

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 20056173
G. SCHOLLER AND)
S. SCHOLLER)
_____)

OPINION

Representing the Parties:

For Appellants: Mauro P. Colabianchi, Attorney

For Respondent: Brad J. Coutinho, Attorney Supervisor

For Office of Tax Appeals: William J. Stafford, Attorney

A. VASSIGH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, G. Scholler and S. Scholler (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$100,203, an accuracy-related penalty of \$20,040.60, and applicable interest, for the 2003 tax year.

Administrative Law Judges Cheryl L. Akin, Asaf Kletter, and Amanda Vassigh held a virtual oral hearing for this matter on September 27, 2024. At the conclusion of the hearing, the record was held open for additional briefing by the parties. Effective January 24, 2025, the record was closed, and this matter was submitted for decision.

ISSUES

1. Whether appellants are entitled to a bad debt deduction for the 2003 tax year.
2. Whether appellants are entitled to a worthless stock deduction for the 2003 tax year.
3. Whether the accuracy-related penalty may be abated.
4. Whether any interest can be abated.

INTRODUCTION

Appellants contend that they are entitled to a bad debt deduction, or alternatively a worthless stock deduction, for the 2003 tax year, in relation to funds they transferred to N’Lightning Software Development, Inc. (the Company), a video game developer. FTB denied appellants’ claimed deduction in full.

FACTUAL FINDINGSAppellants' California Income Tax Return, IRS Information, and FTB's Proposed Assessment.

1. Appellants filed a timely joint 2003 California income tax return (Form 540) on October 14, 2004, reporting itemized deductions of \$55,487 and total tax of \$6,677.
2. On December 16, 2008, FTB received a FEDSTAR Data Sheet, showing that the IRS made the following adjustments to appellants' 2003 federal return: (i) disallowance of a short-term capital loss (which appellants state on appeal represents a nonbusiness bad debt deduction) of \$1,233,460, resulting in a net increase to appellants' federal adjusted gross income (AGI) of \$1,020,822, (ii) a partial phaseout of appellants' federal itemized deductions by \$36,496 (i.e., from \$103,915 to \$67,419) due to the increase to appellants' federal AGI, and (iii) a complete phaseout of appellants' federal exemption credits of \$12,200 (i.e., from \$12,200 to \$0) due to the increase to appellants' federal AGI.
3. The FEDSTAR Data Sheet indicated that the IRS imposed additional tax of \$163,233.00, an accuracy-related penalty of \$32,646.60, and applicable interest, for the 2003 tax year.
4. In May of 2009, appellants filed an amended joint federal return (Form 1040X) for the 2003 tax year with the IRS to report a deduction for bad debt incurred in 2003, which was disallowed at audit. Appellants asserted that additional facts and information had become available such that the bad debt deduction should be allowed. Appellants indicated in supplemental information to their 2003 Form 1040X that Mr. Scholler was a shareholder in the Company. Further, appellants stated that from June 2001 and April 2003, they made loans to the Company totaling \$1,233,460 for working capital operations, which were evidenced by promissory notes, terms of which loan included provisions for repayment of the loan with interest at 10 percent per annum. Appellants stated that as of December 31, 2003, the debt is considered uncollectible and completely worthless. Appellants requested that IRS reconsider the 2003 federal adjustments.
5. On November 2, 2009, FTB issued a Notice of Proposed Assessment (NPA), which conformed to the federal adjustment to income of \$1,020,822. The NPA proposed the following California adjustments: (i) disallowance of a Schedule D short-term loss of \$1,020,822; (ii) a reduction of California itemized deductions by \$55,487; (iii) and a

standard deduction allowance of \$6,140.¹ The NPA proposed total tax of \$106,880.00, resulting in additional tax of \$100,203.00, an accuracy-related penalty of \$20,040.60, and applicable interest, for the 2003 tax year.

Appellants' Protest, FTB's Action Affirming the Protest, and Appellants' Appeal.

6. Appellants filed a timely protest dated December 30, 2009, requesting that FTB defer action on the NPA until the IRS had an opportunity to review appellants' 2003 Form 1040X.
7. Subsequently, in a facsimile dated March 26, 2010, appellants requested that FTB continue to defer action on the NPA so that the IRS could review appellants' 2003 Form 1040X.
8. On April 5, 2010, FTB sent appellants a letter, stating that it was deferring further action on the NPA in anticipation of appellants' final settlement with the IRS.
9. The IRS started its examination of appellants' 2003 Form 1040X on April 1, 2010. The IRS closed its examination of appellants' 2003 Form 1040X on April 11, 2011, without making any changes.
10. Subsequently, FTB sent appellants letters dated March 23, 2012, and April 7, 2016, requesting information from appellants regarding the IRS's consideration of their 2003 Form 1040X.
11. After receiving no response from appellants, FTB affirmed the NPA in a Notice of Action (NOA) dated April 2, 2020.
12. Appellants subsequently filed this timely appeal.

