a capital asset held for less than six months - a short-term capital loss - and is subject to the limitations of section 18152 of the Revenue and Taxation Code. (Rev. & Tax. Code, § 17207, subd. (d)(1).)

The provisions of section 17207 of the Revenue and Taxation Code are essentially the same as those of section 166 of the Internal Revenue Code; therefore, federal law is persuasive as to the proper interpretation and application of the California Provision. (Holmes v. McColgan, supra; Meanley v. McColgan, supra.)

A business bad debt deduction is one based on a debt created or acquired in connection with the trade or business of the taxpayer. It is now well established that being an employee may be a trade or business for the purposes of section 166. (Putoma Corp., 66 T.C. 652, 673 (1976); Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).) In determining whether a bad debt has a connection (proximate relationship) with a trade or business of the taxpayer, the proper measure is that of dominant motivation. (United States v. Generes, 405 U.S. 93, 103

(31 L.Ed.2d 62] (1972).) The determination of petitioner's dominant motive is essentially a factual inquiry, with the-burden of proof on petitioner. (Putoma Corp., supra, at p. 673; Oddee Smith, 55 T.C. 260 (1970), remanded for consideration in light of Generes at 457 F.2d 797 (5th Cir. 1972), opn.on remand, 60 T.C. 316 (1973).)

We have evaluated the entire record, including appellant's testimony, very carefully. We found him to be a very credible individual, and on that basis have concluded that his dominant motivation in making the aforementioned loan guarantees was not to protect his investment interest, but instead, to protect the employment relationship he had with Pacer. The ties he had with that company offered him a new career, already in transition when he guaranteed the loans, in a field which he had enjoyed for many years and in which he had acquired considerable expertise. On the basis of the foregoing, we are of the opinion that the losses suffered by appellant as a result of the subject loan guarantees should be characterized as business bad debts.

The final issue is whether appellant has substantiated the claimed apartment building expenses. It is a basic tenet of income tax law that deductions are a matter of legislative grace and that the taxpayer bears the burden of furnishing proof of his entitlement to any deductions claimed. '(New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).) Furthermore, as to expenses claimed in connection with business property,

> [T]he regulations of the Franchise Tax Board do not provide that the cost of every repair may be deducted, but only "incidental repairs which neither materially add to the value of the property nor appreciably prolong'its life. . . ." (Cal. Admin. Code, tit. 18, reg. 17202(d).)

(Appeal of Albina G. Cruz, Cal. St. Bd. of Equal., Oct. 6, 1966.)

In support of apartment building expenses which appellant has claimed, schedules of disbursements made in connection with such apartment building were submitted. The schedules are somewhat summary in nature and were prepared by the business entity that managed the apartments. We note that the submitted schedules provide information as to the amount and nature of numerous expenditures.' However, as respondent notes, those schedules are not original documents. Furthermore, many of the schedule

notations describing expenditures are less than exact and others clearly show certain expenditures were for capital items not normally deductible.

Appellant's records do fall short of the desired standards for complete substantiation of the repair expenses claimed. We believe, however, that this is a proper case for application of the so-called "Cohan rule," which provides for the making of an approximation of expenditures of the type at issue where it is readily apparent that "something was spent" but where the taxpayer's records are inadequate to the extent that it is impossible to make an accurate determination of how much was spent for deductible business purposes. (Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).) On the basis of appellant's testimony, the fact that the disbursement schedules in evidence were those of a business entity not related to appellant by ownership or otherwise, and our own examination of such schedules., we are persuaded that appellant is entitled to deduct 30 percent of the claimed repair expense for 1968, and 50 percent of the claimed repair expenses for 1969. (R.O. Watts, ¶ 75,131 P-H Memo. T.C. (1975).)

Appeals of David B. Haag and
Estate of Carol D. Haag, Deceased

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 protests of David B. Haag and Estate of Carol D. Haag, Deceased, against proposed assessments of additional personal income tax and penalties in the total amounts of $961, $4,762.42, and $1,363.31 for the years 1967, 1968, and 1969, respectively, and on the protests of David B. Haag against proposed assessments of additional personal income tax and penalties in the total amounts of $8,818.03 and $363.80 for the years 1971 and 1972, respectively, be and the same is hereby modified to reflect the allowance of the claimed bad debt loss for 1971 and the partial allowance of claimed repair expenses for 1968 and 1969. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 15th day Of September, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9