

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the **Matter** of the Appeal of)
KUANG W. AND BIE C. WU) No. **82A-903**

For Appellants: Larry **Rothman**
Attorney at Law

For **Respondent**: Lazaro L. Bobiles
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 Kuang W. and Bie C. Wu against a proposed asses-sment of additional personal income tax in the amount of **\$4,597.73** 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.

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The sole issue in this appeal is whether **appellant^{2/}** has established that an advance he made to Oakland Electric Co. and an indemnity payment made to Continental Casualty Co. during the year at issue are deductible as business bad debts.

During 1979, appellant was employed by both Northrop Corporation (Northrop) and West Engineering Company (West). He was also vice president and the majority shareholder of Oakland Electric Co. (Oakland). Appellant reported salary amounts from both Northrop and West on his 1979 personal income tax return but none from Oakland. On the same **return, appellant** also claimed business bad debt deductions for a payment of \$47,445 to Oakland and \$12,000 to Continental Casualty Co. (Continental). Following an audit of appellant's 1979 return, respondent disallowed the business bad debt deductions on the ground they were nonbusiness bad debts. This timely appeal followed.

In 1979, appellant advanced the \$47,445 amount to Oakland. Also that year, Oakland required a surety bond in connection with a contract for construction work to be performed on Athens High School in **Troy**, Michigan. Appellant obtained a bond from Continental and was held personally liable to Continental if the corporation defaulted on the contract. Oakland did **default** on the contract and performance on the contract was completed by Continental. **As a result**, Continental acquired the assets of Oakland. In exchange for releasing appellant from **his** personal guarantee, Continental received \$12,000 from appellant. Appellant deducted as business bad debts the full amounts of the \$47,455 advance to Oakland and the \$12,000 indemnity payment to Continental.

Appellant contends that he is engaged in the business of making loans and therefore is entitled to deduct the losses he incurred as business bad debts. To substantiate this contention, appellant submitted copies of a loan made to **Westlake** Electric and a canceled check from a former employee, John C. Goodballet, Jr. (Resp. Br., Ex. I and Ex. J.)

^{2/} This case actually involves two appellants, husband and wife. Appellant-wife, Mrs. Bie C. Wu, is a party to this appeal only by virtue of having filed a joint return. All references to appellant in this opinion will be to appellant-husband, Mr. Kuang W. Wu.

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Respondent contends that appellant has failed to establish that the claimed losses are business bad debts because appellant has not shown that he is in the business of making loans or that his dominant motive for advancing funds to Oakland or in making the indemnity payment to Continental was to protect his interest as an employee of Oakland.

It is well settled that respondent's determination to disallow a deduction is presumed correct and the burden of proof is upon the taxpayer. to establish his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.) Business bad debt losses are fully deductible against taxable income in the year sustained, whereas nonbusiness bad debt losses are regarded as capital losses which are deductible only to the extent of capital gains, plus taxable income or one thousand dollars, whichever is less. (Rev. and Tax. Code, §§ 17207 and 18152.)

For purposes of a bad debt deduction, section 17207, subd. (d)(2), defines a "nonbusiness debt" as a debt other than one created or incurred in connection with the taxpayer's business. Thus, in order to deduct the advance and indemnity payment in question as business bad debts, appellant must establish that such payments were proximately related to his trade or business.

The question of whether an individual is engaged in the business of making loans turns on whether the activity in making bona fide loans is "extensive, varied, and-regular."- (Cushman v. United States, 148 F.Supp. 880 (D. Ariz. 1956).) In Cushman, the taxpayer demonstrated that she was in the **business** of making loans because she had loaned a total of \$116,000 to 27 separate parties over a continuous f-year period. Similarly, in Minkoff v. Commissioner, ¶ 56,269 T.C.M. (P-H) (1956), the same result was reached when the taxpayer showed that he had made loans totalling \$300,000 to 40 people over a f-year period. The court concluded that by virtue of the substantial number and amounts of loans which the taxpayer made, he was in the business of lending money for profit.

Although appellant has stated that many of the other loans he allegedly made were made on the basis of oral agreements, he has failed to submit further **substantiation**. In any case, we agree with respondent's position that making four loans between 1978 and 1979 does

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not qualify appellant as being in the business of making loans. We must conclude that appellant's loan-making activity is on too small a scale and transacted with insufficient regularity to characterize him as being in the business of making loans.

Appellant could still deduct the amounts in question as business debts if he can demonstrate that such payments were proximately related to his trade or business as an employee of Oakland. It is now well established that being an employee may constitute a trade or business for the purposes of determining whether a debt is a business debt. (Trent v. Commissioner, 291 **F.2d** 669 (2d Cir. 1961); Putoma Corp. v. Commissioner, 66 T.C. 652, 673 (1976).) If appellant's advances and indemnity payments were made in order to protect his job or were otherwise related thereto, the resulting debts are "business debts" deductible against taxable income. (Jaffee v. Commissioner, ¶ 67,215 T.C.M. (P-H) (1967).) On the other hand, where the motivation for the payments is that of an investor and gain is sought in the form of an increase in the value of the investment or in dividends, those payments are "nonbusiness debts." (Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963); Appeal of Walter E. and Pearl Robertson, et al., Cal. St. Bd. of Equal., June 2, 1969.) In determining whether a bad debt has a proximate connection with a trade or business of the taxpayer, we must determine the dominant motivation of the taxpayer. (United States v. Generes, 405 U.S. 93, 103 [31 L.Ed.2d 62] (1972).) The determination of a taxpayer's dominant motive is essentially a factual inquiry, with the burden of proof on petitioner. (Putoma Corp. v. Commissioner, supra; Smith v. Commissioner, 55 T.C. 260 (1970).)

From the facts presented, we must conclude that appellant's dominant motivation was to protect his investment in Oakland and not to protect his interest as an employee. Appellant's investment in Oakland was substantial. In the year at issue, appellant was the majority **shareholder** in the corporation with a total of 25,500 shares. His basis in this **stock** was \$25,500. In comparison, appellant's interest as an employee was quite insubstantial. The record does not show a salary was paid to him for his services as vice president of Oakland.

Where the salary at issue is small compared to the investment at stake, it is difficult to prove that a loan was necessary to keep a job. (United States v. Generes, supra; Appeals of Robert E. and M. E. Hink,

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Lester W., Jr. and Bertha M. Hink, Cal. St. Bd. of Equal., Apr. 5, 1983.) Appellant cannot be considered to have been protecting his interest as an employee when he advanced the \$47,455 to Oakland because although he was an "employee", he received no **salary and** was employed during the same period by Northrop and West, where he received a substantial salary. We must conclude that appellant's dominant motive for making the advance was the protection of his interests as an investor because his interest in Oakland was an investment. As such, there was no proximate relation between the advances made to appellant's trade or business. Accordingly, the loss in question cannot be properly deducted as a business bad debt.

Appellant has also failed to **show** that the indemnity payment to Continental was proximately related to his trade or business as an employee of Oakland. In United States v. Generes, supra, the court found that a taxpayer who was a shareholder and officer of a corporation whose debts he had guaranteed could not deduct as a business debt the amount paid to a surety company for indemnification because the taxpayer failed to show that his **interest** in preserving his salary predominated over his motive as an investor. Similarly, in the instant case, appellant cannot show that his dominant motive was to preserve his salary as opposed to the preservation of his capital investment.

For the foregoing reasons, we conclude that respondent's action in this matter must **be** sustained.

