

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:)
C. CARDINAL AND)
B. CARDINAL)
)
)
)
)

OTA Case No. 240616481

OPINION

Representing the Parties:

For Appellants: Cameron Davidson, Attorney

For Respondent: Christopher Davis, Attorney

E. PARKER, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Cardinal and B. Cardinal (appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing additional tax of \$65,511, \$7,218, and \$6,313, and applicable interest for the 2018, 2019, and 2020 tax years, respectively.

Appellants waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUES

1. Whether appellants are entitled to their claimed worthless stock deduction.
2. Whether appellants are entitled to a theft loss deduction.

FACTUAL FINDINGS

Kitchen Experts of California, Inc.

1. Appellant C. Cardinal purchased a 100 percent interest in Kitchen Experts of California, Inc. (Kitchen Experts), a California S corporation, from the sole shareholder, J. Lupo, for \$2,000,000 pursuant to a Stock Purchase Agreement dated May 25, 2017.
2. On January 11, 2018, appellant C. Cardinal, Kitchen Experts, and American Appliance Outlet (the plaintiffs) filed a civil lawsuit in the United States District Court for the Northern District of California against J. Lupo and others (the defendants). In the complaint, the plaintiffs alleged, among other things, that the defendants participated in a

plan to defame, defraud, and unfairly compete with Kitchen Experts and appellant C. Cardinal by misrepresenting Kitchen Experts's assets and liabilities to induce appellant C. Cardinal to purchase Kitchen Experts for an amount grossly in excess of its actual value. The complaint further alleged that defendants created a competing remodeling business for the sole purpose of devaluing Kitchen Experts after the close of the sale, strained Kitchen Experts's relationship with GreenSky, a consumer finance company that financed its projects, and eroded Kitchen Experts's goodwill.

3. On February 11, 2019, appellant C. Cardinal contributed his entire stock in Kitchen Experts to Good Development Company & Enterprise (Good Development) in exchange for 5,100 shares of Good Development.
4. On May 10, 2019, appellant C. Cardinal sold his 5,100 shares of Good Development to J. Franchini, the owner of the remaining shares of Good Development, in exchange for a promissory note for \$2,139,412 and J. Franchini's assumption of all personal guarantees and liability of operations. On this same date, appellant C. Cardinal also agreed to offset \$826,236 of the promissory note resulting in an outstanding promissory note balance of \$1,313,176.
5. On December 11, 2019, the U.S. District Court entered a judgment in the lawsuit, which states that the jury rendered a verdict in the plaintiffs' favor in the amount of \$250,000. The Court's Final Verdict Form states that the jury found J. Lupo was liable to appellant C. Cardinal for intentional misrepresentation for \$250,000, and J. Lupo did not make a false representation to appellant C. Cardinal with malice, oppression, or fraud.

California Tax Returns

6. Appellants timely filed their joint California Resident Income Tax Return (Return) for the 2018, 2019, and 2020 tax years. On Schedule D (540) of their 2018 Return, appellants reported their Kitchen Experts's stock as worthless and claimed a capital loss deduction of \$1,113,004.
7. Kitchen Experts filed its California S Corporation Franchise or Income Tax Return (Form 100S) for the 2018 tax year reporting a net loss of \$526,389. On its balance sheet, Kitchen Experts reported total assets of \$1,600,835 and total liabilities of \$1,215,799 at the end of the 2018 tax year.

Procedural History

8. FTB examined appellants' returns for the 2018, 2019, and 2020 tax years and requested that appellants substantiate their worthless stock deduction for the 2018 tax year.

9. FTB issued Notices of Proposed Assessment (NPAs) for the 2018, 2019, and 2020 tax years. FTB proposed to disallow appellants' claimed \$1,113,004 worthless stock deduction for their shares in Kitchen Experts for the 2018 tax year and made related net operating loss carryover adjustments to the 2019 and 2020 tax years.¹
10. Appellants timely protested the NPAs for the 2018, 2019, and 2020 tax years.
11. FTB issued Notices of Action affirming the NPAs for the 2018, 2019, and 2020 tax years.
12. Appellants timely filed this appeal.

