BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 83A-538
CHESTER H. AND )
VIRGINIA B. SPIERTNG )

For Appellants: Martin J. Tierney
Attorney at Law

For Respondent: Mary E. Olden
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 Chester H. and Virginia B. Spiering against a proposed assessment of additional personal income tax in the amount of $5,314 for the year 1979.

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

There are two issues raised in this appeal: first, whether appellants are entitled to their claimed bad debt deductions; and second, if it is determined that the bad debt losses are deductible, whether the losses were business or personal.

Appellants have invested in and developed real property in Northern California through a number of enterprises, including the four corporations involved in this appeal: Spiering Homes, Inc.; Janes Development Company; Silverado Realty Projects, Inc.: and Sunny Brae Developers, Inc. Prior to the year at issue, these companies had not conducted any business operations for up to eight years. All of the corporations were closely held, usually with no more than one other shareholder in addition to appellants.

Appellants allowed the various corporations to lapse into extended periods of inactivity due to the economic climate. These periods of inactivity followed the completion of specific development projects and extended through periods of recession in the real estate industry. It was also appellants' practice to allow these corporations to be suspended by the State of California during these periods of inactivity, because they felt it was uneconomical to expend funds for franchise taxes and tax preparation fees. Such was the case with each of the corporations for which the losses were claimed. Spiering Homes, Inc., was formed in 1954 to build homes in Arcata, California. In the early fifties, it built and sold many homes. After the recession of 1957 caused the home building market to collapse, it' never fully recovered. Janes Development Company was formed in 1955 to purchase land and develop lots. This company was also hurt badly by recurrent recessions and was unable to recoup its losses when it had to carry completed lots and pay real property taxes, Silverado Realty Projects, Inc., was formed in 1974 to purchase and develop property in Napa County. After a great deal of expense had been incurred to acquire the necessary use permits, changes in the law required an environmental impact report as well. According to appellants, it was not economically feasible to start over again; therefore, the property owned by this company was sold but the overall losses amounted to more than was realized from the sale. Sunny Rrae Developers, Inc., was formed to conduct real estate developments. Like the other three corporations described above, Sunny Brae ran into financial. difficulties and was allowed to lapse.

Appellants state that they were preparing to reactivate all of their closely held corporations during 1979 and merge them into one entity, Western Realty Projects, Inc. Appellants were advised by an accounting firm and a lawyer, engaged to assist in the handling of this merger, that the four corporations could not be merged without incurring a substantial income tax liability under the reorganization provisions of the Internal Revenue Code. Appellants then proceeded with the merger of two other companies into Western Realty Projects, Inc., and determined that since the four subject corporations could not be merged, they had become worthless. In addition to investing various amounts in these companies, appellants contended that they also made numerous loans to the corporations. The loss on the stock and the bad debts were claimed as business bad debt deductions on appellants' personal income tax return for 1979. Respondent disallowed the claimed deductions. This timely appeal followed.

Respondent contends that appellants have failed to establish the propriety of the claimed deductions. It argues that appellants have failed to demonstrate that they had any basis in the stock for which they claim a loss or that they, in fact, made any loans to the subject corporations. Respondent also argues that a loss from a worthless security or a bad debt may be deducted only in the year that it becomes worthless and appellants have failed to establish that the stock or debts in question became worthless during the year at issue. Respondent also contends that even if it is shown that appellants did in fact sustain a loss during 1979, the loss is a personal one and, therefore, only $1,000 of the claimed $29,884 bad debt loss is deductible.

Appellants argue that they clearly intended to reactivate the corporations at some future date and thus the corporations had potential value until 1979 when it was determined that it was not economically feasible to merge the corporations. It was only at this point, argue appellants, that the corporations and the stock and the debts became worthless. Finally, appellants contend that because they are in the business of conducting real estate operations through a number of corporations, the losses were clearly business losses.

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, the security or debt must have some value at the beginning of the year. Second, the security or debt must have become worthless in the taxable year for which the deduction is claimed. (Appeal of V.I.E. Industries, Inc., Cal. St, Bd. of Equal,, June 29, 1982; Redman v. Commissioner, 155 F.2d 319 (1st Cir. 1946): Appeal of Grace Bros. Brewing Company, 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.)

