BEFORE TEE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85R-1277-SW
GEORGE AND SANDRA JOENSON)

For Appellant: Alan E. Irish
Certified Public Accountant

For Respondent: David Len
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of George and Sandra Johnson for refund of personal income tax in the amount of $10,754 for the year 1983.

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

The sole issue presented in this appeal is whether appellants have shown that a worthless debt deduction in the amount of $100,000 is proper for taxable year 1983.

Appellant George Johnson owned a sole proprietorship known as Johnson Energy Labs.[2/] Sometime in 1983, JGA, a California general partnership engaged in the solar energy business, approached appellant and requested a $100,000 loan. JGA wanted to undertake a solar construction project, but lacked the necessary funds to finance the project. No collateral was offered for the loan, but profits were projected to reach $200,000. Appellant was informed that a third individual named Harold Dahl was soon to become a partner in JGA and that Dahl would add assets to the business. Once Dahl was a partner, JGA was to seek a loan from the Small Business Administration and appellant was to be repaid with this loan.

Although it soon become evident that Dahl would not be joining the partnership, on August 31, 1983, appellant made the loan of $100,000 to JGA. The loan stated that appellant was to be repaid within 90 days at an interest rate of 13 1/2 percent.

In November of 1983, appellant was informed by Mike James, one of the principals in JGA, that JGA would not be able to repay its note. Appellant made several personal attempts to collect on the note, but took no legal action as he considered such action to be futile. JGA filed for bankruptcy in February of 1984.

In December of 1984, appellant filed an amended return for taxable year 1983 and claimed a $100,000 bad debt loss. Respondent denied the claim on the basis that the debt had not been shown to be worthless in taxable year 1983. Appellant contends that by the end of 1983 he knew that JGA would not be able to pay the note after personal collection attempts failed. Appellant further contends that this establishes 1983 as the year of worthlessness.

2/ Sandra Johnson is a party to this appeal solely because she filed a joint return with George Johnson. Accordingly, references to appellant are references to George Johnson.

For taxable years beginning on or after January 1, 1983, the state deductions for bad debts are the same as those allowed by the Internal Revenue Code. (Rev. & Tax. Code, § 17201.) Internal Revenue Code section 166 provides that a bad debt deduction will be allowed for any debt which becomes worthless within the taxable year. As with any deduction from gross income, the taxpayer has the burden of proving entitlement to the deduction. (Appeal of Donald E. and Judith E. Liederman, Cal. St. Bd. of Equal., Oct. 26, 1983.) The first burden required of appellant in this case is to show that the debt is a bona fide debt. Although the facts of this appeal appear to indicate that a prudent businessman would not have made the loan, we will assume, without deciding, that a valid debtor-creditor relationship was created. We cannot conclude, however, that appellant has met his second burden of proving that the debt became worthless in 1983. (See Appeal of Frank and Enedina Leon, Cal. St. Bd. of Equal., May 8, 1984.) Before appellant will have met this burden of proof, he must show that the debt had some value at the beginning of the year in which the deduction is claimed and that some event occurred during the year which caused the debt to become worthless. (Appeal of Myron E. and Daisy Miller, Cal. St. Bd. of Equal., June 28, 1979.) The facts available show that in November of 1983, one of the principals of JGA verbally, and then subsequently in writing, informed appellant that the partnership could not repay the loan. The partnership did, however, remain in business through 1983. Appellant did not, once informed of JGA's financial problems, take any legal action on the note to enforce collection. In February of 1384, JGA filed for bankruptcy..[3/] These facts show that appellant did not take any assertive legal action to enforce payment in 1983. We have historically held that mere nonpayment of a debt does not by itself establish a debt's worthlessness and that a taxpayer's failure to take reasonable steps to enforce collection, regardless of the motive, does not justify a bad debt deduction unless there is proof that those steps would have been futile. (Appeal of Samuel and Shirley Chess, Cal. St. Bd. of Equal., July 30, 1985.) Appellant has presented no evidence that in November of 1983, JGA had no assets. A debtor's own declaration that it is unable to pay is

3/ It is not known whether appellant filed a claim with the bankruptcy court.

insufficient to establish the worthlessness of the debt. (Appeal of H.J. and **Lillyan** Tanenbaum, Cal. St. **Bd.** of Equal., Apr. 7, 1964.)

Given the information discussed above, we must conclude that respondent acted properly in denying the bad debt deduction as appellant has failed to carry his burden of proof. The action of respondent must be sustained.

Appeal of George and Sandra Johnson

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 1-9060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of George and Sandra Johnson for refund of personal income tax in the amount of $10,754 for the year 1983, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of July ,1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9