

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ANDRE AND SUZANNE ANDRESIAN) No. **84A-708-MA**

Appearances:

For Appellants: Berbert B. Wittenberg
Certified Public Accountant

For Respondent: Terry L. Collins
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 Andre and Suzanne Andresian against a proposed assessment of additional personal income tax in the amount of \$719 for the year 1981.

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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There are two issues to be decided in this appeal: (1) whether a note received in partial consideration for the sale of assets of appellants' sole proprietorship was a trade or business debt, and (2) when did that note become worthless.

Appellants are husband and wife who file joint personal income tax returns. In 1978, they purchased a retail lamp store. Mrs. Andresian was the manager of the store although she received no **salary** in 1981. Mr. Andresian, a physician, was not involved in the business.

In March 1981, appellants contracted to sell the business to Dennis Phillips **for** \$17,000. In consideration for the transfer, Mr. Phillips paid \$10,000 in cash at the time the agreement was signed and executed a note to appellants for the \$7,000 balance. The **first** payment was to be made in September 1981. The note was secured by the stock in trade and equipment, furniture, and fixtures of the store, all valued at \$17,000 in the sales agreement. The note provided, in pertinent part, as follows:

Section 4: TIME AND MANNER OF PAYMENT

* * *

Said note shall bear the rate of 10% interest per annum, and shall not be amortized **over** the life of the loan. If, in the event, that any two consecutive payments become in arrears, the remaining balance, in full, shall become immediately due and payable.

(Resp. Br., Ex. A **at** 3.)

Mr. Phillips made only the first \$400 monthly payment. He made no further payments although appellants requested payment several times, both personally and through their attorney. In December 1981, Mr. Phillips filed a Chapter 11 bankruptcy petition and on August 31, 1982, he filed a Chapter 7 bankruptcy petition. On March 16, 1983, he received a discharge in bankruptcy, apparently without any dividend ordered paid to creditors. Appellants claimed a bad debt deduction for the balance of the note in 1981. Respondent made several adjustments to that return, **but** appellants contest only the year in which respondent maintains that bad debt loss is deductible, 1983, and respondent's characterization of the loss as resulting from a nonbusiness debt.

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Appellants argue that the loan in question was a debt created or acquired in connection with their trade or business and that it became worthless with the filing of the debtor's Chapter 11 petition in December 1981.

The question of whether debts are business or nonbusiness bad debts has come before the federal courts and this board on many occasions. (See generally Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963); Appeal of Robert E. and M. E. Hink and Lester W., Jr. and Bertha M. Hink, Cal. St. Bd. of Equal., May 5, 1983; Appeal of Richard M. Lerner, Cal. St. Bd. of Equal., Oct. 28, 1980.) In each case, the test to be determined is whether the debt in question has a proximate connection to the trade or business of the taxpayer. In Whipple, supra, the court cautioned that not every income or profit-making activity has a proximate connection to a trade or business and that there is a whole spectrum of profit-seeking activities of which a trade or business is just one narrow category. In the case before us, appellants are not in the business of buying and selling small retail shops. The store was an investment and any bad debts occurring as a result of this investment must accordingly **be considered** as nonbusiness bad debts.

The second question which must be answered is at what date the debt owed to appellants was determined to be worthless. Respondent argues that only upon Mr. Phillips' discharge of indebtedness issued by the bankruptcy court in March 1983 could appellants finally determine that the debt was worthless. We must agree.

In order to show that a bad debt is worthless, a taxpayer-creditor must exhaust every reasonable means of collection and demonstrate that there was no hope of recovering anything from the debtor. If the notes are secured, he must show that he has realized all he can from the security. (Bell v. United States, 120 F.Supp. 931 (M.D. Penn. 1954).) The taxpayer-creditor must establish, by objective standards, that a substantial change in the debtor's financial condition occurred in the year the deduction is taken. (Findley v. Commissioner, 25 T.C. 311 (1955), affd. per curiam 236 F.2d 959 (3d Cir. 1956).) An attorney's appraisal of the collectability or noncollectability of the debt does not establish worthlessness unless supported by objective facts. (Edwards v. Commissioner, ¶ 59,150 T.C.M. (P-H) (1959).)

When Mr. Phillips failed to make the monthly payments on the outstanding amount due on the loan,

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appellants' attorney wrote to him requesting payment. According to appellants, the attorney also later brought suit against Mr. Phillips. In December 1981, Mr. Phillips filed for reorganization under Chapter 11 of the Bankruptcy Act (11 U.S.C.A. § 701 et seq.). The reorganization attempt was apparently unsuccessful and Mr. Phillips filed a bankruptcy petition under Chapter 7 for full discharge of his debts on August 31, 1982. The petition was granted on March 16, 1983. In January 1983, appellants received a letter from their attorney that he had been unsuccessful in overcoming the bankruptcy of Mr. Phillips and that he would recommend writing off the bad debt. (Resp. Br., Ex. B at 4.) This letter coupled with the granting of the bankruptcy petition two months later makes it clear that the debt became worthless in 1983 rather than 1981.

For the reasons stated above, respondent's action will be sustained in all respects.

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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 Andre and Suzanne Andresian against a proposed assessment of additional personal income tax in the amount of \$719 for the year 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day Of February , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9