2024-OTA-118
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

M. SEGAL AND
A. SEGAL

OTA Case No. 21067917

OPINION

Representing the Parties:

For Appellants: William Weintraub, Attorney

For Respondent: David Hunter, Attorney

For Office of Tax Appeals: Andrew Jacobson, Attorney

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Segal (appellant-husband) and A. Segal (together, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an additional tax of $274,457 and applicable interest for the 2013 tax year.

Office of Tax Appeals Administrative Law Judges Amanda Vassigh, Sheriene Anne Ridenour, and Andrea L.H. Long held an oral hearing for this matter in Cerritos, California, on September 12, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

ISSUE

Whether appellants have established that FTB erred in disallowing appellants' claimed bad debt deduction carryover for 2013.

FACTUAL FINDINGS

1. In 1981, appellant-husband and two other partners left an accounting firm to start their own practice, which provided financial management services to the entertainment sector in Southern California. By 2010, appellant-husband was a managing partner of the accounting firm Nigro, Karlin, Segal and Feldstein, LLP (NKSF).

2. K. Roberts became one of NKSF's first clients. During the early 1980s, K. Roberts took over a failing Pasadena, California radio station, KROQ, and turned it into a leading broadcaster for Southern California audiences. In 1986, K. Roberts sold KROQ for about $50 million. In 1991, K. Roberts purchased MARS-FM 103.1, another distressed radio station for $18 million, which he resold in 1998 for $80 million. With his prominence in the entertainment industry, K. Roberts introduced appellant-husband and other NKSF partners to entertainment lawyers and agents, who became lucrative sources of clients for NKSF. Appellant-husband subsequently served as K. Roberts' business manager and tax preparer.

3. K. Roberts regularly borrowed money from the partners at NKSF, as well as from clients that NKSF referred to him, at high interest rates to fund his radio operations. From the early 1980s through the early 2000s, NKSF partners and clients collectively loaned K. Roberts over $15 million. At least on his earlier loans, K. Roberts diligently made repayments. Four promissory notes (Roberts Notes) are particularly relevant to this appeal, whereby K. Roberts purportedly promised to repay loans from appellant-husband, as well as two third-party loans on which appellant-husband allegedly served as guarantor. Each of these Roberts Notes and guaranties are discussed in greater detail below.

Appellant-Husband's Advancements to K. Roberts

4. On July 14, 2003, appellant-husband wrote a check to K. Roberts for $200,000; as well as an alleged additional $100,000. That same day, K. Roberts signed a promissory note (July 14, 2003 Roberts Note) by which he promised to repay appellant-husband a principal sum of $300,000, as well as 10 percent annual interest to be paid monthly, with the principal due on July 30, 2008. The July 14, 2003 Roberts Note states, "It is expressly agreed that upon maturity, the unpaid principal balance of this Note, together with any and all unpaid interest accrued thereon, shall be due and payable in accordance with the terms of this Note…." The July 14, 2003 Roberts Note also provides that "on maturity, the unpaid principal balance of this Note, together with any and all unpaid interest accrued thereon, shall be due and payable in accordance with the terms of this

Note….This note may not be changed, modified, amended or terminated except by a writing duly executed by Maker and the Holder hereof."[1]

5. On April 26, 2005, appellant-husband wrote a check to K. Roberts for $100,000. That same day, K. Roberts signed a promissory note (April 26, 2005 Roberts Note) by which he agreed to repay appellant-husband $100,000, as well as interest at an annual rate of 10 percent to be paid monthly, with the principal due on April 30, 2010. The April 26, 2005 Roberts Note contained language similar to the July 14, 2003 Roberts Note.
6. On June 25, 2008, appellant-husband wrote a check to K. Roberts for $100,000. That same day, K. Roberts signed a promissory note (June 25, 2008 Roberts Note) by which he promised to repay appellant-husband $100,000, as well as interest at an annual rate of 10 percent to be paid monthly, with the principal due on June 30, 2012. The June 25, 2008 Roberts Note also contained language similar to the July 14, 2003 Roberts Note.
7. On October 29, 2009, appellant-husband wrote a check to K. Roberts for $20,000. That same day, K. Roberts signed a promissory note (October 29, 2009 Roberts Note) by which he promised to repay appellant-husband $20,000, as well as interest at an annual rate of 10 percent to be paid monthly, with the principal due on October 31, 2012. The October 29, 2009 Roberts Note contained language similar to the July 14, 2003 Roberts Note.
8. In an email to appellant-husband dated May 23, 2012, K. Roberts wrote that he valued his 30-year friendship with appellant-husband and that he was currently suffering from health issues. K. Roberts also wrote, "Things are pretty rough right now but I have faith in myself and in the future. I never meant things to be as they are and again, I value you as a person and your friendship and hopefully your faith in me will be justified. I am sorry to be the cause of any hardship and pain to you and your family. Believe me, the biggest regret and disappointment in life is that 'I let you down.' I am working on a few very exciting projects that I hope will come to fruition that will definitely help our situation." That same day, appellant-husband emailed K. Roberts in response, stating,

