OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. BLACK AND** **T. BLACK**	OTA Case No. 19095223

OPINION

Representing the Parties:

For Appellants: J. Black and T. Black

For Respondent: Bradley J. Coutinho, Tax Counsel III
Ellen Swain, Tax Counsel IV

For Office of Tax Appeals: David Kowalczyk, Tax Counsel

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Black (appellant-husband) and T. Black (appellant-wife) (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $39,731, plus applicable interest, for the 2012 tax year.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Kenneth Gast, John O. Johnson, and Richard Tay held an electronic oral hearing for this matter on August 30, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for a decision.

ISSUE

Whether appellants have established error in FTB's proposed assessment for the 2012 tax year, which is based on a final federal determination.

[1] As discussed below, appellants only dispute additional tax on appellant-husband's alleged unreported income of $424,485.09, which consists of wages of $416,414.78 and his employee portion of payroll taxes on those wages of $8,070.31 that was reported by his former employer, RSB Vineyards, LLC.

FACTUAL FINDINGS

Appellant-Husband's Employment with RSB Vineyards, LLC (RSB)

1. S. Black is appellant-husband's brother. R. Black is appellant-husband's sister-in-law. S. Black and R. Black (collectively, Family) are married,[2] and they owned RSB, a family-run wine business located in California.
2. By 2011, as Family began to expand RSB's business, Family believed they needed to hire a sales and marketing person to sell their wine. Since RSB was a family-run business, Family sought to hire appellant-husband because he had many years of experience working in sales and marketing.
3. On May 1, 2011, RSB sent a letter to appellant-husband confirming an employment offer for him to be its Senior Vice President of Sales and Marketing. The letter is signed by R. Black and indicates that as part of his employment, appellant-husband would receive an annual salary of $130,000, a year-end bonus of $10,000, and could share in RSB's net profits. The letter also states RSB would provide additional benefits to appellant-husband, such as $300,000 in housing assistance, and pay for relocation and moving costs. Appellant-husband accepted the offer as an at-will employee, and he and his family moved from New Jersey to California around June 2011, when he began working for RSB.

Purchase of Appellants' California House

4. To help with appellants' move, Family purchased a residential house located in California for appellants (the California House).
5. On or about June 1, 2011, Family, through its trust, assigned a residential purchase agreement to appellants to purchase the California House.
6. On June 29, 2011, in a document entitled Buyer's Final Settlement Statement, appellants, who were listed as buyers, purchased the California House from a third-party seller. The funds used to purchase the California House came from Family, who are listed on the settlement statement as making two deposits into escrow totaling over $700,000 in

[2] To avoid confusion, and unless otherwise noted, S. and R. Black will be collectively referred to as Family since they share the same last name with appellants.

June 2011. Also on June 29, 2011, the third-party seller grant deeded the California House to appellants as joint tenants.

Prior to and After Appellant-Husband's Separation from RSB

7. Shortly before appellant-husband's separation from RSB, Family provided two promissory notes to appellants in April 2012, which was almost a year after appellant-husband began employment with RSB and purchased the California House. The notes are both dated April 6, 2012, and appellants are listed as borrowers and Family as payees. Collectively, the notes indicate appellants promised to pay back to Family a principal sum totaling $655,432.44, plus interest. Specifically, one note is for $248,000, with a 1.08 percent interest rate and maturity date of April 30, 2022, and the other is for $407,432.44, with a 2.62 percent interest rate and maturity date of April 30, 2032. The notes have various terms that are nearly identical, including for prepayment and a 7 percent interest rate in the event of default. The notes do not indicate their purpose other than stating, "For value received," or specify whether they are secured or unsecured. There is no mention of RSB, and the California House is only mentioned in the context of where appellants, as borrowers, resided at that time. After consulting with counsel,[3] appellants did not sign either promissory note.[4]

[3] Specifically, in an email dated May 10, 2012, apparently sent to Family's legal counsel or representatives, appellants' attorney indicated: the April 6, 2012 promissory notes "pose[] several significant problems for my clients [i.e., appellants]"; having appellants "[a]cknowledg[e] that they 'defaulted' on a non-existent loan is a non-starter"; and to move the matter to a resolution, "the agreements and conveyance will have to be structured along the lines of what was originally presented, with due allowances made for my clients' [i.e., appellants'] $300,000 housing allowance and the maximum gift amounts for 2011 and 2012."