DISCUSSION

Issue 1: Whether appellants are entitled to their claimed worthless stock deduction.

FTB's determinations are generally presumed correct, and the taxpayer bears the burden of proving otherwise. (*Appeal of Vardell*, 2020-OTA-190P.) Income tax deductions are a matter of legislative grace, and taxpayers who claim a deduction have the burden of proving by competent evidence that they are entitled to that deduction. (*Ibid.*) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Ibid.*)

Internal Revenue Code (IRC) section 165(a) provides that taxpayers may deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise.² If any "security" that is a capital asset becomes "worthless" during the taxable year, the loss resulting therefrom may be deducted under IRC section 165(a) as a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. (IRC, § 165(g)(1).) The term "security" includes "a share of stock in a corporation." (IRC, § 165(g)(2)(A).) "A loss shall be allowable as a deduction under [IRC] section 165(a) only for the taxable year in which the loss is sustained." (Treas. Reg. § 1.165-1(d)(1).) Such "a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year." (*Ibid.*)

Stock that is "worthless" is devoid of any present (liquidating value) and potential value. (*Morton v. Commissioner* (1938) 38 B.T.A. 1270, 1278; *Delk v. Commissioner* (9th Cir. 1997) 113 F.3d 984; *Flint Industries v. Commissioner*, T.C. Memo. 2001-276.) There is no present value when the liabilities (including contingent liabilities) of the company exceed the fair market value of its assets. (*Morton v. Commissioner*, *supra*, at p. 1278.) Generally, a stock is not

¹ FTB proposed to make additional adjustments to appellants' tax returns for the 2018, 2019, and 2020 tax years that appellants do not dispute. The only adjustment that appellants dispute is the proposed disallowance of appellants' worthless stock deduction for the 2018 tax year.

² California conforms to IRC section 165, except as otherwise provided. (R&TC, § 17201(a).)

considered worthless if the fair market value of a company's assets exceeds the liabilities reported on the company's balance sheet. (*Richards v. Commissioner*, T.C. Memo. 1976-380.) There is no potential value when the facts and circumstances indicate that there is no potential for the shareholders to receive any return on their investment. (*Morton v. Commissioner*, *supra*, at p. 1278.) Ordinarily, the loss of any potential value can be established only by some identifiable event that puts an end to any hope and expectation that the stock will become valuable at some future time. (*Ibid.*) The determination of worthlessness is based on all the surrounding facts and circumstances. (*Ibid.*)

Here, the evidence indicates that the stock of Kitchen Experts had a liquidating value at the end of 2018. Kitchen Experts had a liquidating value of \$385,036 because it reported assets of \$1,600,835 and liabilities of \$1,215,799 on its balance sheet at the end of the 2018 tax year. Appellants do not contend, and the evidence does not show, that Kitchen Experts ceased operations in 2018. Furthermore, the evidence indicates that appellant C. Cardinal engaged in actions that were inconsistent with the contention that his Kitchen Experts stock became worthless in 2018. On February 11, 2019, appellant C. Cardinal contributed his entire stock in Kitchen Experts in consideration for 5,100 shares of Good Development.³ On May 10, 2019, appellant C. Cardinal sold his 5,100 shares of Good Development to J. Franchini in exchange for a promissory note for \$2,139,412 and J. Franchini's assumption of all personal guarantees and liability of operations. Appellant C. Cardinal agreed to offset \$826,236⁴ of the promissory note, resulting in an outstanding promissory note balance of \$1,313,176. Accordingly, the record indicates the shares in Kitchen Experts were not wholly worthless.

