*84-SBE-106*

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
PETER I. AND INGA M. KUNE )

For Appellants: George F. Galles
Certified Public Accountant

For Respondent: John A. Stilwell, Jr.
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 Peter I. and Inga M. Kune against a proposed assessment of additional personal income tax in the amount of $1,845.85 for the year 1977.

The issues raised by this appeal are:

1. Is respondent's proposed assessment fior 1977 barred by the statute of limitations?

2. Is appellant entitled to a $1,000 deduction in 1977 for a capital loss carryover from a nonbusiness bad debt deduction respondent disallowed for the prior year?

3. Is appellant entitled to a $10,833 deduction in 1977 for a business bad debt in connection with a loss resulting from his guarantee of a loan made by a bank to the brother of appellant's wife?

4. Is appellant entitled to a deduction in 1977 for worthless stock as a result of the 1977 bankruptcy of Guarantee Tire Stores, Inc.?

Appellants' return for 1977 was filed on March 30, 1978. An audit of that return was initiated on September 29, 1979. The audit was concluded in early 1980 and resulted in the disallowance of several of the deductions claimed on that return. Appellants objected. On September 23, 1980, respondent issued a notice of proposed assessment against appellants for 1977, and on November 13, 1980, appellants formally protested the proposed assessment. They assented to the denial of certain of their claimed deductions but maintained that the deductions here at issue were proper. Respondent held a hearing on appellants' protest on January 5, 1982. Following the hearing, appellants submitted additional evidence on the matters at issue. On September 29, 1982, respondent issued its notice to appellants that it had affirmed its proposed assessment.

This appeal followed. In appellants' letter of appeal, they first contended that the assessment was null and void because they had attended the audits and hearings scheduled by respondent, who failed to issue its affirmance of its assessment for 1977 until September 29, 1982, more than four years after appellants had filed their return for 1977. A decision in favor of appellants on this issue would moot the issues relating to respondent's denial of appellants' claimed deductions and its consequent assessment, so we will address the statute of limitations issue first.

Section 18586 of the Revenue and Taxation Code, which contains the basic statute of limitations, provides, in part:

> (a) Except in case of a fraudulent return and except as otherwise expressly provided in this part, every notice of a proposed deficiency assessment shall be mailed to the taxpayer within four years after the return was filed. No deficiency shall be assessed or collected with respect to the year for which the return was filed unless the notice is mailed within the four-year period or the period otherwise fixed.

Appellants' return, which was actually filed on March 30, 1978, is deemed to have been filed on April 15, 1978, the last day on which a 1977 calendar year taxpayer could file a timely return. (Rev. & Tax. Code, §§ 18432 & 18588; Appeal of LaRue and Alice Harcourt, Cal. St. Bd. of Equal., Dec. 7, 1982.) The last date on which a timely notice of proposed assessment for 1977 could have been mailed was April 15, 1982. Since respondent's notice was mailed on September 23, 1980, it was timely. There is no statutory requirement that respondent mail its notice of action on the protest of a proposed assessment within some specified time after a return is filed or after a protest is made. Therefore, the fact that respondent's notice of action on its proposed assessment was mailed on September 29, 1982, is irrelevant to the assessment's validity.

Accordingly, we turn to the individual deductions at issue. Appellants have explained that the claimed $1,000 capital loss deduction was the allowable portion carried over from a nonbusiness bad debt which arose out of a $10,000 loan which Mr. Peter Kune (hereinafter referred to as "appellant") made in 1975 to DeCloss Travel, Inc. The loan was made through several checks dated from April 1975 through July 1975 and evidenced by a non-interest-bearing note dated July 7, 1975, signed by Harry A. Levine as president of DeCloss. Appellant stated that the loan was made to DeCloss because his wife was employed by DeCloss, and appellants wished to keep DeCloss in operation for that reason.

Respondent maintains that the available records of DeCloss indicate that its president at the time the note was issued was Angie DeCloss, that the note had a period of one year and did not provide for any interest, and that there was no indication that appellant demanded repayment of the loan. Respondent disallowed the claimed deduction on the ground that appellant failed to establish that the transaction created a bona fide indebtedness and also on the ground that appellant failed to establish that any event occurred in 1976 making the "debt" worthless in that year. Respondent has observed that apparently DeCloss went out of business in 1975, although the petition in bankruptcy was not filed until 1976, and the key employees of DeCloss, including Mrs. Kune, formed Alpha Travel on January 27, 1976, to do business at the same address formerly used by DeCloss. Respondent maintained also that even if the loan created a bona fide indebtedness, the fact, as alleged, that the loan was made to continue Mrs. Kune's employment with DeCloss demonstrated that it was a business debt rather than a nonbusiness debt, and such a debt could be taken in its entirety only in the year it became worthless. Therefore., respondent observes that even if the debt became worthless in 1976, no part of it could be carried over to 1977.