[4] FTB submits a third promissory note dated June 16, 2011, which is almost a year prior to the two other notes from April 6, 2012, and closer in time to when appellants moved to California and purchased the California House. The June 2011 note lists appellants as "maker" and Family as "holder." The note indicates appellants promised to pay back to Family a principal sum of $700,822.44, with a 0.46 percent interest rate and no stated maturity date. The June 2011 note also indicates appellants were required to make a payment within 10 days after Family issued a demand for payment, and further states Family shall have the right to institute legal proceedings against appellants to collect the amounts due if not paid. Unlike the April 2012 notes, this note references it "is secured by that certain deed of trust" dated from 2012, and "executed and delivered by Maker, as trustor, and naming Holder, as beneficiary, which encumbers the real property more particularly described therein." However, the June 2011 note does not provide any additional detail surrounding the deed of trust or a description of the real property it encumbered. Like the April 2012 notes, the June 2011 note does not indicate its purpose, does not mention RSB, only specifically mentions the California House as appellants' mailing address at that time, and is unsigned by appellants. Although appellants contend they never received the June 2011 note, that issue does not need to be addressed to resolve this appeal.

8. Also, shortly before appellant-husband's separation, appellants and RSB (specifically, R. Black) exchanged several written communications.
    a. In an email dated April 16, 2012, with a subject of "Layoff Recap," R. Black informed appellant-husband he will lose certain benefits associated with working for RSB. There is no mention of the California House.
    b. In an email dated April 18, 2012, which R. Black sent to appellant-wife, R. Black stated the following in relevant part: "We are bound by law to report all gifts made to family"; "We have asked our attorneys and accountants to step in so that you and [appellant-husband] are not hit with a huge tax bill"; "You sign the promissory note for the $248,000.00 and we continue to make a yearly internal book entry for the maximum allowed by the IRS. No further severance will be given, the house is completely yours and the matter is closed"; and "These documents will not be open to negotiation since we are asking that they do what is necessary so that you are not subject to taxes and/or penalties where the house is concerned."
    c. In an email dated May 16, 2012, R. Black informed appellant-husband that his last paycheck would be processed. She also stated "the [California House] is yours," she would be cancelling the California House's dedicated phone line and alarm monitoring service, and appellant-husband could set up his own alarm service account.
    d. In a letter dated May 17, 2012, R. Black reiterated to appellant-husband that the alarm system was purchased and "remains with your home."
9. On May 31, 2012, appellant-husband separated from his employment with RSB.[5] This was memorialized in a document entitled Separation Agreement and General Release. The separation agreement states appellant-husband would receive all compensation due to him and does not specifically mention the California House.
10. In August 2012, after appellant-husband's separation from RSB, appellants sold their California House for over $700,000 and kept the proceeds.

[5] The record contains conflicting assertions by Family and appellant-husband regarding why he separated from his employment. However, that issue does not need to be addressed to resolve this appeal.

11. On November 5, 2012, also after appellant-husband's separation, RSB sent a letter to him notifying him of changes it intended to make to his Form W-2 for the 2011 and 2012 tax years.
    a. For the 2011 tax year, RSB issued a corrected 2011 Form W-2 that reported as additional taxable compensation the $300,000 in housing assistance from his employment offer, plus his employee portion of the payroll taxes on the $300,000 that was reported by RSB.
    b. RSB also indicated it loaned appellant-husband $416,414.78 to purchase the California House and when he left RSB, he refused to repay the loan, sold the California House, and kept the proceeds from the sale. As a result, RSB concluded $424,485.09 (i.e., the $416,414.78, plus appellant-husband's employee portion of the payroll taxes of $8,070.31 on that amount that was reported by RSB) became part of his taxable compensation for the 2012 tax year. RSB reported that amount on his 2012 Form W-2,[6] but did not report it on his final paystub for 2012, which was previously issued in May 2012 and showed year-to-date earnings of $66,168 (rounded).

