**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Consolidated Appeals of:<br>**T. HO,**<br>**J. CHEN, AND**<br>**N. CHEN** | ) OTA Case Nos. 20086546, 20086547<br>)<br>)<br>)<br>)<br>) |

**OPINION**

Representing the Parties:

For Appellants: Balaji Manohar, CPA, MST

For Respondent: Nathan H. Hall, Tax Counsel III

For Office of Tax Appeals: Neha Garner, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, T. Ho, J. Chen, and N. Chen (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $133,933 with respect to T. Ho and $125,888 with respect to J. Chen and N. Chen, and applicable interest, for the 2015 taxable year.

Appellants waived the right to an oral hearing; therefore, we decide the matter based on the written record.

## ISSUE

Are appellants entitled to deduct their pro rata share of a bad debt expense deduction originally claimed by Beaconstar, Inc. (Beaconstar), a Subchapter S corporation,[1] for the 2015 taxable year?[2]

## FACTUAL FINDINGS

1. In 2015, T. Ho and J. Chen each owned a 50 percent interest in Beaconstar, which is in the business of providing printed marketing and packaging materials that are

[1] Beaconstar's 1.5 percent Subchapter S tax is not at issue in this appeal. The deduction determination is made at the entity level and then flows through to the shareholders.

[2] Appellants have not disputed the other adjustments made by FTB.

manufactured overseas and shipped to its customers.[3] Beaconstar's main customer was Trendsettah USA, Inc. (TSI).

2. In 2015, TSI stopped making payments to Beaconstar. TSI's unpaid product orders from Beaconstar totaled $2,779,479, including collection costs and late fees, as of November 20, 2015.
3. On its 2015 California tax return, Beaconstar claimed a bad debt loss of $2,779,479. T. Ho and J. Chen (jointly with N. Chen) each claimed one-half of this bad debt deduction on their individual tax returns.[4]
4. Beaconstar had a $500,000 insurance policy with Coface American Insurance Company (Coface) on its TSI accounts receivable. On November 20, 2015, Beaconstar filed a claim based on the outstanding balance due from TSI.
5. On March 9, 2016, Coface determined that Beaconstar was entitled to a loss payment of $435,000 under the terms of the insurance policy. A day later, Beaconstar assigned its claim against TSI for the unpaid debt to Coface. The assignment agreement provided that Beaconstar is entitled to 83.81 percent of net proceeds collected after deducting all expenses and costs of collections. Beaconstar would also receive a refund of any amount Coface were to collect that exceeded the sum paid to Beaconstar under its insurance policy.
6. Coface retained an attorney and filed a lawsuit against TSI, with Beaconstar as plaintiff, to recover the outstanding debt.
7. On August 16, 2017, Beaconstar obtained a judgment against TSI in the amount of $2,656,585. Thereafter, to secure the debt, Beaconstar filed a lien against the potential proceeds in litigation that TSI filed against a third-party.
8. On February 13, 2019, Beaconstar and TSI entered into a Mutual Release and Forbearance Agreement wherein TSI agreed to make installment payments totaling $1,655,000, with the last payment due March 12, 2020.

[3] Appellants T. Ho and J. Chen each owned a 50 percent interest in Beaconstar. Appellant N. Chen filed a joint tax return with J. Chen for the 2015 taxable year.

[4] The individual tax returns are not in our record, but the parties do not dispute that the deductions were taken and were disallowed by FTB, among other adjustments made by FTB on the Notices of Proposed Assessment.

9. FTB issued Notices of Proposed Assessment (NPAs)[5] to appellants, proposing to disallow the bad debt expense deductions, among other adjustments not at issue here. FTB proposed to assess additional tax of $133,933 and $125,888 to T. Ho and to J. Chen and N. Chen, respectively, plus applicable interest.
10. Appellants protested the NPAs, and FTB issued Notices of Action affirming the NPAs.
11. This timely appeal followed.

## DISCUSSION

Income tax deductions are a matter of legislative grace, and a taxpayer has the burden of proving its entitlement thereto. (See *INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *Appeal of Dandridge*, 2019-OTA-458P.) Unsupported assertions are not sufficient to satisfy appellants' burden of proof. (*Appeal of Morosky*, 2019-OTA-312P.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Gillespie*, 2018-OTA-052P.) There is a presumption of correctness as to FTB's denial of deductions. (*Appeal of Vardell*, 2020-OTA-190P.)