Whether appellants were entitled to a bad debt deduction for the year 1977 is controlled by section 17207, subdivision (a)(1), of the Revenue and Taxation Code, which in part provides that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." This section is the counterpart of section 166 of the Internal Revenue Code of 1954. Accordingly, federal case law is persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).) Under the interpretations of those sections, two tests must be satisfied in order for the taxpayer to take a bad debt deduction. First, a bona fide debt must exist. (Former Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3), repealer filed April 16, 1981 (Register 81, No. 16).) No deduction may be taken for a loan made with no intention of enforcing payment (C. B. Hayes, 17 B.T.A. 86 (1929)), or where there was no reasonable expectation of repayment when the loan was made. (Appeal of Harry P. and Florence O. Warner, Cal. St. Bd. of Equal., April 22, 1975.) Secondly, the debt must have become worthless in the taxable year for which the deduction is claimed. (Redman v. Commissioner, 155 F.2d 319 (1st Cir. 1946); Appeal of Grace Bros. Brewing Co., Cal. St. Bd. of Equal., June 28, 1966; Appeal of Isadore Teacher, Cal. St. Bd. of Equal., April 4, 1961.) The taxpayer has the burden of proving that both of these tests have been satisfied. (Appeal of Andrew J. and Frances Rands, Cal. St, Bd. of Equal., Nov. 6, 1967.)

Whether a debt has become worthless in a given year is to be determined by objective standards. (Redman v. Commissioner, supra; Appeal of Cree L. and June A. Wilder, Cal. St. Bd. of Equal., Sept. 15, 1958.) No deduction may be allowed for a particular year if the debt became worthless before or after that year. (Redman v. Commissioner, supra.) To satisfy their burden, therefore, appellants must show that the alleged debt had value at the beginning of the taxable year (W. A. Dallmeyer, 14 T.C. 1282, 1291 (1950)) and that some identifiable event occurred during 1977 which formed a reasonable basis for abandoning any hope that the debt would be paid sometime in the future (Bruce V. Green, ¶ 76,127 P-H Memo. T.C.; Appeal of Samuel and Ruth Reisman, Cal. St. Bd. of Equal., March 22, 1971; Appeal of George H. and G. G. Williamson, Cal. St. Bd. of Equal., April 24, 1967).

The facts available raise serious doubt that a bona fide debt was created. The execution of the note occurred four months after appellant's first check to DeCloss and was signed by a person whose authority to bind DeCloss to repayment is in question. No security was taken for the note, although DeCloss was in apparent financial difficulties and filed bankruptcy in 1976, apparently after the formation of Alpha Travel. Finally, there is no evidence that appellant ever demanded repayment of the note. The- facts available also raise serious doubt that if a debt existed and had value, it became worthless in 1977. Appellants point to the petition in bankruptcy filed for DeCloss in 1977 as the event which made the note worthless. But appellants have not established that the note and debt had value at the end of 1976. Considering that apparently DeCloss ceased business in 1975 and Alpha Travel was formed in January 1976, there is no reason to conclude that any debt had value at the end of 1975 simply because the bankruptcy petition was not filed until February 1976. Since it is well settled that respondent's determinations are presumptively correct and that the taxpayers bear the burden of proving them erroneous (Appeal of David A. and Barbara L. Beadling, Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Sarkis N. Shmavonian, Cal. St. Bd. of Equal., April 6, 1977), we can only conclude that appellants have failed to establish their right to the deduction. We agree with respondent that since the stated purpose of the loan was to sustain Mrs. Kune's employment by the debtor, any debt created would be a business bad debt rather than a nonbusiness debt and deductible only in the year it became worthless and not subject to carryover. (Appeal of Robert E. and M. E. Hink, et al., Cal. St. Bd. of Equal.;April 5, 198 .

