BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATF OF CALIFORNIA

In the Matter of the Appeal of)
)
BRUCE D. AND DONNA G. VARNER)

For Appellants: Bruce D. Varner, in pro. per.

For Respondent: Bruce W. Walker
Chief Counsel

Kwan K. Wang
Counsel

O P I N I O N

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 Bruce D. and Donna G. Varner against proposed assessments of additional personal income tax in the amounts of $1,260.00, $887.88, $1,041.80 and $343.78 for the years 1970, 1971, 1972 and 1973, respectively.

The issues presented are: (1) whether respondent properly disallowed a portion of appellant's claimed travel and entertainment expenses for lack of substantiation: (2) whether a loan to Russell Olsen became worthless in 1970 and may be deducted as a business bad debt: and (3) whether certain loans and loan guarantees made by appellant resulted in business bad debts.

Reference hereinafter to "appellant" will be to appellant Bruce D. Varner. The deductions at issue were claimed in connection with his business, the practice of law.

We note first that a determination by respondent that a deduction should be disallowed is presumed correct. (Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.) Thus, the burden is on appellant to show that he satisfies the conditions entitling him to a claimed deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934).) With these principles in mind we consider each matter in issue.

Travel and Entertainment Expenses

Appellant claimed business travel and entertainment expenses in the amounts of $10,800, $7,871 and $7,812 for the years 1971, 1972 and 1973, respectively. At the protest hearinp, appellant presented records which included some checks and receipts containing clients' names. Respondent at that time 'revised the proposed assessments, allowing one-half of the deductions claimed and disallowing the rest as unsubstantiated. In the course of this appeal, appellant also submitted a schedule of his total alleged business entertainment costs for the years in issue; this total exceeds the amounts originally claimed.

In order to deduct travel and entertainment expenses, appellant must prove that they are directly attributable to his business and are corroborated'by adequate records.' (Rev. & Tax. Code, § 17202, subd. (a) (2); Cal. Admin. Code, tit. 18, reg. 17202(a); Rev. & Tax. Code, § 17296.) Here, appellant's records show that expenditures were actually made for meals, plane fares and various gifts, but it is not clear that all of these expenditures had a business purpose. Without distinguishing between business and personal expenses, appellant cannot demonstrate that any amounts were improperly disallowed by respondent. (Appeal of Robert J. and Evelyn A. Johnston, Cal. St. Rd. of Equal., April 22, 1975.)

Therefore, we conclude that respondent allowed a reasonable amount of deductions based on the evidence presented. (See James A. Gleason, 1161,344 P-H Memo. T.C. (1961).)

Bad Debt Deductions

In 1970, appellant loaned $6,000 to Russell H. Olsen, Jr., a stockbroker whose office was located in the same building as appellant's law firm. According to appellant, the loan was made to earn interest and to generate referrals to the law firm. Later in 1970, Mr. Olsen lost his job and because the loan was not repaid, appellant deducted $6,000 as a business bad debt for 1970. Initially, respondent doubted the existence of the debt but now stipulates that the only issues are whether the debt became worthless in 1970 and whether it was connected with appellant's business.

In 1970 and 1971, appellant, as guarantor for Holiday Purveyors, Inc., made payments of $7,760 and $5,699, respectively, on bank loans. Holiday Purveyors, Inc., was a wholly owned subsidiary of Holiday Caterers, Inc., in which appellant owned one-third of the capital stock. Appellant claimed business bad debt deductions for the above payments.

In 1970, 1971 and 1972, appellant advanced a total of $8,600 to Highland Enterprises, Inc., for the purpose of satisfying, the corporation's trade creditors, some of whom were clients of appellant's law firm. Appellant-held one-fourth of this corporation as an equal shareholder. Highland Enterprises, Inc., ceased doing business in 1971 because of financial difficulties and the corporation was sold in 1972. Appellant deducted the advances as business bad debts in 1972.

Appellant's stated motive for making the described bank guarantees and advances was to protect existing client relationships and to generate legal fees. However, respondent reclassified the guarantees and advances as nonbusiness bad debts on the grounds that appellant failed to establish a proximate relation between the debts and his law practice, and it is this issue which must be decided.