As we noted in the Appeal of Fred and Barbara Baumgartner, decide?! by this board on October 6, 1976, 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 stock and 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 1979 which formed a reasonable basis for abandoning hope that the stock would have some value or 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 stock became worthless upon the occurrence of some identifiable event in 1979. Appellants have offered as proof the fact that they controlled several other previously inactive corporations which became active in 1979 and that the corporations which did not become active were worthless at that point. Appellants 'have failed, however, to present any evidence to show that the corporations had any value in 1979 since all of the corporations in question were defunct previous to that year and had been for several years. Similarly, appellants have failed to provide evidence that they, in fact, made bona fide loans to 'the corporations and that an identifiable event occurred in 1979 that would form a reasonable basis for abandoning

hope that the debts would be repaid since the corporations in question were in financial difficulty, with no assets to pay the debts during previous years when they were allowed to lapse.

Appellants argue that there are two types of value a corporation can have: liquidating value and potential value from future operations. They contend that a stock will not be considered worthless unless there is no reasonable hope and no expectation that it will become valuable in the future. (See Norris v. Commissioner, ¶ 81,368 **T.C.M.** (P-H) **(1981).)** Appellants argue that because, until 1979, there was a possibility that the corporations might be reactivated each had a potential value and that when the decision was made not to merge the corporations, they lost all potential value at that time and **became** worthless, We do not: agree. Appellants have failed to show to our satisfaction the existence of an "identifiable event," as opposed to a subjective decision, in the corporate lives of these corporations which occurred in 1979 which effectively destroyed the value of the stock. We see no evidence of events such as bankruptcy, cessation of business operations, liquidation, or the appointment of a receiver occurring during 1979, as opposed to other years. (See Norris **v.** Commissioner, supra.) This board has repeatedly held that evidence upon which the taxpayer ascertained a debt to be worthless is irrelevant; the taxpayer **must** prove that the debt actually became worthless. (See Appeal of Joyce **D. Kohlman,** Cal. St. Bd. of Equal., June 29, 1982; Appeal of Fred and Barbara Baumgartner, supra.) There is no evidence to establish that any of the corporations in question had had any business activity for many years prior to 1979. In fact, all evidence points to the conclusion that the stock had become worthless when the corporations ceased doing business and were allowed to lapse. (See Appeal of V.I.E. Industries, supra.) Accordingly, we must conclude that appellants have failed to establish the propriety of the claimed deductions during the year at issue.

Because we have decided that the stock and debts in question did not become worthless in the year claimed, we find it unnecessary to address the question of whether the losses were personal or business losses.

For the reasons stated above, we **conclude** that respondent's actions in this matter should be sustained.

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 Chester H. and Virginia B. Spiering against a proposed assessment of additional personal income tax in the amount of $5,314 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of September, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Harvey present;

Ernest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

_____ Member

*For Kenneth Cory, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 82J-1476
FRED DALE STEGMAN )

For Appellant: James H. Cesena
Attorney at Law

For Respondent: Karl F. Munz
Counsel

OPINION ON PETITION FOR REHEARING

On January 8, 1985, we reversed the action of the Franchise Tax Board in denying the petition of Fred Dale Stegman for redetermination of a jeopardy assessment of personal income tax in the amount of $25,650 for the period January 1, 1982, to May 21, 1982.

On February 6, 1985, respondent filed a timely petition for rehearing pursuant to section 18596 of the Revenue and Taxation Code. Respondent has presented six arguments in support of the petition. We reject these arguments as being without merit for the following reasons.

Respondent's first contention is that the appeal was decided on the basis of issues not raised by either party. This is simply not correct. Respondent estimated appellant's income using the cash expenditures method, and we concluded that the assessment was arbitrary on its face in that it failed to establish one of the necessary elements of that method.

