

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:) OTA Case Nos. 20025808, 20025815
RORB, INC. AND)
R. ORBAN)
 _____)

OPINION

Representing the Parties:

For Appellants: Donald L. Williamson, CPA

For Respondent: Nathan H. Hall, Tax Counsel III

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

N. DANG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Rorb, Inc. (Rorb) and R. Orban (collectively, appellants) appeal separate actions by the Franchise Tax Board (respondent): (1) reducing Rorb's reported net operating loss (NOL) by \$1,528,229 for the 2012 tax year and; (2) proposing additional tax of \$176,677, a \$35,335.40 accuracy-related penalty, plus applicable interest for R. Orban's 2012 tax year.

These matters were consolidated for decision by the Office of Tax Appeals, and we decide them based on the written record because appellants waived their right to an oral hearing.

ISSUES

1. Whether Rorb is entitled to a bad debt deduction for the 2012 tax year.
2. Whether the accuracy-related penalty should be abated.

FACTUAL FINDINGS

1. Nabro Able, LLC (Nabro), a subsidiary of Circuit Research Labs, Inc. (CRL), was a manufacturer of radio broadcasting and communications equipment.
2. Nabro began operating in 2009 when it took over the business of its predecessor (either CRL or an entity related to CRL), which could no longer pay its bills and was facing bankruptcy. In 2010, due to the economic downturn and strong competition, Nabro itself began experiencing significant financial difficulties resulting in its primary supplier terminating Nabro's line of credit and putting it on a cash-on-delivery basis.
3. To assist Nabro with what was then assumed to be a temporary business downturn, between July 2010 and August 2010, R. Orban made three cash loans to Nabro which collectively totaled \$150,000. For each loan, Nabro executed a substantially identical promissory note bearing 3 percent interest per annum with a maturity date of December 31, 2010.
4. Later, between November 2011 and October 2012, R. Orban made 10 additional cash loans to Nabro, which collectively totaled \$858,116.50. For each of the 10 loans, Nabro executed a substantially identical promissory note bearing 3 percent interest per annum with a maturity date of December 31, 2012.
5. Excepting the November 21, 2011 promissory note, these aforementioned promissory notes also included an authenticated security agreement granting R. Orban a security interest in all Nabro's assets.
6. In 2010, R. Orban formed a wholly-owned S Corporation, Rorb, to assist Nabro with inventory financing. Instead of lending funds to Nabro directly, Rorb acted as a middleman, purchasing products from Nabro's suppliers and reselling them to Nabro on credit. As a result of its sales to Nabro, by the end of 2012, Rorb accrued an unpaid account receivable balance of \$521,112.
7. On December 20, 2012, R. Orban assigned the above-mentioned 13 promissory notes to Rorb. The unpaid principal balance on the 13 promissory notes when they were assigned totaled \$1,007,117.
8. At about the same time, Rorb sent Nabro a letter dated December 19, 2012, demanding full payment by December 26, 2012, of the outstanding balance owed under the 13 promissory notes and the account receivable balance of \$521,112.

9. In response, Nabro sent Rorb a letter dated December 24, 2012, stating that Nabro was unable to repay even a small portion of the debt owed to Rorb. Nabro also stated that if forced to, it would seek bankruptcy protection, and in that situation appellants' unsecured debt would remain unpaid because there were insufficient assets available to cover the debt owed to Nabro's secured creditor and its employees.
10. As of December 31, 2012, Nabro's balance sheet reflected: (1) total assets of \$3,592,563 comprised primarily of \$2,224,177 in intercompany receivables and \$1,158,535 in raw material inventory; (2) total liabilities of \$4,612,117 comprised primarily of \$558,310 in accounts payable, a \$1,680,681 note payable to R. Orban, and a \$2,220,170 note payable to "J Brentlinger" (Brentlinger note); and (3) negative shareholder equity of \$1,019,554.
11. As of December 31, 2013, Nabro's balance sheet reflected a decline in the book value of the intercompany receivables and raw material inventory to \$1,148,636 and \$1,153,157, respectively. Negative shareholder equity increased to \$2,055,400.
12. As of December 31, 2014, Nabro's balance sheet reflected another decline in the book value of the intercompany receivables and raw material inventory to \$173,379 and \$865,550, respectively. Negative shareholder equity increased to \$4,223,261.
13. On December 31, 2014, Nabro terminated business operations.¹
14. On January 1, 2015, Nabro transferred its intellectual property and various physical assets related to the production and sale of its products to a related entity, which sold these assets for an undisclosed amount sometime in 2016.
15. On its 2012 California S Corporation Franchise or Income Tax Return, Rorb, an accrual method taxpayer, reported a business bad debt deduction of \$1,528,229 (\$521,112 account receivable balance + \$1,007,117 total unpaid principal balance remaining on the 13 promissory notes) and a net loss of \$1,572,614 for the 2012 tax year, which flowed through to its single shareholder R. Orban's 2012 California individual income tax return.
16. R. Orban's gross income for the 2012 tax year, which included a \$1,437,013 taxable IRA distribution, was wholly offset by this net loss.
17. Respondent audited appellants' 2012 returns resulting in a denial of Rorb's business bad debt deduction of \$1,528,229. Respondent thereafter issued a Notice of Proposed

