BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) .
REGIONAL INSURANCE CENTER)

Appearances:

Fdr Appellant: David J. Homsey
Attorney at Law

For Respondent: Jon Jensen
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Regional Insurance Center against a proposed assessment of additional franchise tax in the amount of $948 for the income year ended June 30, 1977.

The issue presented in this appeal is whether appellant is entitled to a bad debt deduction in the income year ended Juhe 30, 1977, for amounts advanced to the daughter of *one* of its directors to finance her college education.

Appellant is a closely held California corporation engaged in an insurance sales and investment business. For the appeal year, appellant's net income of approximately $23,000 was generated exclusively from the sale of insurance. In 1973, Dr. J. C. Fikes, a director of appellant and 25-percent stockholder,-requested that appellant's board of directors consider making *a* loan to his former student, Vernea Johnson, so that she could complete her education. Ms, Johnson is the daughter of Mr. J. Johnson, a member of appellant's board of directors. According to minutes of the meeting of appellant's board of directors, on November 2, 1973, two members of appellant's board, Dr. Fikes and Mr. Gerald Martin, also a 25-percent stockholder, approved a school loan to Ms. Johnson of $6,000, with interest at five percent, for one year. On December 17, 1973, the same board members approved a second school loan to Ms. Johnson in the amount of $4,500 with interest again set at five percent. Mr. J. Johnson was not present when the appropriations were approved. Following these meetings, Ms. Johnson signed unsecured promissory notes and was allegedly informed by Dr. Fikes of her obligation to repay the loans. A third note for $500 was signed by Ms. Johnson on January 23, 1974. This note carried. a five percent interest rate and was to be paid on October 23, 1975, when appellant allegedly determined Ms. Johnson's education would be completed. Appellant has stated that at the time the funds were given, Ms. Johnson was a college student in good standing who was on good terms with Dr. Fikes. However, before completing her education, Ms. Johnson allegedly lost interest in school, moved away from the area, and severed her contacts with Dr. Pikes and her family.

Between 1975 and 1976, Mr. Martin, appellant's secretary-treasurer, allegedly attempted to locate Ms. Johnson. The minutes of appellant's board of directors meeting indicate that on October 12, 1976, the board decided to make written demands on Ms. Johnson for payment. Appellant received no response from Ms. Johnson. On March 2, 1977, appellant's attorney, Samuel A. Hill, Jr., who had been retained by appellant to review and update appellant's minutes and records, indicated that he found three notes issued by Vernea Johnson which were delinquent. Mr. Hill recommended that these amounts be

collected. On March 4, -1977, appellant's board of directors requested, Mr. Martin to make a final attempt to contact Ms. Johnson about payment of the amounts owed. On May 17, 1977, appellant's board of directors decided to declare the notes uncollectable and remove the amounts from the books. The minutes of this meeting state that Ms. Johnson was currently a student and that it appeared that the amounts were uncollectable.

Appellant declared a bad debt deduction of $10,530 which it classified on its return as "loans to shareholders." (We note that it is unclear why appellant claimed only $10,530 when the face value of the three notes, excluding interest, is $11,000.) Respondent disallowed the deduction (1) because it found that the loans were personal loans which are against appellant's stated general policy against loans and (2) because there was no evidence presented that the debt became worthless in the income year ended June 30, 1977.

Appellant contends that the loans were a bona fide debt. In support of this position, appellant states that the board members who approved the loans were not related to Ms. Johnson and that the directors believed that they were lending money to an intelligent, highly motivated student who seemingly had the potential for a good career. Appellant further asserts that the debt is evidenced by notes which bear a reasonable rate of interest and which were due within a reasonable length of time. Finally, appellant contends that the debt became worthless in the income year ended June 30, 1977, because (1) over one year had passed without any payment, (2) appellant was unable to locate Ms. Johnson, and (3) Ms. Johnson had not responded to the demand letters.

Revenue and Taxation Code section 24348, subdivision (a), provides that a corporate taxpayer may deduct all debts which become worthless within the income year. Deductions, however, are a matter of legislative grace and the burden is on appellant to prove that it is entitled to such deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); W. B. Mayes, Jr., 21 T.C. 286 (1953).)

Initially, we note that section 24348 is substantively identical to section 166 of the Internal Revenue Code of 1954. Accordingly, federal case law is highly persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

Respondent's position is that appellant's contentions should fail because (1) the advances made to Ms, Johnson did not 'constitute bona fide loans, and (2) the advances did not become worthless in the income year ended June 30, 1977. Appellant, however, disputes both of respondent's findings. Assuming, without deciding, that the advances to Ms. Johnson were bona fide loans, we cannot conclude that appellant has shown that the loans became worthless in the income year in issue.

In order to be entitled to a deduction for a nonbusiness bad debt, appellant must-demonstrate that the debt became totally worthless during the taxable year. Whether a debt is totally worthless within a particular taxable year is a question of fact. (Earl V. Perry, 22 T.C. 968 (1954); Joe E. Mellen, ¶ 68,094 P-H Memo. T.C. (1968).) The burden is on appellant to prove that the debt for which the deduction is claimed had some value at the beginning of the year in which the deduction is claimed, and that it became worthless during that year. (Cittadini v. Commissioner, 139 F.2d 29 (4th Cir. 1943); Appeal of Xnollwood West Convalescent Hospitals, Inc., Cal. St, Bd. of Equal., March 3; 1982.) The standard for the determination of worthlessness is an objective test of actual worthlessness. (Appeal of Parabam, Inc., Cal. St. Bd. of Equal., June 29, 1982.) *The* time for worthlessness must be fixed by an identifiable event or events in the.period in which the deduction is claimed which furnish a reasonable basis for abandoning any hope of future recovery. (United States v. White Dental Mfg. Co., 274 U.S. 398 [71 L.Ed. 1120] (1927); Appeal of B & C Welding, Inc., Cal. St. Bd. of Equal., Oct. 26, 1983.)

Appellant has stated that during 1975 and 1976, Gerald Martin, appellant's secretary-treasurer, tried unsuccessfully to locate Ms. Johnson. On October 12, 1976, the minutes of the meeting of the board of directors show that Mr. Martin was to make written demands for payment from Ms. Johnson. On March 2, 1977, appellant's attorney, who was retained by appellant to review and update appellant's minutes and records, found the three notes from Ms. Johnson. He informed Mr. Martin that these notes were delinquent and that they should be collected. On March 4, 1977, Mr. Martin was to once again try to contact Ms. Johnson. His attempt was unsuccessful. On May 17, 1977, the board of directors met and declared the notes from Ms. Johnson to be uncollectable. Mr. Martin's minutes state, 'Every reasonable effort has been made to collect these notes, but Miss Johnson is

currently a student and it would appear that they are uncollectable." (App. Br., Exh. C-8.)

We find that appellant has not shown, by any identifiable event, that the loans were worthless in May of 1977. It was known at the time the advances were made that Ms. Johnson was in school and that payment would not be possible until Ms. Johnson had graduated from college and obtained a job. As Ms. Johnson was still in school during May of 1977, expectation of payment would have still existed at this time and it cannot be concluded that the debt was worthless.

For the above-stated reasons, the action of respondent will be sustained.

Appeal of Regional Insurance Center

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 25667 of the Revenue and Taxation Code; that the action of the Franchise Tax Board *on* the protest of Regional Insurance Center against a proposed assessment of additional franchise tax in the amount of $948 for the income year ended June 30, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day of April , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

Richard Nevins , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9