[1] The terms "Maker" and "Holder" are undefined in the July 14, 2003 Roberts Note, but it is presumed that "Maker" is K. Roberts and "Holder" is appellant-husband.

"Thanks [K. Roberts] for the info, but as you are aware that really does not help me with the over $3.5 million you probably owe me[.]"

9. In a letter to appellant-husband dated October 10, 2013, K. Roberts wrote, "As you know, over the years that you were my accountant and my friend, you were kind enough to loan me money personally. Unfortunately, the last few years, as you know, I have had a severe financial reversal and I have not been able to repay you. While I am trying to rebuild, I don't know when I will be able to repay you."

10. On May 22, 2014, K. Roberts died.

The Barr Note and Barr Guaranty

11. On June 21, 2001, K. Roberts executed a promissory note (Barr Note) with R. Barr under which he agreed to make quarterly payments of interest at 12 percent beginning on September 30, 2002, until December 31, 2002, at which time K. Roberts would pay in full all unpaid principal, accrued interest, and any other amounts owed. On that same date, R. Barr wrote a check to K. Roberts for $1 million.

12. Appellant-husband sent a letter with Assante Life Management Solutions (Assante)[2] letterhead to R. Barr's accountant dated December 18, 2002, enclosing a copy of the Barr Note. Appellant-husband wrote, "[K. Roberts] has been a client of our firm for 21 years. Over that time, he has borrowed and repaid both clients and individuals over $25 million…. He has a net worth of about $30 million and a liquid net worth of about $4 million…. [K. Roberts] is an honorable man and as I said above, has never missed a payment."

13. According to a Ledger Report dated May 2, 2017, K. Roberts did not make any payments of principal or interest on the Barr Note from June 21, 2001, through January 31, 2004.

14. On June 23, 2003, appellant-husband executed a guaranty agreement (Barr Guaranty) to act as a guarantor on the "Amended and Restated Promissory Note in favor of [R. Barr] in the original principal amount of [$1 million] dated as of January 1, 2003" (Amended Barr Note.) The Amended Barr Note is not part of the record. The Barr Guaranty states, "For good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, [appellant-husband] ('Guarantor'), hereby unconditionally and

[2] Appellant-husband was also an employee of Assante, and it unclear whether Assante was related to NKSF.

irrevocably guaranties the full and punctual payment when due, whether at stated maturity, by acceleration, demand or otherwise, of all obligations of [K. Roberts] under the [Amended Barr] Note, whether for principal, interest, fees, expenses or otherwise…." Regarding subrogation, The Barr Guaranty states, "Until all indebtedness of [K. Roberts] to [R. Barr] under the [Amended Barr] Note shall have been paid in full, [appellant-husband] shall have no right of subrogation…." The Barr Guaranty also provides that appellant-husband will have no right to proceed against the Amended Barr Note if R. Barr takes any action that destroys or impairs appellant-husband's right of subrogation against K. Roberts.

15. On January 2, 2004, R. Barr's accountant issued a Notice of Delinquency to appellant-husband, stating that the Amended Barr Note principal of $1 million was past due, which activated a 30-day period in which appellant-husband needed to cure the delinquency under the Barr Guaranty.

16. On September 30, 2003, appellant-husband paid R. Barr $125,000.[3]

17. On January 22, 2004, K. Roberts issued appellant-husband a check for $25,000 as payment towards past due interest on the Amended Barr Note.