Mr. Scholler's 20 Percent Interest in the Company and His Advances to the Company in 2000.

13. On appeal, appellants provide a document dated March 15, 2000, entitled loan agreement (Agreement), which purports to memorialize an agreement between the Company and Mr. Scholler that Mr. Scholler would provide the Company with funds of \$400,000 on March 15, 2000, and \$431,590 on August 1, 2000, and that Mr. Scholler would receive a 20 percent ownership interest in the Company.² (141,890 shares of

¹ The NPA stated that FTB "allowed the standard deduction instead of itemized deductions, because after the federal adjustments were applied the standard deduction exceeded the allowable itemized deductions."

² The Agreement was not signed or executed by the parties. Based on credible witness testimony, Office of Tax Appeals (OTA) finds that the Agreement accurately represents the terms of the arrangement between Mr. Scholler and the Company.

Company stock following the recapitalization). Two promissory notes to be executed contemporaneously with the release of funds, Exhibits A and B to the Agreement, provided that the principal sums of \$400,000 and \$431,590 will be paid on or before March 15, 2002, and August 1, 2002, respectively, plus interest thereon at the rate of 25 percent per annum until paid in full.³

Appellants' Advances to the Company between 2001 and 2003 and Mr. Scholler's Assumption of the Company's Line of Credit.

14. On appeal, appellants provide a spreadsheet listing various advances appellants contend were made to the Company between June 4, 2001, and April 3, 2003. The spreadsheet lists: 10 separate advances in 2001 totaling \$272,465.81; 28 separate advances in 2002 totaling \$487,086.00; and eight advances in 2003 totaling \$136,000. These advances, totaling \$895,551.81, plus Mr. Scholler's assumption of the Company's line of credit (discussed below) in the amount of \$400,000 in June 2002, make up the \$1,233,460 bad debt/worthless stock deduction at issue on appeal.⁴
15. Appellants provide on appeal: (1) copies of wire transfer instructions made contemporaneously by Mr. Scholler to his banks between June 2001, and April 2003; (2) copies of the Company's bank statements from August 2001, through April 2003, showing receipt of the advances to the Company; and (3) testimony that Mr. Scholler had funds that were ascribed to him transferred to the Company from CCComplete, a business Mr. Scholler founded and of which he was the CEO. The copies of the bank statements and wire transfer instructions substantiate advances from Mr. Scholler to the Company totaling \$1,144,551.81 (including Mr. Scholler's assumption of the Company's line of credit, discussed below).⁵

³ The sum of \$831,590 to be provided under the Agreement is not part of the \$1,233,460 bad debt expense deduction at issue on appeal. This data is being provided for informational purposes only.

⁴ The sum of \$895,551.81 and the assumption of the line of credit in the amount of \$400,000 totals \$1,295,551.81. Appellants provide no explanation for the \$62,091.81 difference (\$1,295,551.81 - \$1,233,460 = \$62,091.81).

⁵ Appellants failed to substantiate the following claimed advances to the Company totaling \$150,000: (1) \$40,000 on June 4, 2001; (2) \$25,000 on July 11, 2001; (3) \$15,000 on July 15, 2001; (4) \$40,000 on August 8, 2001; (5) \$15,000 on January 16, 2002; and (6) \$15,000 on March 4, 2002." For the first three claimed transfers, appellants provided wire transfer instructions from Mr. Scholler, but did not provide copies of the Company's bank statements confirming receipt of the advances on or around these dates. For the fourth through sixth claimed transfers, appellants provided copies of the Company's bank statements reflecting wire transfers received on or near these dates, but did not provide evidence that appellants were the source of these funds (such as wire transfer instructions from

16. In June 2002, the Company's line of credit with the Home Valley Bank (the bank) was cancelled. The Company attempted to find a new bank to assume the line of credit but could not secure a new lender. Mr. Scholler testified that Bank of America would not extend an unsecured line of credit to the Company and required all existing shareholders to provide personal guarantees for a secured line of credit, which the shareholders other than Mr. Scholler were unwilling to do. As a result, in June 2002, Mr. Scholler assumed the line of credit under the same terms that the Company had with the bank. He did not receive more shares of the Company in exchange for doing so.⁶

Declarations, Witness Testimony, and Other Evidence Appellants Provide on Appeal.

