



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
J. T. AND MILDRED BELLEW } NO, 78A-381

Appearances:

For Appellants: Donald E. Brodeur
Attorney at Law

Harold Chapman
Certified Public Accountant

For Respondent: Mark McEvilly
Counsel

O P I N I O N

This appeal is made pursuant to section 18593^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of J. T. and Mildred Bellew against a proposed assessment of additional personal income tax and penalty in the total amount of \$34,210.32 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.

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The issues presented in this appeal are: (1) whether appellants have established that the debt which arose as a result of their guarantee of certain notes was a business bad debt; and (2) whether appellants have established that they are entitled to a bad debt deduction for amounts advanced to Panorama Products, Inc., their wholly owned corporation.

Appellants **are** husband and wife who filed a joint personal income tax return for 1974. Respondent audited that return and made various adjustments. It issued a proposed assessment for 1974 reflecting these adjustments and imposed a negligence penalty. Respondent affirmed the proposed assessment after considering appellants' protest, and this timely appeal followed. In this **appeal**, appellants question only two of the adjustments made by respondent. Thus, we assume they concede **that** the other adjustments and the imposition of the penalty were correct.

The first issue involves a debt which arose as a result of appellants' involvement with International Marketing Systems (**IMS**), a group that imported and sold meat from Costa Rica. Appellants became guarantors on a letter of credit, in exchange for which they received payments from **IMS** based on the number of pounds of meat shipped under drafts against the letter of credit. **IMS** defaulted **on** two notes, and appellants were required to pay approximately \$37,700. On the same day, appellants received a note in the same amount **from** one Mr. Blowers, who owned the majority interest in IMS. **Mr. Blowers** became bankrupt in 1974, and appellants claimed a bad debt deduction in the full amount of the debt on their 1974 personal income tax return. Respondent agreed that appellants suffered a loss in the amount claimed. It determined, however, that the debt was a nonbusiness debt and, consequently, that the debt was not fully deductible.

Bad debt losses which result from guarantees are treated the same as those which result from direct loans. (Putnam v. Commissioner, 224 **F.2d** 947, (8th Cir. **1955**), **affd.**, 352 U.S. 82 [**1 L.Ed.2d 144**] (**1956**).) Business bad debt losses are fully deductible in the year sustained whereas nonbusiness bad debt losses are regarded as short-term capital losses which are allowed only to the extent of capital gains, plus taxable income or \$1,000, whichever is less. (Rev. & Tax. Code, **§§** 17207 and 18152.)

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Subdivision (d)(2) of section 17207 defined a nonbusiness debt as a debt other than:

(A) A debt created or acquired in connection with a trade *or* business of the taxpayer; *or*

(B) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The determination of whether losses are business bad debts is a question of fact. (Smith v. Commissioner, 60 T.C. 316 (1973); Jaffee v. Commissioner, ¶ 67,215 T.C.M. (P-H) (1967).) The taxpayer bears the burden of proving that respondent's determination is erroneous and that he is entitled to the claimed deductions. (James C. and donablance A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975.)

Mr. **Bellew's** primary business is that of an employee of Panorama Products, Inc. ("Panorama"), a California corporation engaged *in* the manufacture and sale of truck campers and shells. Appellants have not contended that the **IMS** guarantee was in any way connected with that **business**. Rather, they argue that they were involved in the meat business as a second business. The record does not support this contention. Neither appellant was employed by IMS or involved with its activities in any way other than providing financial backing. Such passive investing is not a trade or business. (Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963).) Appellants also contend that they were in the business of loaning money, yet have presented no evidence of any other loans they have made. Finally, appellants argue that the IMS debt is properly treated as a business debt, because any income earned as a result of the loan would have been ordinary income rather than capital gain. This argument is meritless, since the nature of the income produced by a loan does not determine whether the debt is a business or nonbusiness debt; only a loan which is proximately related to the taxpayer's trade or business qualifies as a business debt. (United States v. Geneser, 405 U.S. 93 [31 L.Ed.2d 62] (1972).) Since appellants have not established any proximate relationship between the IMS debt and their trade *or* business, we must agree with respondent that the debt was a nonbusiness debt.

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The second issue involves advances appellants made to Panorama, their wholly owned corporation. Panorama was incorporated on April 23, 1973, and from that **date** until July 1974, appellants made substantial advances to the corporation. Appellants **claimed a \$253,676.91** bad debt deduction for these advances on their **1974** income tax return, contending that the advances were loans which became worthless in 1974. Respondent **disallowed** the entire deduction. Respondent argues that the advances were actually contributions to capital, and that even if the advances were loans, appellants have failed to establish that they became worthless during 1974.

Section 17207 allowed a deduction for "any debt which becomes worthless within the taxable year" In determining that a debt became worthless **in** a certain taxable **year**, the taxpayer bears the burden of showing that some identifiable event occurred-during the taxable year which served as a reasonable basis for abandoning any hope for future recovery. (Appeal of Donald D. and Ann M. Duffy, Cal. St. Bd. of Equal., Mar. 27, 1973.) Mere nonpayment of the debt does not prove worthlessness of the debt (Appeal of Cree L. and June A. Wilder, Cal. St. Bd. of Equal., Sept. 15, 1958.) Similarly, a debtor's insolvency, by itself, does not establish worthlessness, since there may still be assets to partially pay the indebtedness. (Appeal of George J. and Colleen M. Nicholas, Cal. St. Bd. of Equal., Jan. 6, 1981.)

Appellants attempt to prove the worthlessness of the alleged debts by showing that Panorama's accounts payable increased by a factor of 10 between March 31, 1974, and March **31**, 1975, and by showing that the company's liabilities exceeded its assets. They explain that the **business** difficulties were caused by the dramatic increase in the cost of gasoline during 1974, which decreased the demand for Panorama's products, truck campers and shells. We cannot conclude from the evidence presented that the alleged debts became worthless in 19-74. Although, at the end of 1974, Panorama's liabilities exceeded its assets, Panorama had substantial assets and was still doing business. Under these circumstances, it seems unreasonable to assume that it was impossible for Panorama to repay at least part of its debts. We must conclude, therefore, that appellants have failed to establish that the alleged debts became worthless in 1974. Therefore, appellants were not entitled to the claimed bad debt.

Since we have determined that **the** alleged debts did not **become worthless in 1974, it is not necessary to**

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discuss whether the advances were actually loans or contributions to capital.

For the reasons discussed above, respondent's action must be sustained.

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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 J. T. and Mildred Bellew against a proposed assessment of additional personal income tax and penalty in the total amount of **\$34,210.32** for the year 1974, be and the same **is hereby** sustained.

Done at Sacramento, California, this 20th day **of** August , 1985, by the State Board of Equalization, with Board Members Mr. **Collis**, **Mr. Nevins** and Mr. -Harvey present.

_____, Chairman
Conway H. Collis _____, **Member**

Richard Nevins _____, Member

Walter Harvey* _____, Member
_____, Member

*For Kenneth Cory, per Government Code section 7.9