¹ Nabro also stated that it considered the debts owed to Rorb effectively cancelled as of this date.

Adjustment Carryover Amount to Rorb for the 2012 tax year, which reduced Rorb's NOL carryover by \$1,528,229. Respondent also issued a Notice of Proposed Assessment to R. Orban for the 2012 tax year, which set forth an additional tax of \$176,677, an accuracy-related penalty of \$35,335.40, plus applicable interest.

18. Appellants unsuccessfully protested these proposed items with respondent, and these timely appeals followed.

DISCUSSION

Issue 1: Whether Rorb is entitled to a bad debt deduction for the 2012 tax year.

California conforms to Internal Revenue Code (IRC) section 166 which allows taxpayers to deduct against ordinary income, business debts which becomes worthless within the taxable year. (R&TC, § 17201(a).)

Debts become worthless when the taxpayer has no reasonable expectation of repayment. (*Crown v. Commissioner* (1981) 77 T.C. 582, 598.) There is no precise standard for determining worthlessness. (*Ibid.*) Instead, the determination of worthlessness is to be made based upon all the particular facts and circumstances of each case. (*Ibid.*) Some objective factors considered by the courts in determining worthlessness, with no single factor being dispositive, include: the subordinated status of the debt; a decline in the debtor's business; a decline in the fair market value of the collateral securing the debt; claims of prior creditors far in excess of the fair market value of all assets available for payment; the overall business climate; the debtor's earning capacity; the debtor's serious financial reverses; guarantees on the debt; events surrounding the default; insolvency of the debtor; the obligor's refusal to pay; abandonment of the debtor's assets or business; death, illness, or disappearance of the debtor's principals; bankruptcy; collection actions taken by the taxpayer; subsequent dealings between the creditor and debtor; and lack of assets. (*American Offshore, Inc. v. Commissioner* (1991) 97 T.C. 579, 594-595.)

Taxpayers bear the burden of establishing that the debt became worthless in the year it was deducted. (See *Appeal of Vardell*, 2020-OTA-190P [deductions are a matter of legislative grace and the taxpayer bears the burden of proving entitlement to such deduction].) Generally, to demonstrate the worthlessness of a debt, the taxpayer must identify some event indicating that it was reasonable for the taxpayer to abandon any hope of repayment. (*John v. Commissioner*, T.C. Memo. 2004-257.) While subsequent events may be used to evaluate the reasonableness of

the taxpayer's belief that a debt became worthless in the year claimed, they are not evidence of worthlessness itself. (*American Offshore, Inc. v. Commissioner, supra.* at p. 597.)

Appellants argue that it was reasonable for Rorb to write off the 13 promissory notes and the account receivable balance in 2012 because: (1) Nabro's rapidly declining financial condition rendered it incapable of ever repaying these debts; and (2) collection efforts against Nabro would have been futile.

The record shows that by the end of 2012, Nabro was undoubtedly a company in financial distress. In 2010, Nabro began to experience a significant financial decline due to a general economic downturn and strong competition. Although appellants lent large sums to Nabro to help sustain its business from 2010 through October of 2012, the expected turnaround failed to materialize. This is evidenced by Nabro's year-end balance sheet reflecting a substantial accumulated deficit in 2012, which increased nearly four-fold when the business ceased operations in 2014. This suggests that during this period, Nabro operated at a continuing loss which was severe enough to force the cessation of its business operations shortly thereafter, and that as a result, it did not possess sufficient income with which to pay its debts to Rorb. Indeed, at the end of 2012, Nabro stated to Rorb that it was unable to repay even a small portion of the amount owed, and there is no evidence indicating that Rorb ever received any payments from Nabro after 2012. While taxpayers should exercise sound business judgment in assessing whether a debt is worthless, they are not required to be incorrigible optimists. (*Dustin v. Commissioner* (1969) 53 T.C. 491, 503.) Based on the foregoing, we find it was reasonable for Rorb to conclude at the end of 2012 that no voluntary repayment would be forthcoming.