Appellants have explained that the second contested bad debt deduction arose after H. Schein, appellant's brother-in-law, borrowed $20,000 in 1975 from the First National State Bank of New Jersey. Appellant guaranteed the repayment of that loan and was later forced to repay part of the loan as guarantor, and that resulted in the claimed bad debt deduction. Appellants submitted a copy of a letter written by him to 'the Bank stating that the $20,000 had beentransferred to Guarantee Tire Store, Inc. (hereinafter "Guarantee") and that appellant -personally guaranteed the repayment of the loan.

We must sustain respondent on this issue also. First, the copy of appellant's letter does not demonstrate that he was legally obligated to repay the bank as a guarantor of the H. Schein note. Second, if appellant had been called to make good as guarantor of the note,. there is no reason to conclude that the resulting debt which H. Schein would have owed appellant as a performing guarantor was worthless. Finally, if such debt had existed, it -appears that appellant would not have attempted any collection against his brother-in-law, who made the note only for the benefit of appellant and Guarantee and not for himself. Accordingly, appellant is not entitled to a bad debt deduction for his payments on the note. (Cf. Howell v. Commissioner, 69 F.2d 447 (8th Cir. 1934).)

Finally, appellant claimed a $16,700 loss deduction for 1977 on his holdings of the common stock of Guarantee, which filed bankruptcy in February 1977. Apparently in the belief that the stock qualified as "small business corporation stock" merely because Guarantee had elected Subchapter S status for purposes of the income taxes imposed by the Internal Revenue Code, appellant claimed the loss as an ordinary loss rather than as a capital loss from the sale or exchange of a capital asset.

A loss from a security which becomes worthless during the taxable year is deductible pursuant to Revenue and Taxation Code section 17206. A deduction is allowed only for the taxable year in which the loss is sustained, as evidenced by closed and completed transactions and fixed by identifiable events occurring in that year. (Former Cal. Admin. Code, tit. 18, reg. 17206, subd. (e), repealer filed Jan. 15, 1981 (Register 81, No. 3).) The worthless stock provisions of section 17206 are essentially the same as those of Internal Revenue Code section 165; thus, federal case law in this area is persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, supra.)

It is well settled that the taxpayer bears the burden of showing that the stock became worthless in the year for which the deduction is claimed. (Boehm v. Commissioner, 326 U.S. 287, 294 [90 L.Ed. 78] (1945); Appeal of Medical Arts Prescription Pharmacy, Inc., Cal. St. Bd. of Equal., June 13, 1974.) To meet this burden, appellant must show both that the stock had value at the beginning of his taxable year and that some identifiable event occurred in that year which rendered it worthless by the end of that year. (Appeal of Medical Arts Prescription Pharmacy, Inc., supra.)

The loss from "small business corporation stock" may be deductible as an ordinary loss up to a statutory maximum. (See generally Rev. & Tax. Code, §§ 18206-18210; former Cal. Admin. Code, tit. 18, regs. 18206-18210(a)-(h), repealer filed Aug. 25, 1981 (Register 81, No. 35).) Sections 18206 through 18210 of the Revenue and Taxation Code were and are substantially identical to section 1244 of the Internal Revenue Code of 1954. Section 1244 was enacted to encourage the financing of "small business corporations" by providing for beneficial income tax treatment in case of a loss on stock investments in qualified corporations. (See generally Anderson v. United States, 436 F.2d 356 (10th Cir. 1971).) Under the statute as it read in 1977, "small business corporation stock" could be defined as common stock issued for money or other property by a domestic "small business corporation" under a plan adopted to offer such stock for a period specified in the plan, ending not later than two years after the date the plan was adopted.

Appellant points to Guarantee's February 1977 petition in bankruptcy as the identifiable event establishing the worthlessness of his shares in that corporation. But that event does not establish when that stock became worthless. Appellant has not established that his shares had worth at the close of 1976. In setting forth 'his position on another issue, appellant has explained that in 1975 Guarantee was unable to obtain a $20,000 bank loan on its own credit. The implication from that could be that Guarantee's financial position was doubtful as early as 1975. Accordingly, there is no reasonable basis from the available evidence for us to conclude that Guarantee's stock lost its worth because of some event in January or February of 1977 rather than before that time. Thus, we must conclude that appellant has not sustained his burden of proof that his stock became worthless in 1977, and we need not determine whether such a loss would be deductible as an ordinary loss or as a capital loss.

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For the reason stated above, we 'must sustain respondent's actions.

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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 protest of Peter I. and Inga M. Kune against a proposed assessment of additional personal income tax in the amount of $1,845.85 for the year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William II. Bennett, Member

________________, Member