OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **B. VALANI AND** **S. VALANI**	OTA Case No. 20066262

OPINION

Representing the Parties:

For Appellants: Sheikh M. Idrees

For Respondent: David Hunter, Tax Counsel IV

For Office of Tax Appeals: Tom Hudson, Tax Counsel III

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, B. Valani and S. Valani (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $442,998, and applicable interest, for the 2012 tax year.

Appellants waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellants have shown error in FTB's disallowance of a business bad debt deduction related to Trevira Holdings, LLC (Trevira).
2. Whether appellants have shown error in FTB's disallowance of an ordinary loss related to Bellflower Escrow (Bellflower).
3. Whether appellants have shown error in FTB's disallowance of a loss related to Choice Hotels International, Inc. (Choice Hotels).
4. Whether appellants have shown error in FTB's disallowance of flow-through losses related to GAC Rubicon Acquisition, LLC (Rubicon).

FACTUAL FINDINGS

1. Appellants are real estate brokers with significant real estate experience.
2. In 2000, appellants applied for a franchise agreement with Choice Hotels for the purpose of building a hotel. Appellants decided not to pursue the project and litigation arose between Choice Hotels and appellants. Pursuant to arbitration, appellants were ordered to pay $36,125 to Choice Hotels. In 2012, appellants wired $40,000 to a law firm in payment to Choice Hotels.
3. Trevira is a real estate holding company owned 98 percent by appellants' son and 2 percent by appellant-wife. In March 2012, appellants advanced $1,500,000 to the entity. Appellants stated the purpose of the advance was to enable Trevira to purchase specific real estate in London and stated their understanding that the deposit was nonrefundable. Appellants and Trevira executed a promissory note providing for interest and a fixed maturity date of September 2012. Ultimately, Trevira did not purchase the London real estate.
4. Bellflower was an escrow company operating as a C corporation, and was purchased by appellants' relative, A. Valani, in 2003.
5. Rubicon is a real estate holding company taxed as a partnership and owned equally by appellants.
6. Appellants filed their 2012 California income tax return claiming a business bad debt of $1,500,000 for a loan made to Trevira, a loss of $264,000 for their investment in Bellflower, a loss of $154,900 for their investment in Choice Hotels, and a loss of $1,328,646 for their investment in Rubicon.
7. FTB issued a Notice of Proposed Assessment (NPA) recharacterizing the Trevira advance as a nonbusiness bad debt, disallowing the Bellflower loss in full, disallowing $114,900 of the loss for Choice Hotels, and disallowing the loss for the investment in Rubicon in full, on the basis that appellants had not substantiated entitlement to the claimed deduction and losses. The NPA proposed additional tax of $442,998, plus interest.
8. Appellants protested the NPA. Appellants provided FTB copies of checks totaling approximately $164,000 to substantiate the claimed investment in Bellflower. The

checks were written by appellants' son and payable to him and/or appellants' relative, A. Valani.

9. Appellants provided FTB with copies of checks, none of which are cancelled or otherwise show payment, to support the claimed investment in Choice Hotels. Of the checks provided, all but two were written by appellants' son or one of his entities directly to Choice Hotels with no mention of appellants. The other two checks, totaling $20,000, were written by appellants to Lodging Unlimited.

10. During the audit and protest processes, FTB issued letter to appellants on October 20, 2015, and March 11, 2019, requesting evidence of collection actions taken by appellants. On April 15, 2019, appellants responded, stating that they did not make any formal demand for repayment or otherwise attempt to force repayment of the $1,500,000 advance.

11. FTB affirmed the NPA in a Notice of Action (NOA). FTB additionally determined that the advance of funds to Trevira was not a bona fide debt, and instead $30,000 of the amount was a contribution to capital and the remainder was a gift from appellants to their son.[1]

12. This timely appeal followed.

13. On July 22, 2022, appellants submitted into evidence three demand letters dated October 17, 2012, December 27, 2012, and March 11, 2013, addressed to Trevira requesting refund of a nonrefundable deposit in the amount of $1,500,000.

DISCUSSION

Issue 1: Whether appellants have shown error in FTB's disallowance of a business bad debt deduction related to Trevira.

