BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84A-427-VN
ROBERT F. AND	)	
HORTENSE N. SEEDLOCK	)	

For Appellants: Robert F. Seedlock, in pro. per.

For Respondent: Karl F. Munz
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 Robert F. and Hortense N. Seedlock against proposed assessments of additional personal income tax in the amounts of $831.70, $586.06, and $861.00 for the years 1978, 1979, and 1980, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

Appeal of Robert F. and Hortense N. Seedlock

Appellant Robert F. Seedlock is a retired major general of the United States Army and a former engineer with an international construction firm. In this appeal, he contests the decision of the Franchise Tax aoard to disallow certain nonbusiness bad debt deductions that he claimed on his 1978, 1979, and 1980 returns. His spouse, Hortense N. Seedlock, is a party to this appeal solely because she filed joint returns with him for the years in question. For purposes of this appeal then, only Robert F. Seedlock will hereafter be referred to as "appellant."

The major portion of the bad debts in question were incurred by appellant in connection with a closely held corporation. In 1972, appellant and his son, Walter N. Seedlock, organized Entak, Inc. (Entak), a Georgia corporation whose principal business activity was to be the retail sales of clothing. Holding 50 shares of stock, appellant's son was the majority owner of the company as well as its president and treasurer. Appellant owned the remaining 30 shares of outstanding Entak stock and was appointed the company's vice president and secretary. The business of the corporation was located in a shopping center near Georgia Southern College in Statesboro, Georgia. Walter N. Seedlock was the manager of the retail clothing store.

After a promising first month of sales, the corporation's clothing business fared poorly. Appellant was required to advance money to the company on several occasions. In the summer of 1973, appellant transferred $200 to the corporation. On June 9, 1974, appellant wrote a $100 personal check to Entak. On the face of the check, appellant made the notation "loan." Later that same month, appellant advanced $25,420.17 to the company. In consideration for receipt of this sum of money, Walter N. Seedlock executed on behalf of Entak an unsecured promissory note dated June 28, 1974. Under the terms of the note, Entak was obligated to repay the $25,420.17, plus interest at a rate of 6 percent, in one lump sum on December 28, 1974.

In July 1974, Walter N. Seedlock used the $25,420.17 advance from appellant to satisfy Entak's liabilities, including two overdue bank loans totaling $21,716.47. The advance, however, apparently was not sufficient to sustain the business of the corporation, for the clothing store soon failed and its assets were liquidated in August 1974. Thereafter, the company was inactive and did not conduct any business. Appellant

was not repaid for any of his three advances to the corporation.

The remaining bad debt arose from an alleged personal loan that appellant made to a fellow employee at an Atlanta transportation project while appellant was deputy project director there. On August 12, 1976, appellant gave $500 to this friend who in turn drew up the following agreement:

> I promise to pay the sum of FIVE HUNDRED DOLLARS (500) plus the current market rate interest at the [time] that the repayment schedule commences. The repayment schedule is to commence two weeks after I am gainfully employed.

On January 25, 1977, appellant wrote a letter to his friend and inquired about repayment of the money. Appellant repeated his request for repayment on April 27, 1978, after he returned to California from an assignment in Saudi Arabia. Subsequently, in a response dated May 1, 1978, the friend informed appellant that he could not pay him at the present time but indicated that prospects for payment were good because he had set up a business. Appellant never received repayment of the $500 advance from his friend.

Beginning with his 1978 joint California personal income tax return, appellant claimed a capital loss deduction of $3,561 for alleged nonbusiness bad debts resulting from the advances. Due to a net capital loss carryover, appellant also claimed capital loss deductions of $5,326 and $1,000 on his 1979 and 1980 returns, respectively. Upon audit of these returns, the Franchise Tax Board determined to disallow the claimed bad debt deductions and issued the proposed deficiency assessments at issue in this appeal.

Section 17207 allows as a deduction any debt which becomes worthless during the taxable year. A debt other than one which is created or acquired in connection with a taxpayer's trade or business is a nonbusiness debt. (Rev. & Tax. Code, § 17207, subd. (d)(2).) The loss resulting from a nonbusiness debt is to be considered a loss from the sale or exchange of a capital asset held for not more than one year (Rev. & Tax. Code, § 17207, subd. (d)(1)(B)) and is thus deductible only as a short-term capital loss (Appeal of George F. and Sylvia A. Cashman, Cal. St. Bd. of Equal., Jan. 9, 1979). The

annual deduction for losses from sales or exchanges of capital assets is limited to the extent of the gains from such sales or exchanges, plus the lesser of the taxable income for the year or $1,000, with the excess of any net capital loss to be treated as a capital loss in the succeeding year. (Rev. & Tax. Code, § 18152; Appeal of Robert W. Duffin, Sr., Cal. St. Bd. of Equal., May 4, 1983.) Section 17207 is substantially similar to section 166 of the Internal Revenue Code. Federal precedent is therefore persuasive in the proper interpretation and application of the California section. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942); Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

In order for a debt to be deductible under section 17207, it must be a bona fide debt; that is, one 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).) A deduction may not be taken for an advance which was made with no intention of enforcing payment (Hayes v. Commissioner, 17 B.T.A. 86 (1929)) or where there was no reasonable expectation of repayment when it was made (Zarigoni v. Commissioner, 73 T.C. 792, 799 (1980)). In addition, the debt must have become worthless in the taxable year for which the deduction is claimed. (Redman v. Commissioner, 155 F.2d 319 (1st Cir. 1946); Messer Co. v. Commissioner, 57 T.C. 848, 861 (1972).) The taxpayer bears the burden of proving all the elements of deductibility of a bad debt. (Andrew v. Commissioner, 54 T.C. 239, 244-245 (1970); Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal., Nov. 6, 1967.)