17. On appeal, appellants provide a police report filed April 17, 2003, and a newspaper article dated August 13, 2004, to show that the Company's CFO embezzled \$102,000 from the Company and destroyed many of the Company's financial records in an attempt to hide his embezzlement; that the Company discovered the CFO's actions and reported him to the police; and that the CFO was later prosecuted and sent to prison.
18. Appellants testified that evidence relevant to this matter was also destroyed because of a snowstorm. Paper records the Company stored in a warehouse, including the promissory notes and corporate minutes memorializing the advances at issue in this appeal, were impacted by water damage.
19. A declaration dated May 13, 2021, from R. Bagley, the Company's former CEO, investor and board member, affirms that in early 2001, Mr. Bagley participated in a telephonic board meeting in which the Company's finances were discussed and the probability that the Company would need additional funding before revenues from sales would make the company cash flow positive. Mr. Bagley declared that the board discussed and accepted the offer by appellants' family trust to make loans of approximately \$400,000 to the Company, as needed, to keep the Company's line of credit with Home Valley Bank in good standing and meet the Company's cash flow requirements.
20. Mr. Bagley's declaration also affirms that "[o]nce revenue from sales was sufficient, the [C]ompany would make [its] best effort to pay off those loans as quickly as possible."

Mr. Scholler to his bank). Total claimed transfers of \$1,295,551.81, minus unsubstantiated transfers of \$150,000, equals \$1,144,551.81.

⁶ Mr. Scholler's assumption of the Company's line of credit is evidenced by a wire transfer request dated June 27, 2002 to the Company's account at Home Valley Bank, and the Company's bank statement reflecting receipt of a wire transfer of \$400,000 on July 1, 2002, followed by a loan "payoff" of \$400,552 made by the Company on July 1, 2002.

- Mr. Bagley's declaration further affirms, and his testimony reaffirms, that Company's revenue in 2003 was too low to sustain the business and pay back the loans.
21. A declaration dated April 25, 2022, from D. Hilderbrand, the President of CCComplete, affirms in relevant part that, "[o]n several occasions when money was wired from a CCComplete account to [the Company], it was at the direction of [Mr. Scholler] for money ascrib[ed] to him." In his testimony, Mr. Hilderbrand reaffirmed that CCComplete sent Mr. Scholler's money to the Company at Mr. Scholler's direction.
 22. A declaration dated May 14, 2021, from D. Caputo, the Company's former Director of Marketing and Sales, affirms that Mr. Bagley often discussed the Company's finances in employee meetings, and that Mr. Bagley announced in early 2001 that Mr. Scholler had agreed to make loans to the Company. Mr. Caputo affirms that Mr. Bagley discussed the Company's responsibilities to repay those loans as quickly as possible once sales revenue started coming in, and that the Company would have to continue with its current staff, and Mr. Caputo would have a limited travel budget, until the loans were paid off. Mr. Caputo further affirms that everyone in the Company knew that successful video games generated sales revenue very quickly.
 23. A declaration dated June 12, 2021, from C. Perkins, the Company's former Project Lead, affirms that after the Company's release of its first video game, Catechumen [in October 2000], the Company began production of its second video game, Ominous Horizons [which was subsequently released in September 2001].⁷ Mr. Perkins affirms that the Company's CEO made it known to the employees that Mr. Scholler "was stepping up" and "would provide [the Company] with a series of loans that would be paid back when sales began to pick up." He certifies that the Company was "forced to close after its CFO embezzled over \$100,000."
 24. In a written declaration dated May 13, 2021, D. Detrick, a former investor in the Company and Director of its Board, stated that "[i]n 2003, the [C]ompany was selling games, but at too low of a volume to sustain the [C]ompany or pay back the loan."
 25. Mr. Bagley informed Mr. Scholler that the Company was unable to repay the advances in the form of a "loan default letter" (default letter) dated September 22, 2003. The default letter stated that: (i) the Company developed two "critically acclaimed, Christian video games, 'Catechumen' and 'Ominous Horizons'" however, "the critical acclaim has not translated into commercial success"; (ii) as a result, the Company had eliminated its

⁷ Evidence in the record provides the release dates for these games.

entire staff (including himself) from its payroll; (iii) former employees have decided to voluntarily provide support to the Company and its customers while pursuing new jobs; (iv) the Company's remaining shareholders have declined to take on a share of the Home Valley Bank line of credit and have instead chosen to surrender their shares to Mr. Scholler, and therefore Mr. Scholler was, from that date forward, the sole shareholder of the Company; (v) the Company was unable to repay appellants' assumption of the Home Valley Bank line of credit or appellants' advances to the Company; and (vi) the Company had little to no assets beyond "the inventory of games still in our warehouses (the total value of which is far less than the monies owed [to appellants])" and the "reputation [the Company] has built in the Christian and video gaming communities."

