BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HARRY E. AND MILDRED J. AINE)

-Appearances:

For Appellants: Harry E. Aine, in pro. per.

For Respondent: Tim W. Boyer
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Harry E. and Mildred J. Aine against proposed assessments of additional personal income tax in the amounts of $1,040.00 and $1,330.00 for the years 1967 and 1968, respectively.

Appellant Harry E. Aine is an attorney specializing in patent and copyright law. Appellant and Ralph Mossino acquired title to a patent application for an automotive brake pad invented by Carlo Mione. In August 1966 Mione Competition Rrake, Inc. (Competition) was formed to enter into the automobile brake business. Its principal activity was the manufacture of specially designed brake pads. Competition was organized under section 18208 of the Revenue and Taxation Code as a "small business corporation. " Appellant and Mr. Mossino each contributed $10,000.00 to the capital of the corporation, and each received 25 percent of the stock. The remaining 50 percent of the stock was issued to Mr. Mione as promotional shares. Mr. Mione was experienced in the automotive brake business and had previously been the general manager of a brake company. Although the patent application was initially rejected by the United States Patent Office, ultimately, a patent was issued on September 10, 1968.

Competition proved to be financially unsuccessful and lostmoney from its inception. In September 1967 it was decided that Competition should be abandoned and a new corporation formed to restructure the capital contributions and ownership of the corporation. The new corporation was called Mione Sales, Inc. (Sales), and was also organized pursuant to section 18208 of the Revenue and Taxation Code as a "small business corporation. " Appellant contributed $25,000.00 to the capital of the new corporation, and Mr. Mossino contributed $5,000.00. Mr. Mione received no promotional shares of Sales, although he was elected its president and received a salary of $1,000.00 per month.

Sales lost $12,945.00 during the last four months of 1967 and reported a net operating loss of $17,695.00 in 1968. In June 1968, Mr. Mione's salary was reduced to $750.00 per month, and a search for a purchaser of the corporation was commenced. Shortly thereafter, Mr. Mione and the former sales manager for Sales formed a competing company and began soliciting customers of Sales. As a result of this action and additional disagreements concerning operating policy, Mr. Mione left the corporation in September 1968. At this time, both appellant and Mr. Mossino were active in the day-to-day operations of the company and had to travel long distances to the plant location. Since appellant and Mr. Mossino also had other full

time employment, it was desirable to move the plant to a more convenient location. Accordingly, in September 1968, the corporation leased new facilities for a term of three years. At the same time appellant began to advance funds to the corporation, During the last four months of 1968, appellant advanced $15,354.47 to the corporation and received interest bearing promissory notes in return. No payments of either principal or interest were ever made on the notes.

Sales continued to lose money in 1969 and 1970, and appellant continued to advance substantial sums to the corporation in those years. The corporation finally terminated operations in October 1970 when it sold its remaining inventory to Silver Line Brake Company of Pasadena. All proceeds from the sale were used to pay corporate debts. Concurrent with the sale of the inventory, appellant and Mr. Mossino sold the brake patent to Silver Line Brake Company.

In his personal income tax returns for 1967 and 1968, appellant deducted the corporate losses in the amounts of $18,722.00 and $15,384.00, respectively. At the protest hearing, appellant agreed that he had improperly deducted the corporate losses, but maintained that his $10,000.00 stock interest in Competition became worthless in 1967 when that corporation was abandoned. Respondent agreed that the $10,000.00 loss on the Competition stock was properly deductible in 1967, and revised the proposed assessment accordingly. Appellant also maintained that his stock in Sales became worthless in 1968 and was deductible as a loss in that year. Respondent denied the deduction on the basis that the stock in Sales continued to have some value in 1968 and that no loss deduction could be claimed in that year. It is also appellant's position that certain expenses incurred by him in the amounts of $457.00 and $1,548.00 for the years 1967 and 1968, respectively, were deductible.

The first issue for determination is whether appellant's stock in Sales became worthless in 1968 and was deductible as a loss in that year.

Section 17206 of the Revenue and Taxation Code provides for the deduction of the loss from any security which becomes wholly worthless during the taxable year. In order to qualify for the

deduction, the loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. (Cal. Admin. Code, tit. 18, reg. 17206(a), subd. (2).) The burden is on the taxpayer to establish that the securities became totally worthless during the year for which the deduction is claimed. (Mahler v. Commissioner, 119 F. 2d 869, cert. denied, 314 U. S. 660 [86 L. Ed. 529]; Appeal of William C. and Lois B. Hayward, Cal. St. Bd. of Equal. , Oct. 3, 1967..)