Appellants contend that the Kitchen Experts stock was worthless in 2018 because Kitchen Experts was insolvent, and its balance sheet does not accurately reflect the undisclosed loans Mr. Lupo had taken out on Kitchen Experts's assets. Appellants are apparently referring to the \$192,000 of undisclosed loans that appellants alleged in their complaint against J. Lupo. However, appellants have not substantiated this assertion and, even if this assertion were true, Kitchen Experts would still have a liquidating value of \$193,036 (\$385,036 - \$192,000).

Appellants assert that the Kitchen Experts stock was worthless when they purchased the stock in 2017 because of J. Lupo's misrepresentations. However, OTA does not have

³ The record indicates appellant C. Cardinal may have also contributed stock in Elite Appliance Showrooms, Inc. in exchange for the 5,100 shares of Good Development. However, appellants have not provided any additional information regarding the transfer or valuation of their interest in Elite Appliance Showrooms, Inc.

⁴ The offset of \$826,236 is comprised of amounts appellant C. Cardinal owed to Kitchen Experts and amounts Kitchen Experts owed to the purchaser, J. Franchini.

jurisdiction to determine whether appellants' stock in Kitchen Experts was worthless for the 2017 tax year because appellants did not file an appeal from an action of FTB for the 2017 tax year. (Cal. Code Regs., tit. 18, § 30103(a).)

Appellants argue that the Kitchen Experts stock was worthless because J. Lupo interfered with Kitchen Experts's business operations to devalue Kitchen Experts, which eventually led appellants to wind down the business. However, a shrinkage in value of stock, even though extensive, does not give rise to a deduction under IRC section 165(a) if the stock has any recognizable value on the date claimed as the date of the loss. (Treas. Reg. §§ 1.165-4(a), 1.165-5(f).) As explained above, appellants claimed the worthless stock deduction for the 2018 tax year and the record shows that Kitchen Experts had a liquidating value of \$385,036 at the end of the 2018 tax year.

Appellants reason that the standard to determine whether a stock was worthless is whether a prudent businessperson would have determined the stock to be worthless, relying on *Steadman v. Commissioner (Steadman)* (1968) 50 T.C. 369, affd. (6th Cir. 1970) 424 F.2d 1. However, in *Steadman*, the tax court analyzed whether a company has any potential value and confirmed that the taxpayer has the burden of proof to show that a company had neither liquidating value nor potential value when determining whether a stock was worthless. (*Id.* at pp. 376-377.) As explained above, the record shows that Kitchen Experts had a liquidating value of \$385,036 at the end of 2018.

Lastly, appellants argue that they subjectively believed that the Kitchen Experts stock was worthless relying on *Echols v. Commissioner* (5th Cir. 1991) 935 F.2d 703 (*Echols*). However, the court in *Echols* stated that the test for worthlessness requires the taxpayer to establish that the taxpayer subjectively believed an asset was worthless and the asset was worthless objectively. (*Id.* at p. 707.) This appeal is distinguishable because the record shows that Kitchen Experts objectively had a liquidating value of \$385,036 by the end of the 2018 tax year. Additionally, in 2019, appellant C. Cardinal exchanged his shares of Kitchen Experts for shares in Good Development, which he subsequently sold for a promissory note and an assumption of all personal guarantees and liability of operations.

Appellants have not established that they are entitled to a worthless stock deduction.

Issue 2: Whether appellants are entitled to a theft loss deduction.

An individual is allowed a deduction for losses, not compensated by insurance or otherwise, that arise from fire, storm, shipwreck, or other casualty, or from theft. (IRC, § 165(a),

(c)(3); R&TC, § 17201(a).⁵ To deduct a theft loss, the taxpayer must establish: (1) the occurrence of a theft under the law of the jurisdiction where the loss occurred; (2) the amount of the loss; and (3) the year in which the loss was discovered. (*Gerstell v. Commissioner* (1966) 46 T.C. 161, 175; *Giunta v. Commissioner*, T.C. Memo. 2018-180.) A taxpayer does not need to demonstrate that there was a criminal conviction, but the taxpayer must prove by a preponderance of the evidence that an actual theft occurred. (*Bruno v. Commissioner*, T.C. Memo. 2020-156.)