18. On January 28, 2004, appellants provided K. Roberts with a cashier's check for $500,000 to use as payment towards the Amended Barr Note.

19. According to the May 2, 2017 Ledger Report, the $1 million in principal was deemed paid in full on January 31, 2004.[4]

The Thomas Note and Appellant-Husband's Payments to B. Thomas and K. Roberts

20. On April 26, 2002, K. Roberts signed a note on behalf of Kelsho Radio Group, Inc.,[5] the general partner of Kelsho Communications, LP (Kelsho) by which B. Thomas agreed to loan Kelsho $1 million in exchange for quarterly repayments of principal, plus 12 percent annual interest, beginning on July 21, 2002 (Thomas Note).[6] The principal was due on October 31, 2003. Section 12 of the Thomas Note provides that the Thomas Note

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[3] Appellants have not provided a cancelled check or account statement evidencing this payment; however, FTB does not dispute the payment.

[4] The evidence provided does not indicate who paid the remaining $400,000 in outstanding principal.

[5] K. Roberts served as president of Kelsho Radio Group, Inc.

[6] There is no evidence that K. Roberts signed the Thomas Note in his individual capacity.

agreement represented the complete and final agreement of the parties, and that the Thomas Note could not be superseded by any oral agreement but only by a written amendment signed by all of the parties. A Ledger Report issued by B. Thomas dated May 29, 2018 (Thomas Ledger Report), shows that B. Thomas disbursed $1 million on April 25, 2002.

21. The Thomas Ledger Report shows that K. Roberts did not repay any principal or interest on the Thomas Note between April 25, 2002, and May 23, 2012.

22. On March 18, 2010, appellant-husband wrote an email to K. Roberts demanding that K. Roberts find a way to repay B. Thomas. Appellant-husband stated, "[B. Thomas] has lost his patienca [sic] on the loan he made to you over 9 years ago. As you know he has received no interest or payments in 9 years. I cannot calm [him] down anymore. He has given me one week to get some payment to him or he is suing both you and me. I am fully aware of your financial position but that is no longer the answer.…In addition, if we get sued it will create substantial problems to our firm[']s reputation. The time has come for you to do something. I have always been there for you and now you NEED to be there for me. Excuses, lines I have no money are not going to work.…I have done everything you have asked me to do over the last few years and now I need you to return this friendship to me. If he sues us, 25 years of building a reputation will be gone. <u>Please don't let this happen</u>." (Original underscoring.)

23. Three months later, on June 18, 2010, appellant-husband made a payment of $80,000 to K. Roberts so that K. Roberts could pay interest due on the Thomas Note.

24. On May 24, 2012, appellant-husband made a payment of $700,000 to B. Thomas in partial payment of Thomas Note. On that same day, appellant-husband made a second payment of $150,000 to B. Thomas.

25. On September 26, 2013, appellant-husband made an investment in a third-party business of $100,000 in partial payment of the Thomas Note.

Appellants' 2012 and 2013 Tax Reporting and FTB Audit

26. Appellants attached to their 2012 U.S. Individual Tax Return (Form 1040) a Schedule D, *Capital Gains and Losses* and a federal Form 8949, *Sales and Dispositions of Capital Assets*, reporting a short-term capital loss of $1,958,000. On the Form 8949, appellants

characterized this loss as "ROBERTS LOAN – NON-BUSINESS BAD DEBT." Appellants were only able to utilize $270,277 of this amount during 2012.

27. Appellants filed a 2012 California Resident Income Tax Return (Form 540) that was signed on October 10, 2013. On an attached statement titled Schedule 5 to California Schedule D (540), appellants reported a capital loss of $1,958,000 titled "ROBERTS LOAN – NON-BUSINESS BAD DEBT."
28. On their 2013 Form 1040, Schedule D, appellants reported a short-term capital loss carryover of $1,687,723.
29. On October 15, 2014, appellants filed a 2013 Form 540, reporting on the California Schedule D (540) capital loss carryover from 2012 of $1,680,484.
30. FTB subsequently initiated an audit of appellants' 2012 and 2013 California returns.
31. As a result of the audit, FTB determined that appellants' claimed bad debt deductions reported on the 2012 return and the carryover of the bad debt deductions on the 2013 return should be denied. [7]
32. On March 28, 2019, FTB issued a Notice of Proposed Assessment (NPA) for 2013, which disallowed bad debt deductions of $2,065,723.
33. On December 17, 2019, FTB issued a Protest—Determination Letter in which it continued to find that appellants had not established their right to 2013 nonbusiness bad debt carryover deductions of $2,040,000.
34. On May 6, 2021, FTB issued a Notice of Action that affirmed its NPA for 2013, resulting in additional tax due of $274,457 plus applicable interest.
35. Appellants filed this timely appeal.[8]