26. Mr. Bagley testified that the embezzlement by the Company's CFO, which was discovered in 2003, "was catastrophic" for the Company.
27. Mr. Bagley testified that once the Company laid off all its employees, sometime around July 2003, its operations consisted of tech support for its customers, performed voluntarily by Mr. Bagley and Mr. Perkins.
28. In his testimony regarding the Company's operations in the summer of 2003, Mr. Bagley stated, "There was no continued development of new games. We did try to contract out with some people that might hire us but none of it panned out. But as far as, you know, sales, it had gone down to [a] trickle. We did have a few units in the warehouse that we ended up donating to Campus Crusades for Christ and some other organizations. So the answer [to the question of whether there were continued sales or development of new games after the summer of 2003] is really no. If it was, it was very, very minimal. Anything we did get, we paid off our vendors with."
29. Mr. Bagley testified that "part of the reason that [Mr. Scholler] was a very attractive option for us, [was that] he understands that [the Company] wasn't just about making money. We wanted to provide a high-quality, faith-based alternative out in the marketplace, and we did that."
30. Mr. Scholler and Mr. Bagley testified that the Company did not repay the advances made by appellants to the Company.
31. Mr. Scholler testified that by late 2003 and early 2004 the Company encountered problems with the distribution of its games, as its negotiations with Walmart and other large distributors had stalled.
32. An October 2003 article in the Boston Globe reports that the Company won the right to

coproduce the first computer game based on “Left Behind,” the best-selling series of Christian adventure novels, and purchased the rights to use a specific game engine which would a “deliver world-class performance.” In news articles in 2005 and 2006, Mr. Bagley touted the success of the Company.

33. Both appellants testified that R. Berry, appellants’ financial advisor and tax preparer, came to their home to discuss their 2003 tax preparation and verbally advised appellants to claim the bad debt deduction. Mr. Scholler testified that appellants met with Mr. Berry each year to “go over the tax preparation requirements for that year, and then start talking about planning for the succeeding year.” Regarding the 2003 tax year, Mr. Scholler discussed with Mr. Berry the default letter and the advances Mr. Scholler had made to the Company. Mr. Berry asked Mr. Scholler whether there was any chance the loans would be repaid, and when Mr. Scholler shared that there was none, Mr. Berry told him to take the bad debt deduction in the year when Mr. Scholler knew it was a loss.

DISCUSSION

Issue 1: Whether appellants are entitled to a bad debt deduction for the 2003 tax year.

Applicable Law

Burden of Proof

An income tax deduction is a matter of legislative grace and taxpayers have the burden of proving they are entitled to the claimed deduction. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *Appeal of Dandridge*, 2019-OTA-458P.) Unsupported assertions are not sufficient to satisfy taxpayers’ burden of proof. (*Appeal of Morosky*, 2019-OTA-312P.)

Nonbusiness Bad Debt

A deduction is generally allowed for any debt which becomes worthless within the taxable year. (Internal Revenue Code (IRC), § 166(a); R&TC, § 17201(a).) The deduction allowed for a worthless, or bad, debt depends on whether it is a business or nonbusiness bad debt.⁸ A business bad debt can be partially worthless, and a taxpayer may be allowed a partial deduction. (IRC, § 166(a)(2); Treas. Reg. § 1.166-3(a)(2) [partially worthless debt allowable to the extent charged off during the taxable year].) For an individual, a nonbusiness bad debt must be completely worthless before it may be deducted; it is then completely deductible in the year it

⁸ IRC section 166(d)(2) defines nonbusiness bad debt as one other than “created or acquired in connection with the taxpayer-creditor’s trade or business” or “the loss from the worthlessness of which was incurred during the operation of the taxpayer-creditor’s trade or business.”

became worthless. (Treas. Reg. § 1.166-5(a)(2).) A nonbusiness bad debt “shall be treated as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year”—i.e., a short-term capital loss. (*Ibid.*)

Bona Fide Debt

Only a bona fide debt qualifies for purposes of the bad debt deduction. (Treas. Reg. § 1.166-1(c).) A “bona fide debt” is defined as “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.*; see also *Zimmerman v. U.S.* (9th Cir. 1963) 318 F.2d 611, 612.) If the existence of a genuine debt cannot be established, the transfer of funds, if any, might be considered a gift or a capital contribution, either of which is not a debt. (See *Rutter v. Commissioner*, T.C. Memo. 2017-174.) Whether a bona fide debtor-creditor relationship exists is a question of fact to be determined upon consideration of all the pertinent facts. (*A.R. Lantz Co. v. U.S.* (9th Cir. 1970) 424 F.2d 1330; *Fisher v. Commissioner* (1970) 54 T.C. 905, 909.)

Factors used to determine whether a bona fide debt exists include: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation and management; (6) a status equal to or inferior to that of regular corporate creditors; (7) intent of the parties; (8) “thin” or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of “dividend” money; and (11) the ability of the corporation to obtain loans from outside lending institutions. (*A.R. Lantz Co. v. U.S.*, *supra*, at p. 1333 [11 factors]; *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973); see also *Fin Hay Realty Co. v. U.S.* (3d Cir. 1968) 398 F.2d 694, 696 [16 factors].) The identified factors are not of equal significance, and no one factor is determinative. (*Estate of Mixon v. U.S.* (5th Cir. 1972) 464 F.2d 394, 402.) “The various factors which have been identified in the cases are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship.” (*Fin Hay Realty Co. v. U.S.*, *supra*, at p. 697.)