Procedural History

12. Appellants filed their 2012 joint California Nonresident or Part-Year Resident Income Tax Return, reporting only $66,168 of California source wages, which are the year-to-date earnings from appellant-husband's final paystub from RSB for 2012. Appellants did not include the additional income at issue of $424,485[7] that RSB reported on appellant-husband's 2012 Form W-2. On Form 3525,[8] which appellants attached to their California return, they asserted RSB improperly included the additional income on Form W-2 and RSB refused to correct it.

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[6] Although the record reflects a schedule showing how the $416,414.78 was computed, which appears to have been prepared by either Family or RSB, it is unclear how that amount relates to the purchase of appellants' California House. For example, the principal amounts in promissory notes from April 2012 and June 2011, and the June 29, 2011 Buyer's Final Settlement Statement that shows Family made two deposits into escrow totaling over $700,000, do not tie to the amount at issue and there is no documentation in the record reconciling all these figures, including the $300,000 in housing assistance.

[7] This is the additional income at issue of $424,485.09, which has been rounded to $424,485.

[8] Form 3525 can be used by an employee when the employer issues an incorrect Form W-2.

13. On their 2012 joint federal tax return, appellants also reported only $66,168 of wages from RSB. They attached Form 4852, the federal equivalent to California's Form 3525, making similar assertions to those on Form 3525.
14. The IRS reviewed appellants' 2012 federal tax return and issued several letters to RSB to confirm whether appellant-husband's 2012 Form W-2 was correct. The IRS received a reply from Family (specifically, R. Black) confirming the 2012 Form W-2 was correct. As support, R. Black attached the above-referenced letter dated November 5, 2012. The IRS then increased appellants' 2012 federal taxable income by, among other items, $424,485 of unreported wages from RSB, and assessed additional tax, plus interest.[9] Appellants did not notify FTB of these federal adjustments.[10]
15. Based on the federal assessment, FTB issued a Notice of Proposed Assessment (NPA) for the 2012 tax year that increased appellants' California taxable income by, among other items, the $424,485 at issue and proposed to assess additional tax of $39,731, plus interest. Appellants protested the NPA, and FTB issued a Notice of Action affirming it. This timely appealed followed.

DISCUSSION

Burden of Proof

A taxpayer shall concede the accuracy of a final federal determination to a taxpayer's income or state where the determination is erroneous. (R&TC, § 18622(a).) It is well settled that a deficiency assessment based on a federal adjustment to income is presumed to be correct and a taxpayer bears the burden of proving FTB's determination is erroneous. (*Appeal of Valenti*, 2021-OTA-093P.) Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) A preponderance of the evidence means the taxpayer must establish by documentation or other evidence the circumstances it asserts are more likely than not to be correct. (*Appeal of Estate of Gillespie*, 2018-OTA-052P, fn. 6.)

[9] Appellants assert they paid the federal assessment under protest and filed a refund claim for 2012, but they testified they did not prevail before the IRS because RSB did not issue a revised 2012 Form W-2 excluding the income at issue.

[10] It appears the IRS notified FTB of the federal adjustments.

Although FTB may base its proposed assessment on a final federal determination to the extent applicable under California law, it is not bound to do so and can conduct an independent investigation. (See Cal. Code Regs., tit. 18, § 19059(d); see also *Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.) Likewise, appellants can establish FTB's proposed assessment based on a final federal determination is incorrect. (See *Appeal of Surrey House, Inc.* (80-SBE-047) 1980 WL 4975.) However, in the absence of credible, competent, and relevant evidence showing FTB's determination is incorrect, it must be upheld. (*Appeal of Valenti*, *supra*.)

FTB received information from the IRS that it increased appellants' 2012 federal taxable income by, among other items, $424,485 of unreported wages from RSB. Based on this federal determination, FTB proposed to assess additional taxes, plus interest. Because there is no evidence to indicate the federal determination was adjusted or cancelled, FTB's proposed assessment is presumed correct and appellants bear the burden of showing it is erroneous.