Theft shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery. (Treas. Reg. § 1.165-8(d).) Theft may also include a loss of property caused by swindling, false pretenses, and any other form of guile. (*Bellis v. Commissioner* (1973) 61 T.C. 354, 357.) Under California law, a theft may constitute the taking of money from another upon false pretense. (Cal. Penal Code, § 484.)⁶ Theft by false representations contains the following elements: (1) the defendant made a false pretense or representation to the owner of the property; (2) with the intent to defraud the owner of that property; and (3) the owner transferred that property to the defendant in reliance on the false representation. (*People v. Wooten* (1996) 44 Cal.App.4th 1834, 1842; *People v. Webb* (1999) 74 Cal.App.4th 688, 693-694; *Baum v Commissioner* T.C. Memo. 2021-46.) Whether the pretense is a false promise or a misrepresentation of fact, the defendant's intent must be proved in both instances by something more than mere proof of nonperformance or actual falsity. (*People v. Ashley* (1954) 42 Cal.2d 246, 264.)

Here, appellants present an alternative position that if OTA finds that appellants are not entitled to a worthless stock deduction, they should be entitled to a theft loss deduction for the 2019 tax year. Appellants contend the December 11, 2019 civil suit judgment is evidence of theft by false pretenses because the jury found that J. Lupo used false statements and promises to obtain appellants' money. Appellants also assert that the year of the theft loss deduction

⁵ The Tax Cuts and Jobs Act (TCJA) modified casualty and theft losses to be available only for cases of natural disasters for the 2018 to 2025 tax years. (Public Law 115-97, § 11044.) However, this provision of TJCA does not apply to California because California conforms to the January 1, 2015 version of the IRC. (R&TC, § 17024.5(a)(1)(P).)

⁶ Appellants argue that the crime involved is theft by false representations under California Penal Code section 532. However, California Penal Code section 532(a) is nearly identical to California Penal Code section 484(a) and provides that these acts are punishable in the same manner and to the same extent as larceny. (*Bell v. Feibush* (2013) Cal.App.4th 1041, 1048.) California Penal Code section 484 consolidated the historic categories of larceny, theft by false pretenses, and embezzlement into the general crime of theft. (*People v. Gonzales* (2017) 2 Cal. 5th 858, 863-866.)

should be 2019 since the civil action was their last avenue of recovery, and it was reasonably certain that they would not receive additional reimbursement for the theft as of December 2019.

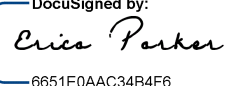
The appropriate jurisdiction to determine if a theft occurred is in California because appellants allege Mr. Lupo stole appellants' money using false pretenses in California. Accordingly, appellants must establish J. Lupo made false pretenses or representations with the *intent to defraud* appellants and that appellants transferred property in reliance on the false representations. Contrary to appellants' assertions, the civil suit judgment does not establish that a theft occurred. While the Court's Final Verdict Form states that the jury found J. Lupo liable for intentional misrepresentation, it also specifically states that J. Lupo did not make a false representation to appellant C. Cardinal with malice, oppression, or fraud. Appellants fail to point to any credible evidence showing that J. Lupo made false pretenses or representations with the *intent to defraud* for purposes of proving theft under California law. Therefore, appellants have not established that they are entitled to a theft loss deduction.⁷

HOLDINGS

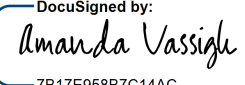
1. Appellants are not entitled to their claimed worthless stock deduction.
2. Appellants are not entitled to a theft loss deduction.

DISPOSITION


FTB's actions are sustained in full.

DocuSigned by:

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 Erica Parker
 Hearing Officer

We concur:
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 Amanda Vassigh
 Administrative Law Judge

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 Josh Lambert
 Administrative Law Judge

Date Issued: 12/10/2025

⁷ Because appellants have not proven a theft occurred, OTA need not discuss the amount of the claimed loss or the year in which the claimed loss was discovered.