However, the mere fact that a debtor is experiencing financial difficulties or refuses to pay upon demand is insufficient to establish that a debt is worthless. (*Production Steel, Inc. v. Commissioner*, T.C. Memo. 1979-361; *Sutherland v. Commissioner*, T.C. Memo. 1991-619.) To establish worthlessness, taxpayers must also demonstrate that collection efforts against the debtor were, or would have been, futile. (*John v. Commissioner, supra.*)

We consider whether there were sufficient facts available in 2012 to justify Rorb's belief that the debts at issue were uncollectible. Respondent points out that, as of December 31, 2012, Nabro's balance sheet shows it had ample assets to fully cover the debts it owed to Rorb. We agree with respondent's reasoning that this is a strong indicator that these debts were not worthless in 2012. Although Nabro's balance sheet shows that it was insolvent (i.e., its liabilities

exceeded its assets), “Secured creditors often recover the full amount of their debt from an insolvent debtor, and unsecured creditors often recover a significant fraction, at least, of what they are owed by such a debtor.” (*Buchanan v United States* (7th Cir. 1990) 87 F.3d 197, 200.) Appellants counter however that the book value of Nabro’s assets was illusory and did not accurately reflect the reality of any potential collection action against it.

Appellants assert that not only were Nabro’s debts to Rorb unsecured,² but they were subordinate to the much larger Brentlinger note, making the majority of Nabro’s assets unavailable to Rorb. Appellants further argue the fair market value of Nabro’s assets as of December 31, 2012, was significantly lower than the amount shown on Nabro’s balance sheet because Nabro had “no reasonable expectation” of collecting the \$2,224,177 in intercompany receivables or recouping the full value of the \$1,158,535 in raw materials, as demonstrated by a large year over year decline in the book value of these assets from 2012 to 2014.

We first address the issue of priority. The record indicates that both appellants and Nabro considered the Brentlinger note to be secured debt. However, there is no corroborating evidence, such as an authenticated security agreement, indicating that the Brentlinger note was secured by Nabro’s assets. Nevertheless, until it is perfected, a security interest is insufficient to grant a creditor priority over a subsequently filed or perfected notice of judgment lien or security interest. (Code Civ. Proc., § 697.590(b).) Appellants did not produce any evidence showing that “J Brentlinger,” or any other individual or entity, had perfected a security interest in Nabro’s assets. Instead, appellants provide a UCC-1 financing statement filed with the Arizona Secretary of State on November 13, 2013, showing that the “C. Jayson Brentlinger Family Limited Partnership” (Brentlinger FLP) perfected a security interest in the assets of Nabro’s parent company, CRL.

This document is insufficient to demonstrate that Nabro’s assets were subject to a senior lienholder as of December 31, 2012. The Brentlinger FLP’s security interest was perfected well after December 31, 2012, and therefore, it is not relevant to establishing the priority of any liens against Nabro’s assets as of that date. Moreover, appellants do not explain, and we fail to see, how the Brenglinger FLP’s lien on CRL’s assets extends to Nabro’s assets. “[I]n accordance with basic personal property conveyancing principles, the basic rule is that a security interest

² Appellants assert that the security agreement contained in the promissory notes was inadvertently added due to the use of boilerplate language and that Nabro did not intend to grant any security interest to R. Orban.

attaches only to whatever rights a debtor may have, broad or limited as those rights may be.” (Com. Code, § 9203, comment 6.) While it is true that CRL’s assets included a membership interest in Nabro, the ownership of Nabro is distinct from the ownership of its assets. (*Dole Food Co. v. Patrickson* (2003) 538 U.S. 468, 475 [“A corporate parent which owns the shares of a subsidiary does not, for that reason alone, own or have legal title to the assets of the subsidiary”].) There is no evidence indicating that CRL directly owned any of Nabro’s assets. Accordingly, we find that appellants have not shown that the debts owed to Rorb were subordinate to the Brentlinger note, or any other debt. Thus, we need not consider this note in determining whether Nabro had sufficient assets to satisfy the debts it owed to Rorb.