The statute governing bad debt deductions provides, in part:

> There shall be allowed as a deduction any debt which becomes worthless within the taxable year; ... (Rev. & Tax. Code, § 17207, subd. (a)(1).)

This deduction is not allowed, however, when the loss results from the worthlessness of a nonbusiness bad debt. Such a debt is subject to capital loss limitations. (Rev. & Tax. Cede, § 17207, subd. (d) (1) (B); Cal. Admin. Code, tit. 18, reg. 17207(e), subd. (2) (i)-(ii).) For purposes of section 17207 and the regulations thereunder, a nonbusiness bad debt is a debt other than:

> (A) A debt created or acquired ... in connection with the 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. (Rev. & Tax. Code, § 17207, subd. (d) (2).)

Thus, in order to claim a business bad-debt deduction, appellant must show that his dominant motivation in advancing funds was to protect his business or was otherwise proximately related to his business. (U.S. v. Generes, 405 U.S. 93 [31 L. Ed. 2d 62] (1972); Oddee Smith, 60 T.C. 316 (1973).) The record must demonstrate clearly that the primary reason for making the loans was business rather than investment related; a balanced business-investment motivation or a significant business motivation is insufficient. (Oddee Smith, supra.)

Loan to Russell Olsen, Jr.

Appellant's initial burden with respect to the Russell Olsen debt is to establish the worthlessness of the debt based on the actual financial condition of the debtor. (Appeal of Grace Bros. Brewing Co., Cal. St. Bd. of Equal., June 28, 1966.) Here, Olsen indicated that he would file bankruptcy if payment of his debt was demanded; however, a threat of bankruptcy standing alone does not in itself show a change in financial position. (Appeal of Grace Bros. Brewing Co., supra.) Further, although appellant was not required to take legal action against Olsen, he must have at least made reasonable attempts to collect, or present facts showing that legal action would not have effected repayment. (Frederick L. Sullivan, 1168,111 P-H Memo. T.C. (1968); Cal. Admin. Code, tit. 18, reg. 17207(b), subd. (2).) Absent such proof, appellant has failed to establish worthlessness of the debt and the deduction therefor was properly disallowed. That being so, the relation of the debt to appellant's business is immaterial.

Bank Loan Guarantees on Behalf of Holiday Purveyors, Inc., and Advances to Highland Enterprises, Inc.

The bank loan guarantees allegedly executed by appellant on behalf of Holiday Purveyors, Inc., were made at the request of the corporation's organizer, who was also appellant's client. Appellant arques that his "dominant motivation" was to generate legal fees from Holiday Purveyors, Inc.,. and related enterprises; absent such loans, he argues, no such fees would have been earned. However, the record does not support appellant. In his own words, the guarantees were "part of this venture" (i.e., the acquisition of Holiday Purveyors, Inc., by Holiday Caterers, Inc.), indicating that the guarantees were intended to further the success of the investment, and in turn assure that Holiday Caterers, Inc., did not lose money. Furthermore, the actual amount of fees earned from the various entities involved here was only a small portion of appellant's total income from his law firm. Under these circumstances, we must conclude that any business-related motive cannot be considered dominant with respect to the bank guarantees. Thus, the losses resulting therefrom are properly classified as nonbusiness bad debts and are deductible only as capital losses. (See Cal. Admin. Code, tit. 18, reg. 17207(h), subd. (2).)

For the same reasons, we must conclude that respondent correctly classified the losses resulting from advances to Highland Enterprises, Inc., as nonbusiness bad debts. It is not clear that appellant's professional reputation would have suffered merely because he was a shareholder in a corporation that could not pay its debts. (Samuel J. Grauman, ¶64,226 P-H Memo. T.C. (1964).) Had this been appellant's primary concern, we see no logical reason why he continued to advance funds to Highland Enterprises; Inc., even after it was clear that the business had little or no chance of success. Rather, appellant's conduct indicates a hope of eventually profiting from his initial investment or at least minimizing his losses. (Oddee Smith, supra.)

Our conclusion is that in all issues herein, respondent's action must be upheld.

Appeal of Bruce D. and Donna G. Varner

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 Bruce D. and Donna G. Varner against proposed assessments of additional personal income tax in the amounts of $1,260.00, $887.88, $1,041.80 and $343.78 for the years 1970, 1971, 1972 and 1973, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member