Stock will not be considered as worthless so long as there is a reasonable hope and expectation that it will become valuable at some future time. In order to establish that such hope and expectation is foreclosed it is necessary to show the existence of identifiable events which have destroyed the actual or potential value of the stock. (See generally Sterling Morton, 38 B. T. A. 1270; aff'd, 112 F. 2d 320.) Appellant has offered a number of factors which, he maintains, constituted identifiable'. events establishing that the stock was totally worthless in 1968. Such factors include; the departure and competitive interference of Mr. Mione, the unsuccessful search for a buyer, the unsatisfactory level of sales, and the failure of certain purchasers to reorder brake pads. While these factors may have indicated that the corporation was beset with economic difficulties, we are not persuaded that they constituted identifiable events which established that the stock was worthless in 1968. This conclusion is compelled by the fact that appellant advanced over $15,000.00 to the operating corporation during the last four months 'of 1968, almost $12,000.00 during 1969, and an unknown amount in 1970. Surely, appellant did not believe that the stock was worthless in 1968. It has frequently been held that such factors as operating losses, poor business conditions and similar circumstances are insufficient to establish the worthlessness of stock. (See; e.g. , Joseph C. Lincoln, 24 T. C. 669, 696, aff'd, 242 F. 2d 748; Anthony P. Miller, Inc., 7 T. C. 729, 744, aff'd, 164 F. 2d 268.)

Appellant also urges that the stock was totally worthless in 1968 because liabilities exceeded assets. Although the excess of liabilities over assets of a corporation, properly valued, may be evidence that stock is worthless, it is not conclusive.

(See Mahler v. Commissioner, supra at 872.) In support of his position appellant submitted a schedule indicating that the book value of liabilities exceeded assets by $1,221.00. However, appellant claims that when properly valued, liabilities exceeded assets by $25,180.00. After reviewing the schedule in light of the entire record, we are unable to agree with appellant's suggested valuation in, at least, three respects.

First, although appellant included in liabilities a $9,985.00 obligation for the three year lease of the plant facility, he failed to attribute any asset value to the leasehold. Since the corporation continued to use the leased facilities for, at least, two years, and did not abandon the premises until late in 1970, the value of the lease should also have been included as an 'asset for the year in issue.

Second, appellant contends that $9,344.00 of the corporation's $12,651.00 in accounts receivable were uncollectible at the end of 1968. However, the corporation reported no bad debts for that year, and reported bad debts of only $24.00 and $2,710.00 in 1969 and 1970, respectively. Appellant has offered no convincing evidence why these accounts should have been written off in 1968.

Third, appellant wrote down the corporation's inventory from $13,374.00 to $8,644.00 without furnishing any convincing evidence of the basis for the write-down. Arbitrary write-downs of inventory are not permissible. (See Jack Rose, 24 T. C. 755, 767.)

We must conclude that this is not one of those exceptional cases where the liabilities of a corporation so greatly exceeded its assets as to compel a conclusion that the stock was worthless in 1968. (See Sterling Morton, supra.) This conclusion is buttressed by appellant's continued advancement of funds to the functioning corporation. Such advances are strong evidence of the continued potential value of even an insolvent corporation and sufficient cause for the denial of the worthless stock deduction for the year in issue. (See Nelson v. United States, 131 F. 2d 301; Joseph C. Lincoln, supra; Appeal of Estate of John M. Hiss, Sr. , Deceased, and Ella N. Hiss, Cal. St. Bd. of Equal. , Sept. 23, 1974; Appeal of William C. and Lois B. Hayward, supra.)

The next issue for determination is whether appellant may deduct the expenses paid by him in the amounts of $457.00 and $1,548.00 for the years 1967 and 1968, respectively.

Appellant has advanced several theories to support the deductibility of these expenses. However, we are convinced that, with the one exception noted below, these expenses were either personal expenses or expenses paid by a corporate officer or shareholder on behalf of his corporation. In either case, the expenses are not deductible. (See generally Atlas Heating & Ventilating Co., 18 B.T.A. 389; Merritt J. Corbett, 16 B.T.A. 1231; Roy L. Harding, T. C. Memo., June 29, 1970; William Ockrant, T.C. Memo., Mar. 22, 1966.)

The one exception concerns the $594.00 deduction claimed for transportation expenses incurred in traveling to the brake company during 1968. Respondent does not contest the fact that this amount was actually expended. The record indicates that during 1968 appellant, who was employed full time in his law practice, worked nights at the corporation's plant manufacturing brakes and conducting other activities on behalf of the corporation. It was in traveling from his law practice to the plant that the expenses in question were incurred. Where the taxpayer maintains two established places of business, all costs of transportation between one place of employment and the other constitute ordinary and necessary expenses incurred in carrying on the combined trade or business. (See generally James A. Kistler, 40 T. C. 657; Clarence J. Sapp, 36 T. C. 852, aff'd, [illegible] F. 2d 143; William L. Heuer, Jr., 32 T. C. 947, aff'd, 283 F. 2d 865; cf. Julian D. Freedman, 35 T. C. 1179, aff'd, 301 F. 2d 359.) Accordingly, the $594.00 should have been allowed as a deduction from appellant's gross income for 1968.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Harry E. and Mildred J. Aine

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 Harry E. and Mildred J. Aine against proposed assessments of additional personal income tax in the amounts of $1,040.00 and $1,330.00 for the years 1967 and 1968, respectively, be and the same is hereby modified to reflect the allowance of the $594.00 travel expense deduction for 1968. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 22nd day of April, 1975, by the State Board of Equalization.

William M. Bennett, Chairman

George R. Reilly, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: W. W. Dunlop, Executive Secretary