BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84R-763
SAMUEL AND SHIRLEY CHESS)

For Appellants: Teresa P. Clark
Attorney at Law

For Respondent: Grace Lawson
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Samuel and Shirley Chess for refund of personal income tax in the amount of $13,470 for the year 1974.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Appeal of Samuel and Shirley Chess

The sole issue to be determined in this appeal is whether appellants are entitled to their claimed nonbusiness bad debt deduction.

During 197'3 and 1974, appellants borrowed funds from Security Pacific Savings and Loan to invest at a profit. Subsequently, appellants invested the money by making a series of loans totaling $168,002 to Nordic Mountain Homes, a developer of recreational cabins in the San Bernardino mountain area. The sole shareholder of Nordic Mountain Homes, Thomas Miller, was and is unrelated to appellants. The loans were made to help Nordic overcome increasing financial difficulties including four loans which were used to satisfy mechanics' liens. Sometime after June 30, 1973, Nordic ceased doing business, The corporation did not initiate bankruptcy proceedings. Or April 1, 1.974, respondent suspended Nordic, On January 20, 1978, Nordic was revived as Agoura Land Company, Incorporated, with the same corporate identification number.

In 1978, after Nordic's revival, appellants filed an amended return for the 1974 tax year claiming a nonbusiness bad debt deduction. The deduction was disallowed by respondent. On April 24, 1979, respondent held a hearing affirming the disallowance of the bad debt deduction. Appellants paid the amount disallowed under protest and appealed the denial of their claim for refund.

Respondent argues that appellants have failed to establish that the original notes had value in 1974 and were rendered worthless by an identifiable event in that year. It contends-that appellants may not rely on the self-serving statements of the debtor or its agent to establish worthlessness of a nonbusiness debt and that the advice of counsel not to seek collection of a debt does not establish worthlessness of the nonbusiness debt. Respondent also contends that appellants have failed to take affirmative action to enforce the notes.

Appellants argue that the existence of a valid debt was clear and that the debt was clearly worthless in the year claimed because the corporate debtor was insolvent and without any means to obtain assets in the foreseeable future. Appellants also argue that the deduction claimed was allowed under identical federal law and that allowance of the deduction by the Internal Reve-nue Service (IRS) should be determinative.

Section 17207, subdivision (a)(1) provides, in pertinent part: "There 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. Two tests must be satisfied in order for the taxpayer to take a bad debt deduction. First, a bona fide debt must exist. Second, the debt must have become worthless in the taxable year for which the deduction is claimed. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976; 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., Apr. 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.)

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. While it is clear that in the instant case a valid debt existed, there is a question as to whether the notes became worthless as a result of an identifiable event.

As we noted in Baumgartner, supra, 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 debts had value at the beginning of the taxable year (Dallmeyer v. Commissioner, 14 T.C. 1282, 1291 (1950)), and that some identifiable event occurred during 1974 which formed a reasonable basis for abandoning any hope that the debts would be paid sometime in the future. (Green v. Commissioner, ¶ 76,127 T.C.M. (P-H) (1976); Appeal of Samuel and Ruth Reisman, Cal. St. Bd. of Equal., Mar. 22, 1971; Appeal of George H. and G. G. Williamson, Cal. St. Bd. of Equal., Apr. 24, 1967.)

In the present case, appellants have failed to provide objective evidence that the notes became worthless upon the occurrence of some identifiable event in 1974. They have presented evidence that sometime in 1974 the corporation ceased operations because of financial difficulties; however, they have not presented any

evidence that they took any action to actually pursue collection of the debt and to determine that the notes were actually worthless. In fact, during this same time period, appellants granted several extensions on the notes, thus indicating a continuing belief in the solvency of the corporation or its sole shareholder, Other than an oral demand for repayment and a discussion with an attorney, appellants have made no serious effort to enforce the notes. They did not make written demand, did not enlist the aid of a collection agency, or bring any legal action. Mere nonpayment of a debt does not prove its worthlessness and the taxpayers' failure to take reasonable steps to enforce collection of the debt, regardless of the motive for the failure, does not justify a bad debt deduction unless there is proof that those steps would have been futile, (Appeal of Myron E. and Daisy T. Miller, Cal.. St. Bd. of Equal., June 28, 1979.) Furthermore, the record shows that Nordic, which was suspended in 1974, was revived as Agoura Land Company, Inc., in 1978 (the same year appellants filed their amended return), with the same corporate identification number. These factors suggest the note may still be enforceable against the revived corporation,

Appellants also argue that respondent should allow the deduction because it was allowed by the IRS and the virtual identity of the federal and state statutes controlling the availability of bad debt deduction renders the IRS's allowance of such deduction determinative. We disagree. Although appellants claim the IRS allowed the deduction, they have presented no evidence of such a determination. Presumably, the IRS simply accepted the return as filed and allowed the deduction without any scrutiny, In any event, it is well established that respondent and this board are not bound to adopt the conclusion reached by the IRS in any particular case, even when the determination results from a detailed audit, (See Appeal of Raymond and Rosemarie J. Pryke, Cal, St. Bd. of Equal., Sept. 15, 1983; Appeal of Der Wiener-schnitzel International, Inc., Cal, St, Bd. of Equal., Apr. 10, 1979.)

For the reasons stated above, we conclude that respondent acted properly in denying appellants' claim for refund and respondent's action must be sustained.

Appeal of Samuel and Shirley Chess

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 Samuel and Shirley Chess for refund of personal income tax in the amount of $13,470 for the year 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of July, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburq,. Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9