Worthlessness of Debt

Debts become worthless when the taxpayer has no reasonable expectation of repayment. (*Crown v. Commissioner* (1981) 77 T.C. 582, 598.) There is no standard test of formula for determining worthlessness within a given year; the determination must be made based upon all the particular facts and circumstances of each case. (*Ibid.*)

Appellants' Contentions

Appellants state that Mr. Scholler was a shareholder in the Company and a member of its board of directors from March 2000, through September 2003. Appellants explain that in early 2001, Mr. Scholler participated in a telephonic board meeting where the finances of the Company were discussed and, at the time, the board accepted his family trust's offer to make loans to the Company until revenues from the release of its new game titled "Ominous Horizons" would sustain the Company's operations. Ominous Horizons was subsequently released in September of 2001, and appellants assert that the "outlook for the game" at the time of its release was positive.

Appellants further contend that between June 2001 and April 2003, they made short-term loans totaling \$1,233,460 to the Company at a 3.5 percent interest rate, and that the terms of this "loan" were memorialized in a one-page loan document, which Company's board of directors subsequently approved.⁹ Mr. Scholler testified that the agreement stated that the first advancement of funds was a loan, which came with a stock grant and a seat on the board. This testimony is supported by the unexecuted Agreement which indicates that Mr. Scholler received a 20 percent interest in the Company, which, after the contemplated and required recapitalization, would constitute 141,890 shares of stock.

Appellants further assert that the Company's bank announced in June of 2002 that it would not renew the Company's line of credit. Appellants contend that the bank's explanation for not renewing the Company's line of credit was that the bank was no longer going to offer that "particular financial product." Appellants add that the bank's explanation had nothing to do with the Company's financial situation. In response to the bank's action, appellants contend that they assumed the Company's line of credit and loaned it an additional \$400,000.

According to appellants, by late 2003 and early 2004 the Company encountered problems with the distribution of its games, as its negotiations with Walmart and other large distributors had stalled. Appellants further claim that Mr. Scholler made the decision, at that time, to cease any further loans to the Company. Subsequently, in March of 2003, the

⁹ Appellants alternatively refer to the document as either a loan agreement, a loan document, or a promissory note in briefing. However, a copy of a loan agreement, loan document, or promissory note for the advances made by appellants to the Company between June 2001, and April 2003, is not in the appeal record. Instead, the only "loan agreement" in the appeal record is the March 15, 2000 Agreement which relates to Mr. Scholler's advances of \$400,000 and \$431,590 to the Company on March 15, 2000, and August 1, 2000, respectively. These advances are not included in the \$1,233,460 bad debt expense deduction at issue in this appeal, see footnote 4, above. Additionally, this Agreement (and the attached promissory notes) specified interest at a 25 percent rate, not the 3.5 percent appellants assert here for the "loans" made between June 2001, and April 2003.

Company discovered that its CFO had embezzled funds of \$102,000 from the Company and had destroyed many of the Company's financial records to hide his embezzlement. Appellants contend that the Company's discovery of the CFO's embezzlement was the "final nail in the coffin" for the Company.

Appellants argue that: (1) they transferred funds totaling \$1,233,460 to the Company, (2) the funds represent a bona fide debt, and (3) that debt became worthless in 2003. The Office of Tax Appeals (OTA) addresses appellants' first and second arguments in the following section.

Analysis

1. Transfers of Funds

During the course of this appeal, appellants have provided: (1) copies of wire instructions dated June 2001, through April 2003, from appellants to their banks and/or financial institutions, instructing those entities to transfer funds to the Company, (2) copies of the Company's bank statements from August 2001 through April 2003, and (3) a declaration dated April 25, 2022, from Mr. Hilderbrand, President of CCComplete, that affirms that "[o]n several occasions when money was wired from a CCComplete account to [the Company], it was at the direction of [Mr. Scholler] for money ascrib[ed] to him."