Appellants argue the funds at issue of $424,485 were a nontaxable gift from Family, and RSB incorrectly reported that amount as additional taxable compensation on appellant-husband's 2012 Form W-2. FTB counters the funds were either taxable compensation for appellant-husband's services to RSB, or in the alterative, constitute cancellation of debt income. For reasons discussed below, OTA finds appellants have met their burden of showing the $424,485 was not taxable for the 2012 tax year.

Appellants are Not Taxable on $424,485 as Additional Compensation for the 2012 Tax Year

In general, California conforms to the federal definition of gross income under Internal Revenue Code (IRC) section 61.[11] (R&TC, § 17071.) That section provides that gross income means all income from whatever source derived, including compensation for services, such as fees, commissions, fringe benefits, and similar items. (IRC, § 61(a)(1).) On appeal, FTB primarily contends the funds at issue were taxable compensation to appellant-husband. It argues the funds were not a nontaxable gift because Family's intention was to compensate appellant-husband rather than bestow the California House upon appellants.

But even assuming, without concluding, the $424,485 was properly treated as additional compensation, a threshold question is whether appellants should have recognized it as income for

[11] For the 2012 tax year, California conformed to the version of the IRC as of a January 1, 2009 specified date. (R&TC, § 17024.5(a)(1)(O).)

the 2012 tax year, as FTB asserts, or the 2011 tax year. The amount of any item of income shall be included in gross income for the tax year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. (R&TC, § 17551(a); IRC, § 451(a).) Because appellants use the cash receipts and disbursement method of accounting, they must include items of income in their gross income when actually or constructively received. (Treas. Reg. § 1.451-1(a); R&TC, § 17024.5(d); see also IRC, § 448.) Income is constructively received in a tax year when it is credited to the taxpayer's account, set apart, or otherwise made available to be drawn upon at any time, and income is not constructively received if the taxpayer's control is subject to substantial limitations or restrictions. (Treas. Reg. § 1.451-2(a).)

FTB contends its proposed assessment correctly included the funds as income for the 2012 tax year, when they were constructively received, because appellant-husband's use of the funds was subject to substantial restriction for the 2011 tax year, which was repayment to Family, the payors. It argues most of the funds at issue were deposited into escrow in June 2011, to enable appellants to purchase the California House, and the first promissory note dated June 16, 2011, was issued for appellants to review with the intent the funds would be repaid once appellants were settled in California. FTB concludes the restriction on the funds continued until October 2012, because (1) appellants were again issued two promissory notes in April 2012, (2) R. Black, in a May 14, 2020 letter to FTB, stated she believed repayment would occur when the California House was sold in August 2012, and (3) in that same letter, R. Black stated that in October 2012, after consulting with professional advisors, Family decided not to pursue collection efforts against appellants. FTB also asserts that unlike the $300,000 in housing assistance, the funds at issue cannot be considered income for the 2011 tax year because they were not an incentive for appellants to move to California and they were not commensurate with appellant-husband's job performance in June 2011. Rather, as FTB maintains, the funds were intended to establish a long-term employment relationship that deteriorated in 2012.

However, OTA finds that even if the $424,485 is properly treated as taxable compensation, it should have been recognized as such for the 2011, not 2012, tax year. Specifically, on June 29, 2011, the Buyer's Final Settlement Statement shows appellants, who were listed as buyers, purchased the California House from a third-party seller. The funds used to purchase the California House came from Family, who are listed on the settlement statement

as making two deposits into escrow totaling over $700,000 in June 2011. Also on June 29, 2011, the third-party seller deeded the California House to appellants as joint tenants. Therefore, contrary to FTB's argument, the relevant, undisputed facts indicate appellants did not constructively receive the funds in 2012, because they had *actual receipt* of the funds at issue in 2011, when they received the deed to, and thus had unfettered control and possession over, the California House. (Cf. *Hornung v. Commissioner* (1967) 47 T.C. 428 [car given as prize at year end but unavailable to the taxpayer until following year and therefore no constructive receipt in first year].)