DISCUSSION

Generally, FTB's determinations of fact are presumed correct, and the taxpayer has the burden of proving that such determinations are erroneous. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims

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[7] FTB has stated that it did not issue a Notice of Proposed Assessment to appellants for the 2012 tax year because the statute of limitations had expired. Therefore, appellants have been allowed bad debt deductions of $270,277 for 2012 by default.

[8] On appeal, appellants claim that the total claimed bad debt at issue is $1,950,000 and includes a schedule of each payment made to or on behalf of K. Roberts. However, the schedule lists the debt total as $2,150,000. Regardless, the exact amount at issue is not relevant due to the holding of this Opinion.

a deduction has the burden of proving by competent evidence that they are entitled to that deduction. (*Appeal of Vardell*, 2020-OTA-190P.) This burden requires the taxpayer to demonstrate that the deductions claimed are allowed pursuant to an applicable statute and to show by credible evidence that the taxpayer comes within its terms. (*Appeal of Silver*, 2022-OTA-408P.) Unsupported assertions cannot satisfy the taxpayer's burden of proof. (*Appeal of Vardell*, *supra*.) The taxpayer's failure to produce evidence that is within their control gives rise to a presumption that such evidence, if provided, would have been unfavorable to the taxpayer's case. (*Ibid*.)

To decide whether appellants are entitled to a bad debt deduction carryover in 2013, the 2012 tax year must be examined. The Office of Tax Appeals (OTA) does not have jurisdiction over the 2012 tax year; however, courts have considered events that occurred in prior tax years when such consideration is necessary to determine the tax liability for the year at issue. (See *Loan Manor Farms, Inc. v. Commissioner* (1974) 61 T.C. 436, 440.) Thus, OTA may consider as a preliminary matter whether appellants are entitled to a bad debt deduction in 2012 to determine whether they are entitled to carryover a short-term capital loss deduction to 2013.[9]

The Roberts Notes

Under Internal Revenue Code (IRC) section 166(a)(1), the taxpayer is allowed as a deduction any bona fide debt that becomes worthless within the taxable year.[10] However, IRC section 166(a) does not apply to a nonbusiness debt held by an individual taxpayer. (IRC, § 166(d)(1).) Instead, the taxpayer is allowed a short-term capital loss deduction for the taxable year if the nonbusiness debt becomes entirely worthless during the year it is claimed. (IRC, § 166(d)(1)(B).) A nonbusiness debt is "a debt other than—(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." (IRC, § 166(d)(2)(A)-(B).) It is undisputed that the purported loans at issue would be nonbusiness debt.

[9] The loss from nonbusiness debts is treated as short-term capital loss during the tax year the debt became wholly worthless. (Treas. Reg. § 1.166-5(a)(2).) This loss is subject to the limitations provided in Internal Revenue Code (IRC) section 1211, relating to the limitation on capital losses, and IRC section 1212, relating to the capital loss carryover. (*Ibid.*)

[10] California conforms to IRC section 166 with modifications under R&TC section 24347(b).

To be deductible, the bad debt must be a bona fide debt. (Treas. Reg. § 1.166-1(c).) A debt is bona fide if the parties to a transaction had an actual, good-faith intent to establish a "debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (*Ibid.*) A gift or contribution to capital is not considered debt for purposes of IRC section 166. (*Ibid.*) The bad debt must also have become wholly worthless within the taxable year to be deductible. (Tres. Reg. § 1.166-5(a)(2).) No deduction is allowed for a particular year if the debt became worthless before or after that year. (*Appeal of Kune* (84-SBE-106) 1984 WL 16186.)

Accordingly, appellants must establish the existence of a bona fide debt and that the debt became worthless during the taxable year for which a short-term capital loss is claimed.