Considering the proffered evidence, appellants have substantiated transfers of funds totaling \$1,144,551.81, which represent transfers from Mr. Scholler to the Company between August 2001, through April 2003. Included in this total are transfers of \$2,100 and \$14,286 that were made from an entity called Seraphite to the Company on June 13, 2002, and July 24, 2002, respectively. On appeal, appellants concede that the "Seraphite payment of \$14,286 [made on July 24, 2002] should not be included in the loan amount calculation." As the \$2,100 transfer on July 13, 2002, was also from Seraphite, both amounts must be subtracted from the substantiated transfers of \$1,144,551.81, resulting in net substantiated transfers of \$1,128,165.81 ($\$1,144,551.81 - \$14,286 - \$2,100$). As such, of the claimed \$1,233,460 appellants claim was transferred to the Company between June 2001, and April 2003, appellants have failed to substantiate \$105,294.19 ($\$1,233,460 - \$1,128,165.81$). Thus, any allowable deduction (either as a bad debt expense deduction or worthless stock deduction) will be limited to the substantiated transfers of \$1,128,165.81.

2. Bona Fide Debt

FTB contends that appellants have not sustained their burden of showing that the funds transferred to the Company constituted a bona fide debt. FTB asserts, for example, that appellants have not provided credible evidence (e.g., cancelled checks, bank statements, etc.) showing that the Company ever paid interest or principal on the alleged loans. In addition, FTB argues that the alleged interest rate of 3.5 percent on the alleged debt was unreasonably low, given that the federal prime rate of interest from January 1, 2001, through December 31, 2003, ranged from 9.5 percent to 4.0 percent. In support of its claim, FTB provides a historical interest rate table from the United States Federal Reserve. FTB also asserts that a reasonable lender would not have made such risky “loans” to the Company.

In response, appellants argue that the funds transferred to the Company constituted a bona fide debt. As for the alleged interest rate of 3.5 percent, appellants state that when they agreed to make loans to the Company in June 2001, the prime interest rate was 7.0 percent and was projected to continue dropping. Appellants further state that by the end of 2001, the prime rate had dropped to 4.75 percent and by June 2003, the prime rate had dropped to 4.0 percent. Based on the foregoing, appellants contend that the interest rate of 3.5 percent on the loans to the Company was favorable but not unreasonable.

Courts have used various factors to determine whether a bona fide debt exists. (See *A.R. Lantz Co. v. U.S.*, *supra*, at p. 1333 [listing 11 factors]; *Fin Hay Realty Co. v. U.S.*, *supra*, at p. 697 [listing 16 factors].) The identified factors are not equal, nor is any single factor determinative. (*Estate of Mixon v. United States*, *supra*, at p. 402.) It is the substance, and not the form, of advances that determines whether they are considered loans or capital contributions. (*Crown Iron Works Co. v. Commissioner* (8th Cir. 1957) 245 F.2d 357). The outward form of an advance is not controlling; rather, characterization depends on the taxpayer’s actual intent, as evidenced by the circumstances and conditions of the advance. (*Bauer v. Commissioner* (9th Cir. 1984) 748 F.2d 1365, 1367-1368.)

For the reasons discussed below, OTA concludes that appellants’ transfers were closer in nature to capital contributions than to loans. Regardless of whether appellants may have had the intention to create a bona fide debt, the Company’s financial situation which existed at the

time appellants made the transfers requires that such transfers be characterized as capital contributions.¹⁰ Only the factors considered material to our decision will be discussed below.¹¹

In support of their argument that the applicable funds transferred to the Company constituted a bona fide debt, appellants presented witness testimony at the hearing and provided third-party declarations (set forth above) from the Company's CEO, Director of Marketing and Sales, and Project Lead. The third-party declarations in the appeal record and witness testimony at the hearing establish the following: (1) the transfers were evidenced by a written document, which contained a reasonable (although somewhat low) rate of interest, and (2) appellants and the Company consistently referred to the transfers as "loans." The weight of these findings, however, must be tempered by several considerations.

a. The Names Given to the Certificates Evidencing the Indebtedness

Appellants and the Company refer to the March 15, 2000 Agreement as a "loan agreement" and continued to refer to the subsequent advances made by appellants as loans. Documentation of the terms of the subsequent advances was lost as a result of water damage from a storm. However, appellants and the Company refer to promissory notes and "corporate minutes memorializing the loan agreement." The terminology used is consistently that of a loan arrangement. Thus, appellants and the Company have adequately evidenced objective expression of their intent to create a debt, pursuant to the formal documentation of a debtor-creditor relationship, although this alone is insufficient to establish a valid debt for tax purposes. (*A.R. Lantz Co. v. U.S.*, *supra*.)

b. The Presence or Absence of a Maturity Date

The presence or absence of a maturity date is the second factor identified in *Lantz*. Although appellants characterize the advances as "short-term" loans, they have not shown fixed maturity dates for the advances.¹² The absence of a fixed maturity date shows that the repayment was tied to the fortunes of the business. (*Hardman v. United States* (9th. Cir. 1987) 827 F.2d 1409.)

¹⁰ Mr. Bagley testified that this venture was not only about making money, but that the Company wanted to provide "quality, faith-based alternative" video games. According to Mr. Bagley, Mr. Scholler shared this vision.

