























Appellants argue that if the advancements are not loans, FTB has failed to establish what the correct characterizations of these advancements should be. However, it is appellants' burden to establish by the preponderance of the evidence that the advancements were in fact loans and that the advancements fall within the provisions of IRC section 166. Appellants have not met their burden.

#### *Worthlessness in 2012*

Even if, for the sake of argument, appellants were able to prove that the advances to K. Roberts were bona fide loans, in order to be entitled to be a deduction for that year, appellants must also establish that the debt was wholly worthless as of the close of 2012. (IRC, § 166.) Specifically, appellants must prove that the debt had value at the beginning of the year and that it became worthless during that year. (*Egan v. Commissioner*, T.C. Memo. 2005-234.) The determination of when a debt becomes worthless depends upon the particular facts and circumstances of each case. (*Milenbach v. Commissioner* (1996) 106 T.C. 184, 204.) Worthlessness is an objective determination but is generally fixed by identifiable events that form the basis of reasonable grounds for abandoning any hope of recovery. (*American Offshore, Inc. v. Commissioner* (1991) 97 T.C. 579, 594.) Some objective factors considered in determining worthlessness include the value of the property securing the debt, the debtor's earning capacity, events of default, the debtor's refusal to pay, actions to collect the debt, any subsequent dealings between the parties, and the debtor's lack of assets. (*Id.* at pp. 594-595.) No single factor is conclusive. (*Id.* at p. 595.)

By the beginning of 2012, K. Roberts had yet to repay the \$1 million principal and accrued interest on the Thomas Note or the \$1 million principal and accrued interest on the Amended Barr Note. In addition, K. Roberts did not make any payments towards any of the Roberts Notes. Based on the evidence provided, OTA finds it is difficult to see what, if any, value the Roberts Notes had in 2012. When OTA inquired as to the value of the debts in 2012 at the oral hearing, appellant-husband replied that he simply believed he would receive repayment. Appellant-husband points to his 30-year history with K. Roberts and K. Roberts' repeated ability to go from having no net worth to being worth hundreds of millions of dollars. Although K. Roberts' resiliency is not in doubt, the standard for determining worthlessness is an objective test and does not require appellants to be "incorrigible optimists" as to the value of loans. (*U.S. v. S.S. White Dental Mfg. Co. of Pennsylvania* (1927) 274 U.S. 398, 403.) Appellants'

unsupported opinion that the debt became worthless in 2012, by itself, is not proof of worthlessness. (See *Dustin v. Commissioner* (1969) 53 T.C. 491, 501-502.)

Additionally, the emails between appellant-husband and K. Roberts suggest the Roberts Notes (and possibly the other advances at issue in this appeal) became worthless sometime before 2012. In an email dated March 18, 2010, appellant-husband wrote to K. Roberts that, “Excuses, lines I have no money are not going to work,” suggesting that appellant-husband knew that the Roberts Notes might be worthless on or before 2010. In an email dated October 10, 2013, K. Roberts wrote to appellant-husband, “Unfortunately, the last few years, as you know, I have had a severe financial reversal and I have not been to repay you,” suggesting that appellant-husband might have known K. Roberts was unable to pay his debts sometime before 2012. Accordingly, appellants have failed to meet their burden of proof that the promissory notes became worthless in 2012; therefore, appellants are not entitled to the bad debt deduction.

#### The Barr Guaranty

Appellants state that as guarantor of the Amended Barr Note, payments totaling \$600,000 are nonbusiness bad debt, which allows appellants to treat it as a short-term capital loss. As previously noted, a nonbusiness debt is defined as any debt other than a debt created or acquired in the course of trade or business of the taxpayer, or any debt other than a loss from the worthlessness of which is incurred in the taxpayer’s trade or business. (Treas. Reg. § 1.166-5(b).)

A taxpayer’s payment discharging their agreement to act as a guarantor of an obligation will be treated as worthless debt if: (1) the agreement was a transaction for profit, (2) the taxpayer was subject to an enforceable legal duty to make the payment, and (3) the agreement was entered into before the obligation became worthless. (Treas. Reg. § 1.166-9(b), (d).) To demonstrate a profit motive, the guarantor must receive direct or indirect reasonable consideration for the guaranty. (Treas. Reg. § 1.166-9(e)(1).) For a nonbusiness bad debt, a taxpayer who enters into a guarantor obligation and makes payment in discharge of the obligation may treat the debt as worthless in the year in which they make the payment or in the year in which their right of subrogation becomes worthless. (Treas. Reg. § 1.166-9(b).)