The taxpayer bears the burden of establishing entitlement to any deductions claimed. (*Appeal of Dandridge*, 2019-OTA-458P.) Deductions are a matter of legislative grace, and a taxpayer bears the burden of proving entitlement to a deduction. (*Ibid*.) To support a deduction,

[1] The NOA also increased appellants' taxable income by $110,000 for a disallowed bad debt deduction. Appellants do not dispute this issue; therefore, it will not be addressed. The NOA also imposed a mental health services tax based on the revised taxable income and adjusted itemized deductions by $13,269 based on the revised adjusted gross income.

the taxpayer must establish by credible evidence, other than mere assertions, that the deduction claimed falls within the scope of a statute authorizing the deduction. (*Ibid.*)

Internal Revenue Code (IRC) section 166(a), to which California conforms under R&TC section 17201, allows a deduction for a business debt that becomes worthless within the taxable year. Only a bona fide debt qualifies for purposes of the bad debt deduction. (Treas. Reg. § 1.166-1(c).) A bona fide debt is "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (*Ibid*.) If the existence of a genuine debt cannot be established, the advance of funds, if any, may be considered a gift or a capital contribution, either of which is not a debt. (*Ibid*.) Whether a bona fide debtor-creditor relationship exists is a question of fact to be resolved in light of all the pertinent facts. (*Fisher v. Commissioner* (1970) 54 T.C. 905, 909.) Intrafamily transactions are subject to special scrutiny, and the presumption is that a transfer between family members is a nontaxable gift to the recipient. (*Appeal of Black*, 2023-OTA-023P.) 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. (*Ibid*.)

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 are consistent with a loan. (*Appeal of Black*, *supra*.) No one factor may be determinative. (*Ibid*.)

Appellants reported a business bad debt deduction in the amount of $1,500,000 in the 2012 tax year for an advance of funds to Trevira that was made in March 2012. FTB disallowed

the deduction and further asserted that the advance of funds was comprised of a $30,000 capital contribution to Trevira and the remaining amount was a gift from appellants to their son.[2]

Appellants have not provided evidence of a bona fide debt that became uncollectible in 2012. While appellants complied with the documentary formalities of a loan, including a debt instrument with interest and a fixed due date, no loan or interest payments were made, no security was provided, and appellants declared the debt worthless in a period of months. Appellants assert they did not attempt to enforce repayment because they understood that the funds were used to make a nonrefundable deposit. If the loan were a bona fide debt, the debtor would be required to repay the debt regardless of how it used the funds and repayment would not be contingent upon the success of the business endeavor. Alternatively, if appellants advanced funds without the expectation of repayment, then the advance does not constitute a bona fide debt.

No deduction may be allowed for a particular year if a bad debt became worthless before or after that year. (*Appeal of Kune* (84-SBE-106) 1984 WL 16186.) The standard for the determination of worthlessness is an objective test of actual worthlessness, a time which is fixed by an identifiable event or events that furnish a reasonable basis for a taxpayer to abandon any hope of future recovery. (*Appeal of Southwestern Development Company* (85-SBE-104) 1985 WL 15875.)

Even if it were a bona fide debt, appellants have not shown that debt became worthless in 2012. To the extent appellants assert that Trevira could not repay the loan because the funds were forfeit, no evidence has been presented that the funds were used as a deposit and there is no evidence that the deposit, even if made, would have been nonrefundable. No credible evidence has been presented that appellants engaged in any collection actions. The three demand letters provided by appellants raise additional questions as to their credibility, including why the letters were not provided by appellant during the audit or protest process in response to FTB's requests,

[2] Appellants assert that FTB changed its position during the protest period and that FTB subjected Trevira to cancellation of debt income in 2012, which is inconsistent with its new position. FTB states that it will make a corresponding adjustment to eliminate the cancellation of debt income assessment for Trevira and R. Valani at the shareholder level. In addition, a change in position by FTB from the NPA to the NOA does not invalidate the assessment. While FTB is required to timely issue a notice of proposed assessment advising a taxpayer of the basis for a proposed assessment, FTB's notices satisfied these statutory requirements. (R&TC, §§ 19033, 19034, 19057.) In addition, the change in position did not occur during appeal at OTA; therefore, there is no need to address whether it is a new matter that could shift the burden to FTB. (See, e.g., *Appeal of Mendelsohn* (85-SBE-141) 1985 WL 15923.)

why appellants stated that no efforts to collect were made, and why would appellants attempt to collect a debt in 2013 that they assert became uncollectible in 2012? In addition, there is no evidence that the letters were contemporaneously received by appellants' son. Therefore, appellants have not shown error in FTB's disallowance of a business bad debt deduction.

Issue 2: Whether appellants have shown error in FTB's disallowance of an ordinary loss related to Bellflower.