FTB appears to be really arguing the funds were a loan from Family to appellants because it asserts "the funds were subject to substantial restriction [until 2012], which was *repayment* to the payors, [Family]." (Italics added.) The debt discharge argument is addressed next, but to the extent FTB intends to assert the funds were an advance payment to appellant-husband for services to be performed in the future, it is well settled that such an advance is taxable income at the time of payment, even if appellant-husband was obligated to repay the advance in the event he failed to perform future services. (See *Beaver v. Commissioner* (1970) 55 T.C. 85; Rev. Rul. 79-311, 1979-2 C.B. 25; *Appeal of Beam* (78-SBE-042) 1978 WL 3956.) Accordingly, assuming the funds at issue are properly treated as compensation to appellants, that income should have been taxed when appellants received it in 2011, not in 2012.

Appellants Did Not Receive $424,485 of Cancellation of Debt Income for the 2012 Tax Year

Alternatively, FTB argues the $424,485 constituted a loan from Family to appellants, and Family discharged that loan in 2012, resulting in taxable cancellation of debt (COD) income for that tax year. Appellants disagree and assert no debt existed and therefore the $424,485 was a nontaxable gift from Family to them.[12] (See IRC, § 102(a).)

Gross income includes income from the discharge of indebtedness (i.e., COD income). (R&TC, § 17071; IRC, § 61(a)(12).) The rationale for including COD income in gross income is to the extent a taxpayer has been released from indebtedness, the taxpayer has realized additional income because the cancellation of indebtedness effects a freeing of assets previously offset by the liability. (*Appeal of Johnson*, 2022-OTA-166P.) COD income is generally recognized in the year the debt is cancelled. (*Ibid.*)

[12] Appellants do not assert that if the funds are found to be taxable COD income, the income is nonetheless excluded from gross income under IRC section 108.

However, for COD income to exist, there must be bona fide debt. (*Bullock v. Commissioner*, T.C. Memo. 2017-219.) "[T]he parties to the transaction must have had an actual, good-faith intent to establish a debtor-creditor relationship at the time the funds were advanced." (*Dufresne v. Commissioner*, T.C. Memo. 2019-93.) "An intent to establish a debtor-creditor relationship exists if the debtor intends to repay the loan *and* the creditor intends to enforce the repayment." (*Ibid*., italics added; see also *Fisher v. Commissioner* (1970) 54 T.C. 905 [same].)

Whether a transaction constitutes debt is a factual determination, and the ultimate question is whether there was a genuine intention to create debt with a reasonable expectation of repayment and did that intention comport with the economic reality of creating a debtor-creditor relationship. (*Bullock v. Commissioner*, *supra*.) Intrafamily transactions are subject to special scrutiny, and the presumption is that a transfer between family members is a nontaxable gift to the recipient. (*Estate of Lockett v. Commissioner*, T.C. Memo. 2012-123.) This presumption may be rebutted by an affirmative showing that at the time of the transfer, the transferor had a real expectation of repayment and an intention to enforce the debt. (*Estate of Van Anda v. Commissioner* (1949) 12 T.C. 1158, 1162, affd. *per curiam* (2d Cir. 1951) 192 F.2d 391; *Estate of Lockett v. Commissioner*, *supra*.)

The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) there was a promissory note or other evidence of indebtedness; (2) interest was charged; (3) there was any security or collateral; (4) there was a fixed maturity date; (5) a demand for repayment was made; (6) any actual repayment was made; (7) the transferee had the ability to repay; (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and (9) the manner in which the transaction was reported for federal tax purposes is consistent with a loan. (*Estate of Lockett v. Commissioner*, *supra*; see also *Dufresne v. Commissioner*, *supra* [employing similar factors]; *Welch v. Commissioner* (9th Cir. 2000) 204 F.3d 1228 [same].) No one factor may be determinative. (*Estate of Lockett v. Commissioner*, *supra*.)