¹¹ Factors not discussed were not considered material to OTA's decision.

¹² OTA notes that there is a statement in the amended return that says that the loans were to be repaid during 2004 and 2005, but the evidentiary record does not support whether a maturity date was actually part of the terms of the agreement.

c. The Right to Enforce the Payment of Principal and Interest

Mr. Scholler testified that he had the right to demand repayment of the funds advanced to the Company. However, the appeal record contains no financial documents (receipts, bank statements, etc.) showing that the Company repaid any interest or principal.¹³ Instead, Mr. Scholler's testimony confirms that appellants did not receive repayment of the funds in question. The absence of any repayments sheds light on the true character of the transfers.

d. Source of Payments

Further, Mr. Scholler's testimony demonstrates that appellants would not have demanded payment if doing so would have imperiled the financial condition of the Company.¹⁴ Repayments dependent upon the fortunes of a business are indicative of equity. (*Estate of Mixon v. U.S.*, *supra*, at p. 405.)

e. The Corporation's Ability to Obtain Loans from Outside Lending Institutions

Mr. Bagley's testimony and written declaration make it clear that appellants agreed to provide funds, as needed, to help keep the Company's line of credit with the bank in good standing and to meet the Company's cash flow requirements. None of the investors, other than appellants, were willing to lend the Company funds after the bank declined to continue the Company's line of credit. Appellants have not shown, and it is unlikely, that an outside lender would have loaned over a million dollars to a company burdened by debt, and that has not yet repaid an initial loan (the \$400,000 and \$431,590 advances "loaned" to the Company pursuant to the Agreement on March 15, 2000, and August 1, 2000, which were due to be repaid on or before March 15, 2002, and August 1, 2002, respectively). This is also evidenced by Mr. Scholler's testimony that Bank of America would not extend an unsecured line of credit to the Company and would have required all existing shareholders to provide personal guarantees for a line of credit, which the other shareholders were unwilling to do. Thus, appellants extended credit to the Company, which by Mr. Scholler's own testimony, would not have been

¹³ Appellants contend that "[Mr. Scholler] sent wiring instructions for loan repayment on May 5, 2003, and the [Company's] CEO instructed the then-CFO to wire an interest payment to Mr. Scholler." The appeal record, however, contains no financial documents (receipts, bank statements, etc.) showing that the Company repaid any interest or principal. Unsupported assertions are not sufficient to carry appellants' burden of proof. (*Appeal of Morosky*, *supra*.) Furthermore, Mr. Scholler testified that he did not receive repayment of the funds in question.

¹⁴ Appellants assert that the default letter dated September 22, 2003 is evidence that appellants made a payment demand. However, OTA will not speculate as to possibilities outside of the evidentiary record that may have preceded the default letter. Even if appellants had made a payment demand on or about September 22, 2003, that demand would not change our holdings herein.

granted on the same terms by a commercial lender. (See *American Offshore, Inc. v. Commissioner* (1991) 97 T.C. 579, 605.)

f. Risk Involved in Making the Transfers and Availability of Outside Sources of Funding

In addition to the foregoing factors which indicate that the transfers were not loans, there are others, namely: (i) the risk involved in making the transfers, and (ii) the availability of outside sources of funds. (See *Fin Hay Realty Co. v. U.S.*, *supra*, at p. 697.) These factors focus on the Company's persistent need for cash not only to continue operations, but also to keep its line of credit in good standing—and the evidence in this appeal shows that repayment of the transfers (including payment of interest thereon) was subject to the fortunes of the corporate venture. This is borne out in Mr. Scholler's and Mr. Bagley's understanding, as evidenced in their declarations and testimony, that repayment would be contingent upon revenue from sales.

Under these circumstances, the risks that appellants would not be repaid were substantial and are similar to the risks of an equity investment. As the Third Circuit stated in *Fin Hay Realty Co. v. U.S.*, if a shareholder's transfer of funds is "far more speculative than what an outsider would make, it is obviously a loan in name only." (*Fin Hay Realty Co. v. U.S.*, *supra*, at p. 697.) The economic reality of the situation was that the Company did not have the ability to repay the funds. The Tax Court found in *Allen v. Commissioner*, T.C. Memo. 2023-86, that even though in that case "there was an enforceable right in form, there was not one in substance. This factor weighs in favor of equity." Courts have held that the failure of the debtor to repay on the due date is the most significant factor in analyzing whether funds are properly characterized as debt or equity. (*Mills v. IRS* (4th Cir. 1988) 840 F.2d 229, 233; *In re Lane* (11th Cir. 1984) 742 F.2d 1311 [taxpayer testified that he would not have demanded repayment if it caused the corporation to lose money and business, as the taxpayer was trying to build the corporation up].)

g. Bona Fide Debt Conclusion

Considering the evidence in light of the factors generally utilized in resolving such questions, OTA concludes that the advances were capital contributions. Accordingly, appellants are not entitled to a bad debt deduction for the advances that appellants have substantiated on appeal. Instead, those transfers must be treated as equity as discussed in Issue 2 below.