A business bad debt deduction, which may be claimed as an ordinary loss, is allowed in the taxable year the obligation becomes partially or totally worthless. (R&TC, § 24348; *Redman v. Commissioner* (1st Cir. 1946) 155 F.2d 319.)[6] A bad debt must be a bona fide debt that "arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Treas. Reg. § 1.166-1(c); see also *Adelson v. United States* (Fed. Cir. 1984) 737 F.2d 1569, 1571.) A taxpayer claiming a bad debt deduction has the burden of proof to establish a deductible bad debt loss. (*Appeal of Credo Developers, Inc*. (84-SBE-028) 1984 WL 16108.) No deduction may be allowed for a particular year if a bad debt became worthless before or after that year. (*Redman v. Commissioner, supra,* at p. 321; *Appeal of Kune* (84-SBE-106) 1984 WL 16186.) The standard for the determination of worthlessness is an objective test of actual worthlessness, a time which is fixed by an identifiable event or events

[5] The NPAs are not in our record; however, the parties do not dispute this fact, and the Notices of Action, which are in the record, affirm the NPAs.

[6] Federal law interpreting a federal statute, here IRC section 166, may be considered highly persuasive when interpreting a California statute, here R&TC section 24348, that is substantially similar to a federal statute. (*Douglas v. State of California* (1942) 48 Cal.App.2d 835, 838.)

that furnish a reasonable basis for a taxpayer to abandon any hope of future recovery. (*Appeal of Southwestern Development Company* (85-SBE-104) 1985 WL 15875.)

The parties do not dispute that the debt TSI owed to Beaconstar was a bona fide business debt. The only dispute is whether the debt became worthless in taxable year 2015. Appellants assert that the debt became worthless in 2015 and that, while they took reasonable steps to collect the debt, they were unable to do so. Appellants appear to equate the nonpayment of debt with worthlessness. However, "[m]ere nonpayment of a debt does not prove its worthlessness and the taxpayers (sic) 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 Miller* (79-SBE-106) 1979 WL 4148 [citations omitted].) To establish that a debt is worthless, "taxpayers must exhaust the usual and reasonable means of collection before they are entitled to a deduction." (*Newman v. Commissioner*, T.C. Memo. 2000-345.)

In this case, Beaconstar and appellants did not abandon all hope of recovery in 2015. Instead, Beaconstar continued to pursue recovery of the outstanding debt until at least 2019. Beaconstar submitted a claim related to the TSI debt to its insurance carrier, Coface, in November 2015, and did in fact collect $435,000 from its insurer. Coface notified Beaconstar that its attempts to resolve the debt were unsuccessful, and that legal action was necessary. Thereafter, Beaconstar, either directly or indirectly through its insurer, Coface, pursued repayment, filed a lawsuit, received a judgment, and ultimately entered into an agreement with TSI for payments that extended through early 2020. Moreover, in late 2017, Beaconstar filed a lien against the proceeds of a third-party lawsuit brought by TSI to ensure TSI paid the debt. Appellants exhausted reasonable means of collection, which did in fact result in collection of a substantial portion of the debt, well after the close of the 2015 taxable year.

FTB cites to *Stanley v. Commissioner*, T.C. Memo. 1999-20 (*Stanley*) to support its position that appellants may not take a bad debt deduction in 2015. In *Stanley*, the U.S. Tax Court determined that the taxpayer failed to prove the debt became worthless during the 1994 taxable year because the taxpayer was still actively litigating against the debtor to collect the debt as late as October 1995.

Appellants argue that the facts in *Stanley* are distinguishable since the taxpayer in *Stanley* did not have an insurance policy and filed his own lawsuit to recover the debt. Instead, appellants assert that Coface initiated the lawsuit after appellants had exhausted attempts to collect the TSI debt. While this fact may differ, this distinction is legally irrelevant. Appellants did not individually pursue collection, but Beaconstar and Coface, as its agent, took many steps that ultimately led to collection of a substantial portion of the debt well past the 2015 taxable year. Beaconstar was the plaintiff named in the lawsuit filed in 2016. Furthermore, Beaconstar was the party that was awarded the judgment. That Coface assisted Beaconstar with the lawsuit is immaterial. Collection efforts were ongoing at least through 2019. Therefore, since Beaconstar was actively pursuing collection of the debt, it clearly retained some hope of recovery well after 2015. Therefore, appellants have not met their burden of proving that FTB erroneously disallowed their claimed bad deduction for 2015.

## HOLDING

Appellants are not entitled to deduct their pro rata share of the bad debt expense deduction originally claimed by Beaconstar in the amount of $2,779,479 for the 2015 taxable year.

## DISPOSITION

FTB's action is sustained.

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Teresa A. Stanley
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Teresa A. Stanley
Administrative Law Judge

We concur:

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Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

Date Issued: 12/14/2021