There is no dispute Family deposited the funds at issue into escrow in 2011 to purchase the California House for appellants and thus a transfer of property (i.e., the funds) occurred between family members. Consequently, that transfer is presumed to be a gift from Family to

appellants, unless the record establishes Family had a real expectation of repayment and intended to enforce the debt at the time of the transfer.[13] (*Estate of Lockett v. Commissioner*, *supra*; *Estate of Van Anda v. Commissioner*, *supra*.) As discussed next, seven of the nine factors weigh in favor of finding, more likely than not, the funds were not a loan from Family to appellants. Although no one factor is determinative, factors one and eight strongly suggest no bona fide debt existed and there was no resulting taxable COD income.

1. Whether There Was a Promissory Note or Other Evidence of Indebtedness

Although interfamily loans are often informal arrangements which may not comply with all the customary legal formality that a commercial loan would (see *Zohoury v. Commissioner*, T.C. Memo. 1983-597), the facts do not show appellants intended to enter into a loan at the time the funds of $416,414.78 were advanced. The only evidence of indebtedness are three different unexecuted promissory notes for three different amounts: one is dated June 16, 2011, which was purportedly given to appellants around the time they moved to California and purchased the California House; and the other two are dated April 6, 2012, which were given to appellants shortly before appellant-husband separated from RSB and almost a year after the purchase of the California House.

But after consulting with counsel in or about May 2012, appellants did not sign any promissory note, which suggests they did not consider the funds to be a loan.[14] Specifically, in an email dated May 10, 2012, which was presumably sent to Family's legal counsel or representatives, appellants' attorney indicated: the April 6, 2012 promissory notes "pose[] several significant problems for my clients [i.e., appellants]"; having appellants

[13] For purposes of its alternative COD income argument, FTB does not appear to dispute the funds came from Family, even though Family may have used the funds to benefit RSB by incentivizing appellant-husband to move from New Jersey to California to work for RSB. Therefore, the rebuttable presumption that those funds were a nontaxable gift to appellants applies. Indeed, OTA notes that aside from the November 5, 2012 letter that RSB sent to appellant-husband after his separation that explicitly states he was loaned funds to buy a house, and his 2012 Form W-2 issued by RSB that reports the funds as additional compensation, none of the contemporaneous documents in the record (e.g., assigned residential purchase agreement, Buyer's Final Settlement Statement, grant deed, June 2011 and April 2012 promissory notes, May 2011 confirmation of employment offer) ever mention RSB was involved in the transfer of the $416,414.78 at issue. In fact, even the schedule, prepared by either Family or RSB, that shows how the $416,414.78 was computed explicitly states the funds were a "*private loan* from [Family]." (Italics added, original caps omitted.)

[14] In her letter to FTB dated May 14, 2020, R. Black also acknowledges appellants refused to sign any of the promissory notes.

"[a]cknowledg[e] that they 'defaulted' on a *non-existent loan* is a non-starter"; and to move the matter to a resolution, "the agreements and conveyance will have to be structured along the lines of what was originally presented, with due allowances made for my clients' [i.e., appellants'] $300,000 housing allowance and the maximum *gift* amounts for 2011 and 2012." (Italics added.)

Accordingly, there is no objective evidence in the record establishing appellants entered into a loan with Family to purchase the California House. Indeed, the three unexecuted promissory notes themselves never mention their purpose—let alone a purpose for Family to lend appellants funds to buy the California House. Thus, this factor does not weigh in favor of bona fide debt.[15] OTA notes that even though the promissory notes are unsigned, their contents will still be considered for purposes of rendering a complete analysis of the remaining factors.

2. Whether Interest Was Charged

Interest and a fixed repayment schedule are characteristics of a true debtor-creditor relationship. (*Haag v. Commissioner* (1987) 88 T.C. 604; *Frierdich v. Commissioner* (7th Cir. 1991) 925 F.2d 180.) Here, the June 16, 2011 promissory note includes an interest rate of 0.46 percent, and the two April 6, 2012 promissory notes include interest rates of 1.08 and 2.62 percent, respectively. To be sure, it appears Family may have charged interest of $8,982.34 ($416,414.78 - $407,432.44) because the record contains a schedule, prepared by either Family or RSB, that states there was a "private loan from [Family] (not inclu. int)" of $407,432.44, the principal amount from one of the April 6, 2012 notes. (Original caps omitted.) Since the $416,414.78 (as well as the employee's portion of payroll taxes of $8,070.31) was included in appellant-husband's 2012 Form W-2 as additional compensation, it appears appellants were charged interest.