Next, we examine the worth of Nabro’s assets as of December 31, 2012. Appellants did not provide any evidence to support their contention that, in 2012, Nabro’s intercompany receivables were uncollectible or that the fair market value of its raw materials was substantially less than book value. While Nabro’s year-end balance sheet for 2013 and 2014 do show a large year over year decrease in the book value of these assets, there is no indication of the specific cause of this decline or its relevance to establishing the fair market value of Nabro’s assets in 2012. We therefore find this evidence to be of little probative value. In addition, for a debt to be considered worthless, the taxpayer must also show that it lacks future value. (*Dustin v. Commissioner, supra.*) The record shows that Nabro’s assets were eventually sold in 2016, indicating that those assets, four years later, had retained value which might have been used to satisfy the debts owed to Rorb. Accordingly, we find there is no reasonable basis to support Rorb’s belief that collection efforts against Nabro would have been futile.

In summary, we find that although it was reasonable for Rorb to conclude that Nabro would not voluntarily repay its debts owed to Rorb, based upon all the facts and circumstances known on December 31, 2012, there is insufficient evidence to establish that collection efforts against Nabro would have been futile, and thus, that the debts at issue had become worthless in 2012.³ Consequently, Rorb is not entitled to a bad debt deduction for that year.

³ Because we find that there is insufficient evidence to demonstrate that the debts at issue became worthless in 2012, it is not necessary to address whether they constitute bona fide debts (as conceded by respondent) or were business or nonbusiness debts.

Issue 2: Whether the accuracy-related penalty should be abated.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment attributable to: (1) negligence or disregard of rules and regulations; or (2) any substantial understatement of income tax. (IRC, § 6662(b).)

Respondent states that it imposed the accuracy-related penalty against R. Orban on the bases of (1) negligence and (2) a substantial understatement. For an individual, there is a “substantial understatement of income tax” when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or \$5,000. (IRC, § 6662(d)(1).)

The accuracy-related penalty based on a substantial understatement may be reduced or abated, however, if the taxpayer can show: (1) there is substantial authority for his reporting position; (2) his position was adequately disclosed in the tax return (or a statement attached to the return)⁴ and there is a reasonable basis for treatment of the item; or (3) that he acted in good faith and had reasonable cause for the understatement.⁵ (IRC, §§ 6662(d)(2)(B), 6664(c)(1); R&TC, § 19164(d).)

We find above that Rorb is not entitled to its claimed bad debt deduction for the 2012 tax year. As a direct consequence, R. Orban’s tax liability increased by \$176,677. Appellants do not dispute that this constitutes a substantial understatement of tax. Instead, R. Orban asserts that the accuracy-related penalty (whether imposed on the basis of negligence and/or a substantial understatement) should be abated because he “consulted with knowledgeable, experienced, and respected professionals” (i.e., a CPA and a tax attorney) who each separately agreed with the “legitimacy and timing of the write-off in 2012.”

Other than his unsupported assertions, R. Orban has not provided any evidence (emails, letters, declarations from the CPA and/or tax attorney) demonstrating the specific advice

⁴ To qualify as an adequate disclosure, Treasury Regulations generally require that the taxpayer disclose the details of his or her position on either a Federal Form 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).)

⁵ A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer’s efforts to assess the proper tax liability, the taxpayer’s knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).)


R. Orban allegedly received from the CPA and/or tax attorney and establishing when the specific advice was allegedly provided. Therefore, we cannot determine, among other things, if the advice was actually received, what the content of the advice was, and whether R. Orban reasonably relied on any such advice. In the absence of corroborating evidence, we decline to accept R. Orban’s unsupported assertions, and we find appellants have not shown that the penalty should be abated.

HOLDINGS


1. Rorb is not entitled to a bad debt deduction for the 2012 tax year.
2. The accuracy-related penalty should not be abated.

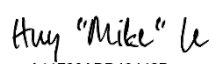
DISPOSITION

We sustain respondent’s actions in full.

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 Administrative Law Judge

We concur:

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 Cheryl L. Akin
 Administrative Law Judge

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 Huy "Mike" Le
 Administrative Law Judge

Dated: 11/24/2021