Appellant contends that his advances were legitimate loans which became worthless in 1978 and thus should have been allowed as nonbusiness bad debt deductions in the appeal years. In particular, appellant argues that the $25,420.17 advance to Entak was a valid debt whose deductibility as a short-term capital loss was verified by the company's accountant. The Franchise Tax Board, on the other hand, makes the initial argument that neither the Entak payments nor the personal advance were bona fide debts. Respondent asserts that the large advance to the corporation should be treated as a contribution to capital. In the alternative, respondent contends that none of these supposed debts became worthless in 1978.

First, with regard to the Entak advances, it is well settled that a contribution to capital is not a bona fide debt for the purpose of the bad debt deduction. (Treas. Reg. § 1.166-1(c); Appeal of Lambert-California Corporation, Cal. St. Bd. of Equal., June 29, 1982.) Here, it is not conclusive to simply characterize appellant's Entak advances as capital contributions, for losses attributable to capital investments or *worthless* securities may be likewise deducted as capital losses under sections 17206 and 18152. (Appeal of Milton and Helen Brucker, Cal. St. Bd. of Equal., July 26, 1982.) Whether we term the advances as bona fide debts or capital investments, however, appellant must also prove in either case "worthlessness" in the taxable year to be entitled to capital loss treatment. In order to meet his burden of showing under section 17207 that an alleged debt became worthless in a particular year, appellant must prove that the debt had value at the beginning of the year in question and that some event occurred during that year which changed the debtor's financial condition and caused the debt to become worthless. (Appeal of Sam and Dina Hashman, Cal. St. Bd. of Equal., June 29, 1982.) Similarly, in order for appellant to take a capital loss deduction under section 17206, he must show that the loss occurred during the taxable year as a result of a closed and completed transaction and a fixed identifiable event. (Treas. Reg. § 1.165-1(d)(1); Appeal of Henry E. and Mildred J. Aine, Cal. St. Bd. of Equal., Apr. 22, 1975.) In the present case, appellant has not submitted any evidence showing that the claimed Entak loans had value in 1978 and became worthless because of an event in the same year. Nor has appellant given any reason to believe that a transaction or identifiable event occurred in 1978 which may have caused his investments in Entak to become deductible as capital losses in that year. If anything, it appears that appellant's losses could have been written off in 1974 when the corporation liquidated its assets and ceased doing any business. Since appellant has not met his burden of proof, we must find that respondent properly disallowed the deductions claimed in connection with the Entak advances.

Second, the critical factor in determining whether a debtor-creditor relationship existed between appellant and the recipient of his $500 advance is that there must be an unconditional obligation on the part of the so-called debtor to repay a definite sum of money. (Appeal of Cecil W. Harris, Cal. St. Bd. of Equal., Jan. 6, 1977.) While an obligation to pay can be contingent, it is well established that a valid debt does not arise for

the purpose of the bad debt deduction where the obligation to repay is subject to a contingency that has not occurred. (Zimmerman v. United States, 318 F.2d 611, 612 (9th Cir. 1963); Milles v. Commissioner, ¶ 74,214 T.C.M. (P-H) (1974).)

Here, appellant has not shown that his friend had an absolute obligation to repay the money. Repayment was contingent upon the friend becoming "gainfully employed." Even though the friend indicated in his 1978 letter that he had started a business, there is no evidence in the record demonstrating that the parties had agreed that the contingency had occurred. Moreover, appellant has not shown that the friend was ever in a position to repay him. Where the contingency is ambiguous and the decision to repay appears to rest in the discretion of the recipient, a valid debt cannot arise for tax purposes. (Jove v. Commissioner, ¶ 75,155 T.C.M. (P-H) (1975).) Furthermore, we question whether appellant ever intended to earnestly seek repayment, for he has stated that he did not commence collection action because it was not cost effective to do so and he did not want to embarrass a friend. Therefore, we must conclude that appellant has not proven all the elements of a bona fide debt in connection with this personal advance. Since we have concluded that the advance in question was not a bona fide debt, it is not necessary to consider the secondary issue that it had not become worthless in the year claimed. Whereas appellant has not shown entitlement to any of the claimed bad debt deductions, we must sustain respondent's action in this matter.

Appeal of Robert F. and Hortense N. Seedlock.

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 Robert F. and Bortense N. Seedlock against proposed assessments of additional personal income tax in the amounts of $831.70, $586.06, and $861.00 for the years 1978, 1979, and 1980, respectively, 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.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9