[15] During a hearing on August 29, 2012, involving an appeal of a California unemployment compensation issue related to appellant-husband's former employment with RSB, R. Black's testified she presented to appellants the April 2012 promissory notes almost a year after the June 2011 purchase of the California House because there was "no hurry" and she wanted appellants and their children to get "settled" after their move from New Jersey. R. Black further testified there was a "verbal arrangement that [appellant-husband] was going to pay us back the money for the loan." Also, according to her letter to FTB dated May 14, 2020, R. Black asserted Family purchased the California House without any signed agreements because appellants were "close family." But the lack of contemporaneous debt instruments weighs against the argument the parties intended to create bona fide debt. (See *Dufresne v. Commissioner*, *supra*.) In addition, it appears such verbal agreement was required to be in writing to be considered valid in California, and since it was not, this further supports no bona fide debt existed. (See Civ. Code, § 1624(a)(6) [under California's statute of frauds, an agreement by a purchaser of real property to pay an indebtedness that is secured by a mortgage or deed of trust ordinarily must be in writing and subscribed by the party to be charged]; see also *Dufresne v. Commissioner*, *supra* [finding, in part, purported loans between family members for purchase of real properties did not satisfy California's statute of frauds and thus no bona fide debt existed].)

However, there is no evidence in the record to establish Family informed appellants when they began to charge interest, what interest rate they used, and during what time period they computed interest. While it appears Family may have charged interest on one of the April 6, 2012 promissory notes, there is no evidence they charged the 7 percent default interest rate as required by that note if Family believed appellants were in default. Thus, this factor does not weigh in favor of bona fide debt.

3. Whether There Was Any Security or Collateral

The June 16, 2011 promissory note references it "is secured by that certain deed of trust" dated from 2012, and "executed and delivered by [appellants], as trustor, and naming [Family], as beneficiary, which encumbers the real property more particularly described therein." However, the June 2011 note does not provide any additional detail surrounding the deed of trust or a description of the real property it encumbered. In addition, the two April 6, 2012 promissory notes do not specify whether they are secured or unsecured. Thus, this factor does not weigh in favor of bona fide debt.

4. Whether There Was a Fixed Maturity Date

The June 16, 2011 promissory note does not specify a maturity date. However, one April 6, 2012 promissory note has a maturity date of April 30, 2022, and the other has a maturity date of April 30, 2032. Thus, this factor weighs in favor of bona fide debt.

5. Whether a Demand for Repayment Was Made

Although the November 5, 2012 letter that RSB sent to appellant-husband after his separation indicates he refused to repay the purported loan after he sold the California House and kept the proceeds, there is no evidence in the record establishing Family ever made a demand for repayment of the purported loan. In her letter to FTB dated May 14, 2020, R. Black explained that Family did not consider any legal options to obtain the funds back until approximately October 2012, when they decided not to pursue any such options against appellants because they were family, and they did not want to start a lengthy and expensive lawsuit. Thus, this factor does not weigh in favor of bona fide debt.

6. Whether Any Actual Repayment Was Made

Appellants never made any payments on the purported loan. Thus, this factor does not weigh in favor of bona fide debt.

7. Whether the Transferee (Appellants) Had the Ability to Repay

A taxpayer's ability to repay the borrowed funds is examined by whether there was a reasonable expectation of repayment in light of the economic realities of the situation. (*Fisher v. Commissioner* (1970) 54 T.C. 905.) Here, appellant-husband's salary was $130,000, he received a $10,000 bonus at the end of the year, he could share in RSB's net profits, and he had several fringe benefits. Therefore, it appears appellants had a reasonable prospect to repay the purported loan. Thus, this factor weighs in favor of bona fide debt.