IRC section 165(g), to which California conforms under R&TC section 17201, provides that if any security, including stock issued by a corporation, which is a capital asset, becomes worthless during the tax year, the loss may be treated as a loss from the sale or exchange of a capital asset. The amount of loss is limited to the taxpayers' adjusted basis in the asset, meaning the cost of the property with adjustments. (IRC, §§ 165(b), 1011, 1012.)[3]

Appellants reported a loss of $264,000 for their investment in Bellflower in 2012. Appellants assert Bellflower was controlled by their relative, A. Valani, and that they learned in 2012 that the relative had abandoned the enterprise and moved abroad. As substantiation of their investment, appellants provided copies of three checks totaling approximately $164,000 and a purchase agreement. The purchase agreement states that A. Valani purchased Bellflower in 2003 and does not mention appellants. The checks were made out by appellants' son, and payable to him and/or A. Valani.

The checks provided by appellants do not substantiate that they made an investment in Bellflower or received an interest in the entity because the checks do not mention appellants or Bellflower. The amount of the checks is also less than the amount of loss asserted. Based on this, appellants have not shown error in the FTB's determination in this matter.

Issue 3: Whether appellants have shown error in FTB's disallowance of a loss related to Choice Hotels.

IRC section 165 allows a deduction for a loss sustained during a tax year that is not compensated for by insurance or otherwise.[4] The amount of the loss is based on the adjusted basis of the property. (IRC, § 165(b).) For individuals, any such loss is limited to losses incurred

[3] Pursuant to R&TC section 18031, California conforms to Subchapter O of Chapter 1 of Subtitle A of the IRC, relating to gain or loss on disposition of property, except as otherwise provided.

[4] Pursuant to R&TC section 17201, California conforms to IRC section 165.

in a trade or business or in a transaction entered into for profit, or certain losses arising from fires, storms, or other casualties, or theft. (IRC, § 165(c).) The taxpayer bears the burden of establishing entitlement to any deductions claimed. (*Appeal of Dandridge, supra*.) Deductions are a matter of legislative grace, and a taxpayer bears the burden of proving entitlement to a deduction. (*Ibid*.) To support a deduction, the taxpayer must establish by credible evidence, other than mere assertions, that the deduction claimed falls within the scope of a statute authorizing the deduction. (*Ibid.*)

Appellants reported a loss of $154,900 for their investment in Choice Hotels. FTB has allowed $40,000 of the loss and disallowed the remaining $114,900. To substantiate the amount of their investment, appellants provided copies of checks written by appellants' son or Martiz Properties, Inc., a C corporation wholly owned by appellant-husband, to Choice Hotels, and checks written by appellants to Lodging Unlimited. Appellants have not substantiated that the checks written by appellants' son represent their personal investment and should be included in their basis. Similarly, appellants have not substantiated that the checks to Lodging Unlimited constituted an investment in Choice Hotels. Notably, while appellants assert they were required to write checks out to Lodging Unlimited, a third-party broker, to invest in Choice Hotels, the checks written by appellants' son were not made out to the same broker and were made out directly to Choice Hotels. For these reasons, appellants have not established error in FTB's disallowance of their loss related to Choice Hotels.

Issue 4: Whether appellants have shown error in FTB's disallowance of flow-through losses related to Rubicon.

California generally conforms to the federal partnership rules. (R&TC, § 17851.) A partner's distributive share of a partnership's losses is only allowable to the extent of the partner's adjusted basis in their partnership interest at the end of the partnership year. (IRC, § 704(d).) Generally, a partner's adjusted basis is equal to the amounts of money and the value of other property contributed to the partnership, plus the partner's distributive share of income from the partnership, minus any distributions to the partner and the partner's distributive share of losses and expenditures. (IRC, §§ 705, 722, 732, 733.) Appellants must show that they have an adjusted basis that exceeds a partnership loss in order to deduct the flow-through loss.

Appellants assert they made direct and indirect capital contributions to Rubicon, but have not provided substantiation of the purported payments, such as wire transfers, cancelled checks,

or other similar items. With regard to the payments made through appellants' other entities, they have not shown that they are entitled to claim basis as the result of payments made by other entities. Without additional information and documentation, appellants have not demonstrated that FTB's determination was incorrect.

HOLDINGS

1. Appellants have not shown error in FTB's disallowance of a business bad debt deduction related to Trevira.
2. Appellants have not shown error in FTB's disallowance of an ordinary loss related to Bellflower.
3. Appellants have not shown error in FTB's disallowance of a loss related to Choice Hotels.
4. Appellants have not shown error in FTB's disallowance of flow-through losses related to Rubicon.

DISPOSITION

FTB's action is sustained.

DocuSigned by:
Veronica I. Long
32D46B0C49C949F...

Veronica I. Long
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
CB1F7DA37831416...

Josh Lambert
Administrative Law Judge

DocuSigned by:
Michael F Geary
1A9B52EF88AC4C7...

Michael F Geary
Administrative Law Judge

Date Issued: 4/10/2023