Regarding whether the Barr Guaranty was a transaction for profit, appellants assert that the “indirect benefit” was the protection of appellant-husband’s reputation, the protection of his

trade or business, and the protection of his business management firm. These asserted benefits, however, all relate to appellant-husband's trade or business. As admitted by appellant-husband during his testimony, "[i]t was clearly a business deduction because it could have destroyed the business," but appellants nevertheless reported it as a capital loss in accordance with IRC section 166(d).

A debt, by its definition in IRC section 166, is either a business debt or a nonbusiness debt; it cannot be both. And the characterization of debt as business or nonbusiness affects the characterization of the loss. Appellant-husband's concern that damage to his reputation if the Amended Barr Note remained unpaid relates directly to his business, thereby falling under the business debt definition. As such, appellants cannot treat the payments made to R. Barr like a nonbusiness debt and report it as a capital short-term loss.

Again, there is also a question of whether the bad debt relating to the Barr Guaranty became worthless in 2012. The Barr Guaranty does mention subrogation, although places limits on appellant-husband's ability to employ it against K. Roberts until the Amended Barr Note had been repaid. The May 2, 2017 Ledger Report indicates that the \$1 million in principal was deemed paid in full by January 31, 2004, but there is no indication if the corresponding interest was also satisfied by K. Roberts and whether appellant-husband held any right of subrogation.

For these reasons, appellants are not entitled to claim a bad debt deduction for the Barr Guaranty payments of 2003 and 2004 in 2012, nor are they entitled to carry over any of those remaining 2012 deductions to the 2013 tax year pursuant to IRC section 166(d).

#### Appellant-Husband's Advances to B. Thomas and K. Roberts as Guarantor on Thomas Note

Appellants claimed nonbusiness bad debt deductions related to the following advancements made to B. Thomas or K. Roberts in satisfaction of a purported guaranty on the Thomas Note: (1) an advance of \$80,000 to K. Roberts on June 18, 2010 for K. Roberts to repay interest due on the Thomas Note; (2) an advance of \$700,000 dated May 24, 2012; (3) an advance of \$150,000 also dated May 24, 2012; and (4) an investment of \$100,000 on September 26, 2013. As a result, appellants claimed total bad deductions of \$1,030,000 related to appellant-husband's alleged guaranty on the Thomas Note.

Section 9 of the Thomas Note provides that California law governs the interpretation of the Thomas Note. Pursuant to California Civil Code section 1624, a "special promise to answer for the debt, default, or miscarriage of another" is invalid unless it is in writing and is signed by

the party to be charged or his or her agent. (Civ. Code, § 1624(a)(2).) As previously stated, a taxpayer who enters into a guarantor obligation and makes payments in discharge of the obligation may treat the debt as worthless. (Treas. Reg. § 1.166-9(b).) The taxpayer must demonstrate, among other things, that they were subject to an enforceable legal duty to make the payment. (Treas. Reg. § 1.166-9(d)(2).)

Here, appellants concede that appellant-husband did not execute a written guaranty with B. Thomas offering to repay B. Thomas the principal and interest on the Thomas Note to Kelsho, and, by extension, to K. Roberts. Although appellants contend that the advancements were required to protect appellant-husband's reputation, the advancements were nevertheless voluntary, which is not a debt for purposes of IRC section 166. (See Treas. Reg. § 1.166-1(c).)

Appellants alternatively argue that the advancements could be characterized as loans to K. Roberts. However, as previously stated, appellants have failed to establish that any of the four advances were bona fide debts or that appellant-husband had a reasonable expectation of repayment when he advanced the funds. When each of the four payments were disbursed, appellant-husband knew that K. Roberts defaulted on his loan repayments to B. Thomas by at least seven years. Moreover, one of the four advancements was made after 2013, which does not qualify as a worthless debt in 2012 because the deduction may not be taken before the purported debt is created. (*Appeal of Kune, supra*, 1984 WL 16186.)

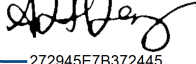
Accordingly, appellants have failed to establish that the Roberts Notes, the Barr Guaranty, and the advances paid toward the Thomas Note were nonbusiness bad debts that became worthless in 2012. Therefore, appellants are not entitled to carryover short-term capital loss deduction related to these advances to 2013.

HOLDING

Appellants have not established that FTB erred in disallowing appellants' claimed bad debt deduction carryover for 2013.


DISPOSITION

FTB's action is sustained.

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Andrea L.H. Long  
Administrative Law Judge

We concur:

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Amanda Vassigh  
Administrative Law Judge

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Sheriene Anne Ridenour  
Administrative Law Judge

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