Respondent argues that a rehearing should be granted so the case of Simeone v. Commissioner, ¶ 83,317 T.C.M. (P-H) (1983) can be briefed and argued. We do not agree, since as described below the Simeone case did not decide the issue involved in this appeal,

Contrary to respondent's next contention and as specificially stated in the original opinion, we have not shifted the burden of proof to respondent, One of the requirements of the cash expenditures method is that the record contain some proof of the extent to which a taxpayer's assets on hand at the beginning of the period at issue could have contributed to the expenditures. Without such proof, the government's assessment is arbitrary. (Taglianetti v. United States, 398 F.2d 558 (1st Cir. 1968).)

Respondent argues that our original opinion incorrectly applied federal precedents and failed to apply other appropriate precedent. In so arguing, respondent mistakenly relies upon Simeone v. Commissioner, supra, as support for the proposition that an assessment based on the cash expenditures method is not arbitrary merely because the government did not establish an opening net worth. In the Simeone case, the taxpayers stipulated at trial that the government's assessment was not arbitrary, and the court held that they were bound by the stipulation since the government withdrew the offer of certain evidence based upon the stipulation. In addition, despite the stipulation, the record in the Simeone case contained some evidence of the taxpayer's opening net worth. The court had the taxpayer's tax returns for the nine years preceding the year at issue, and the cash found in taxpayer's possession exceeded the total amount of taxable income reported during those years. In contrast, in the instant appeal, respondent did not provide this board with any information concerning what, if any, income appellant reported prior to the period at issue.

Respondent also contends that we incorrectly relied upon criminal tax evasion cases in which the government bears the burden of proof and asks that we consider the recent civil case of Meredith v. Commissioner, ¶ 85,170 T.C.M. (P-H) (1985). In our original opinion, we acknowledged that certain cases cited were criminal cases but cited authority which extended the requirements set forth in those criminal cases to civil cases. We fail to see the relevance of the Meredith case to respondent's argument since that case applies the

standards set forth in the criminal cases and requires the government to establish an opening net worth. In that case, the government concluded that the taxpayer had an insignificant amount of cash on hand at the beginning of the period at issue. The court determined that this conclusion was valid, since it was based upon information obtained during the investigation including the taxpayer's employment history, his need prior to the year at issue for many small loans to meet his living expenses, and the lack of any gifts or inheritances. This type of information was lacking in the instant appeal.

Respondent's next argument seems to be that we incorrectly treated this appeal as a net worth case. In our original opinion, we recognized that respondent used the cash expenditures method rather than the net worth method, but pointed out that the cash expenditures method is a variant of the net worth method and that both methods require some proof of the taxpayer's opening net worth. (See generally, Schmidt, Reconstruction of Income (Second Installment), 19 Tax L.Rev. 277 (1964).) Respondent also seems to argue that it used the specific items of income method of reconstructing income, but this is simply incorrect. (See Resp. Br. at 6.) Accordingly, the case of United States v. Smith, 206 F.2d 905 (3d Cir. 1953), cited by respondent, is not relevant to the instant appeal, since it deals with the specific items of income method.

Respondent places great emphasis upon the fact that appellant failed to keep records of his income, but this failure simply does not allow the presumption of correctness to attach to an arbitrary assessment.

Finally, respondent contends that our opinion left it without any guidelines for future action. We believe that a careful review of the authority cited in our original opinion and in this opinion will provide such guidelines. We are not holding that respondent must establish the taxpayer's opening net worth with mathematical exactitude, or by overwhelming evidence, but there must be some evidence in the record which indicates to what extent the taxpayer's beginning resources could have been used to make the expenditures during the period at issue.

For the reasons discussed above, we conclude that none of the grounds set forth in respondent's petition for rehearing constitute cause for the granting of that petition.

Appeal of Fred Dale Stegman

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 18596 of the Revenue and Taxation Code, that the petition of the Franchise Tax Board for rehearing of'the appeal of Fred Dale Stegman from the action of the Franchise Tax Board in denying his petition for redetermination of a jeopardy assessment of personal income tax in the amount of $25,650 for the period January 1, 1982, to May 21, 1982, be and the same is hereby denied, and that our order of January 8, 1985, be and the same is hereby affirmed.

Done at Sacramento, California, this 9th day of October , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, 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