8. Whether Any Records Maintained by the Transferor (Family) and/or the Transferee (Appellants) Reflected the Transaction as a Loan

The November 5, 2012 letter that RSB sent to appellant-husband after his separation that explicitly states he was loaned funds to buy a house, and a schedule, prepared by either Family or RSB, that shows how the $416,414.78 was computed, appear to be the only two records that reflect the purchase of the California House as a loan. However, the other documentary evidence in the record more persuasively suggests there was no bona fide debt.

As discussed above, although Family drafted three promissory notes, one dated June 16, 2011, and the other two dated April 6, 2012, those notes never state Family loaned appellants funds to buy the California House. Rather, the notes are silent as to their purpose. The funds of $416,414.78 are not mentioned in appellant-husband's employment offer from RSB, but the $300,000 in housing assistance, which is not at issue here, is explicitly mentioned. The Separation Agreement and General Release states appellant-husband would receive all compensation due to him but does not specifically mention the California House or any loan.

Critically, shortly before appellant-husband's separation, appellants and RSB (specifically, R. Black) exchanged several written contemporaneous communications that suggest the funds were not a loan. For example, in an email dated April 16, 2012, with a subject of "Layoff Recap," R. Black informed appellant-husband he will lose certain benefits associated with working for RSB, but there is no mention of the California House or a related loan. In an email dated April 18, 2012, which R. Black sent to appellant-wife, R. Black stated: "We are

bound by law to report *all gifts* made to family"; "We have asked our attorneys and accountants to step in so that you and [appellant-husband] *are not hit with a huge tax bill*"; and "You sign the promissory note for the $248,000.00 and we continue to make a yearly internal book entry for the maximum allowed by the IRS. No further severance will be given, *the house is completely yours* and the matter is closed." (Italics added.) In an email dated May 16, 2012, R. Black informed appellant-husband "the [California House] *is yours*," and in a letter dated May 17, 2012, R. Black reiterated to appellant-husband that the purchased alarm system "remains with *your home*." (Italics added.)

Therefore, although R. Black referenced a promissory note as if there were a loan, she mostly indicated the California House was appellants' and even seemed to describe the transaction as a "gift." This suggests either no loan existed or, at best, Family intended to convert the funds into a personal loan at some point in 2011 or 2012 but then annually forgive (or write-off) portions of that loan up to the annual maximum amount allowable as nontaxable gifts to appellants. (See IRC, § 102(a).) The May 10, 2012 email from appellants' attorney, discussed above, also supports the finding that appellants did not agree or intend to be indebted to Family for the purchase of the California House. Thus, this factor does not weigh in favor of bona fide debt.

9. Whether the Manner in Which the Transaction Was Reported for Federal Tax Purposes is Consistent with a Loan

Appellants did not report the funds as taxable on their 2012 joint federal or California income tax returns because they disputed those funds were compensation. The record does not indicate how, if at all, Family reported those funds for personal income tax purposes. RSB also did not report the $424,485.09 on appellant-husband's final paystub for 2012. In contrast, RSB did report this amount on his 2012 Form W-2 as additional compensation because, according to the November 5, 2012 letter, he "refused to re-pay the loan." In response to IRS inquiries, RSB confirmed this was the correct reporting. (See *Neff v. Commissioner*, T.C. Memo. 2012-244 [COD income can be considered compensation for employee services].) Therefore, because there were inconsistencies between how appellants and RSB reported the transaction and even how RSB itself reported it, this factor does not weigh in favor of bona fide debt.

Conclusion

Accordingly, whether the funds at issue were compensation for appellant-husband's services to RSB properly taxable for the 2011 tax year or a nontaxable gift from Family to appellants, appellants have shown, more likely than not, they are not taxable on those funds for the 2012 tax year.

HOLDING

Appellants have established FTB's proposed assessment for the 2012 tax year should not have included additional income of $424,485.

DISPOSITION

FTB shall recalculate its proposed assessment by excluding additional income of $424,485. FTB's action is otherwise sustained.

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
John O Johnson
873D9797B9E64E1...
John O. Johnson
Administrative Law Judge

DocuSigned by:
F8E81582726F448...
Richard Tay
Administrative Law Judge

Date Issued: 11/7/2022