Bona-fide Debt

An intent to establish a debtor-creditor relationship exists if the debtor intends to repay the loan and the creditor intends to enforce repayment. (*Fisher v. Commissioner* (1970) 54 T.C. 905, 909-910.) The expectation of repayment must "not depend solely on the success of the borrower's venture." (*American Processing & Sales Co. v. U.S.* (Ct. Cl. 1967) 371 F.2d 842, 856.)

Courts have identified and considered various factors to resolve the question of whether a transaction is a true loan. The factors include: (1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest was charged; (3) whether a fixed schedule for payments was established; (4) whether collateral was given to secure payment; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and (7) whether the parties conducted themselves as if the transaction were a loan. (*Welch v. Commissioner* (9th Cir. 2000) 204 F.3d 1228, 1230.) No single factor is determinative, and the factors do not constitute an exhaustive list. (*Ibid.*) Often it is a question of substance over form requiring courts to "'look beyond the parties' terminology to the substance and economic realities.' [Citations.]" (*Calloway v. Commissioner* (2010) 135 T.C. 26, 37.)

Here, appellants provide copies of the Roberts Notes for advancements totaling $520,000. The notes each indicate that they were executed by appellant-husband and K. Roberts, imposed an interest rate of 10 percent per annum, and listed a maturity date. On its face, these promissory notes are legally binding documents that favor a finding that the $520,000 is genuine debt.

However, K. Roberts and appellant-husband never followed any of the terms and conditions outlined in the Roberts Notes: K. Roberts did not make any payments of principal or interest, and appellant-husband did not enforce or demand repayment. To contrast, appellant-husband wrote an email to K. Roberts on March 10, 2010, demanding that K. Roberts begin to make payments on the Thomas Note, at which point all four of the Roberts Notes were past due, but there is nothing in the record indicating that appellant-husband demanded payment or attempted collection on the Roberts Notes.

Instead, K. Roberts' payments were contingent on his ability to "bounce back," i.e., tied to the fortunes of his business. At the hearing, appellant-husband testified that he had a 30-year history with K. Roberts, during which K. Roberts was never previously late in loan repayments, and that appellant-husband made advances to K. Roberts based on K. Roberts' history of successful business ventures. Appellant-husband stated that because K. Roberts would always recover from financial loss, he believed K. Roberts' business ventures would eventually succeed, and he would receive repayment on his advances. Appellant-husband's testimony indicates that repayment was tied to the success of K. Roberts' business ventures, an indicator that the Roberts Notes were not bona fide debts. (*Estate of Mixon v. U.S.* (5th Cir.1972) 464 F.2d 394, 404.)

Moreover, as to whether K. Roberts had a reasonable prospect of repaying the Roberts Notes, the record is devoid of evidence that he did. For example, when K. Roberts and appellant-husband executed the July 14, 2003 Roberts Note, the Barr Note had already matured on December 31, 2002, and K. Roberts made no payments toward the $1 million loan. Additionally, K. Roberts also previously executed the $1 million Thomas Note with B. Thomas on April 26, 2002, which remained unpaid. When the other three Roberts Notes were executed, K. Roberts and still had not made any payments towards the Amended Barr Note executed on January 1, 2003, or the Thomas Note, which was also now in default. In fact, appellant-husband had made total payments of $625,000 towards K. Robert's Barr Note, of which K. Roberts only repaid $25,000 to appellant-husband. Based on the above, coupled with the fact that there was no collateral securing the Roberts Notes, OTA finds the prospect that K. Roberts' continued advances would be repaid was far more speculative than any third-party creditor would accept. (See *Fin Hay Realty Co. v. U.S.* (3d Cir. 1968) 398 F.2d 694, 697.) Despite having the formalities of a promissory note, the economic realities indicate that appellant-husband's advances to K. Roberts did not create a bona fide debt for tax purposes.

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. Robberts 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.

<u>The Barr Guaranty</u>

Appellants state that as guarantor of the Amended Barr Note, payments totaling $600,000 are nonbusiness dad 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).

<u>Appellant-Husband's Advances to B. Thomas and K. Roberts as Guarantor on Thomas Note</u>

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
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Amanda Vassigh
Administrative Law Judge

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Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 12/18/2023