BEFORE TRE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
STANLEY R. and HELEN C. SHUTT)

Appearances:

For Appellants: Richard Varnell
Enrolled Agent

For Respondent: Charlotte Meisel
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Stanley R. and Helen C. Shutt for refund of personal income tax in the amount of $105 for the year 1979.

The issue is whether appellants are entitled to a deduction either for a theft loss or for a bad debt in 1979.

On October 3, 1979, appellants, as limited partners, made an original capital contribution of $335,000 to the Johnson/Upland limited partnership. The limited partnership agreement provided that the partnership was to purchase and develop certain real property in the city of Upland in San Bernardino County. On December 17, 1979, the partnership gave appellants a check for $41,000. That check was returned unpaid by the bank because there were insufficient funds in the account on which it had been drawn.

Appellants filed a timely California personal income tax return for 1979, which reported net taxable capital gains of $117,570 and taxable income of $112,942.

On May 29, 1980, the limited partnership paid appellants $5,000 and paid them $1,000 every month thereafter through February 1982.

On April 14, 1982, after auditing appellants' return for 1979 and recomputing the gain from the appellants' sale of a motel, respondent issued a notice of proposed assessment of additional personal income tax of $2,031. Appellants did not file a protest in response to that assessment.

On May 27, 1982, appellants filed a complaint in the Orange County Superior Court against the limited partnership, the limited partnership's general partner, and several others. The complaint apparently alleged, inter alia, that the appellants had been defrauded through deceit on the part of one or more of the defendants.

On June 24, 1982, appellants filed an amended return for 1979. Attached to the amended return was a federal Form 4684, which claimed an investment loss due to theft of $297,000. Since the amended return did not address the gain on the sale of the motel, respondent treated the amended return as a claim for refund rather than a protest of its previous assessment and considered its proposed assessment to have become final on July 3, 1982, pursuant to section 18591 of the Revenue and Taxation Code. After meeting with appellants'

representative, respondent denied appellants' claim for refund, and this appeal followed.

In this appeal, appellants maintain that the deduction is independently allowable either as a theft loss or as a business bad debt.

Section 17206 of the Revenue and Taxation Code provides in relevant part:

> (a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
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> * * *
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> (e) For the purposes of subdivision (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss.

It is well settled that tax deductions are a matter of legislative grace and that the taxpayers bear the burden of proof that they are entitled to a particular deduction claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Joseph A. and Marion Fields, Cal. St. Bd. of Equal., May 2, 1961.) California Revenue and Taxation Code section 17206 is substantially similar to section 165 of the Internal Revenue Code, so federal case law and regulations are persuasive as to the proper interpretation of that California statute, (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941).)

Treasury regulation section 1.165-1(b) provides in part:

> To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year.

Treasury regulation section 1.165-1(d)(2) provides:

> Any loss arising from the theft shall be treated as sustained during the taxable year

> in which the taxpayer discovers the loss (see § 1.165-8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be asdertained with reasonable certainty whether or not such reimbursement will be received.

Appellants point to the bank's rejection of the limited partnership's $41,000 check in December 1979 as the transaction and the time they discovered the theft loss. But the facts do not support a conclusion that their investment in whole or part was lost in 1979 without hope of reimbursement, Indeed, the limited partnership began making repayments to appellants and continued to do so for more than one year after December 1979. There is no basis to conclude that all hope of recovery of their invested funds had been lost when they were yet receiving reimbursement checks. Secondly, appellants' suit against the limited partnership was not commenced until May 1982. The institution of that action at that time implies that appellants themselves maintained hope of recovering their investment from the defendants some 17 months after the close of 1979.

Thus, we cannot conclude that appellants have demonstrated that 1979 was the year in which a theft loss may be deducted, because they have failed to establish that in that year there was no reasonable prospect of recovery and that there was a reasonable certainty that appellants would receive no reimbursement for that loss.

Revenue and Taxation Code section 17207 allows a deduction for "any debt which becomes worthless within the taxable year." In order to be deductible, the debt must be bona fide, that is, it must arise "from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Former Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3), repealer filed April 18, 1981 (Register 81, No. 16).) In addition, to be deductible, the debt must have become worthless during the year in which the deduction is claimed. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976.) Section 17207

is substantively similar to section 166 of the Internal Revenue Code of 1954. So, again, federal law is persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).) The burden of proving that the debt was bona fide and that it became worthless during the taxable year rests on the taxpayer!. (Appeal of Alfred J. and Margaret J. Ersted, Cal. St. Bd. of Equal., Dec. 19, 1962; Appeal of Isadore Teacher, Cal. St. Bd. of Equal., April 4, 1961.)

Treasury regulation section 1.16-6-1(c) provides in part:

> Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. ... A gift or contribution to capital shall not be considered a debt for purposes of section 166.

The determination of whether an advance is a debt or a contribution to capital is a question of fact. (Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.)

The limited partnership agreement specified that the money which appellants paid the partnership was a capital contribution which entitled appellants to a 68% ownership in the limited partnership. That agreement did not in any way characterize appellants' payment as one which created a fixed debt or loan. Indeed, appellants do not claim that their payment to the partnership was other than a capital contribution, nor do they allege that their advance to the partnership created an enforceable obligation to pay them a fixed sum of money. Accordingly, there is no basis upon which we can conclude that appellants are entitled to a deduction for a bad debt in 1979.

Appeal of Stanley R. and Helen C. Shutt

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Stanley R. and Helen C. Shutt for refund of personal income tax in the amount of $105 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of October, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9