Issue 2: Whether appellants are entitled to a worthless stock deduction for the 2003 tax year.Applicable Law

IRC section 165(g)(1) provides that, “[i]f any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall . . . be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.” For purposes of IRC section 165(g), the term “security” means: (A) “a share of stock in a corporation;” (B) “a right to subscribe for, or to receive, a share of stock in a corporation;” or (C) “a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.” (IRC, § 165(g)(2)(A)-(C).)

To be entitled to deduct a loss under IRC section 165(g), taxpayers must carry their burden of proving three distinct facts. (See *Giunta v. Commissioner*, T.C. Memo. 2018-180 (*Giunta*)). First, that the taxpayers owned a “security” as defined by IRC section 165(g)(2). (*Ibid.*) Second, the taxpayers must establish their “adjusted basis” in that security. (*Ibid.*, citing IRC, § 165(b) and *Martin Ice Cream Co. v. Commissioner* (1998) 110 T.C. 189, 220.) The burden is on the taxpayer to establish the basis. If the taxpayer fails to establish any basis, the basis is deemed to be zero (or other amount asserted by the IRS) and the deduction is denied. (*Coloman v. Commissioner* (9th Cir. 1976) 540 F.2d 427.) Third, the taxpayers must establish that the security became worthless during the taxable year for which the deduction is claimed. (*Giunta, supra*, citing IRC, § 165(g)(1).)

Whether shares of stock become worthless, and the taxable year in which such worthlessness occurred, are questions of fact on which a taxpayer bears the burden of proof. (*Austin Co., Inc v. Commissioner* (1979) 71 T.C. 955, 969-970 (*Austin*); *Delk v. Commissioner* (9th Cir. 1997) 113 F.3d 984, 986 (*Delk*)). A determination of worthlessness of a security cannot be confined to an examination of the taxpayer’s beliefs and actions regarding the value or worthlessness of the security, although the taxpayer’s attitude and conduct are not to be ignored. (*Boehm v. Commissioner* (1945) 326 U.S. 287, 292-293.) Shares of stock are worthless when they cease to have liquidating value (i.e., the corporation’s assets are less than its liabilities) and do not have a potential future value. (*Austin, supra*, at pp. 969-970; *Delk, supra*, at p. 986.) A taxpayer has the burden of proving both elements of this two-prong test. (*Delk, supra*, at p. 986.)

If the assets of the corporation exceed its liabilities, the stock has liquidating value. (*Morton v. Commissioner* (1938) 38 B.T.A. 1270, 1278-1279, aff’d (7th Cir. 1940) 112 F.2d 320.)

If a company's assets are less than its liabilities but there is a "reasonable hope and expectation" that the assets will exceed the liabilities of the company in the future, then the company's stock, while having no liquidating value, has potential value and cannot be said to be worthless. (*Ibid.*; see also *Bilthouse v. U.S.* (7th Cir. 2009) 553 F.3d 513, 515 (*Bilthouse*)). A "reasonable hope and expectation" is a standard measured by that of a reasonable investor, not "an incorrigible optimist." (*Bilthouse, supra*, at pp. 515-517.)

The continued operation of a company beyond the year of claimed worthlessness does not, itself, prove future value in its equity interests. (*MCM Investment Management, LLC v. Commissioner*, T.C. Memo. 2019-158 at *16; see *Tejon Ranch Co. v. Commissioner*, T.C. Memo. 1985-207 [a partnership's hopeless insolvency justified a deduction for a worthless partnership investment under IRC section 165(a), although the partnership had not ceased operations].) However, the taxpayer "must show a relevant identifiable event ... which clearly evidences destruction of both the potential and liquidating values of the stock." (*Austin, supra* at p. 970.

Analysis

As indicated in the analysis of Issue 1, appellants have substantiated advances totaling \$1,128,165.81, which must be treated as equity/capital contributions. On March 15, 2000, appellants made advances to the Company and in exchange acquired a 20 percent ownership interest in the Company, consisting of 141,890 shares of the outstanding common capital stock of the Company after recapitalization. FTB argues that the stocks appellants received in exchange for the advances cannot be a security under IRC section 165(g)(2)(C) because the stocks are not in registered form. While "registered form" is a requirement for "a bond, debenture, note, or certificate" described in IRC section 165(g)(2)(C), IRC section 165(g)(2)(A) defines "security" as "a share of stock in a corporation." In this case, Mr. Scholler received 20 percent interest in the Company, consisting of 141,980 shares of stock in the corporation.¹⁵ As such, the stock that Mr. Scholler received is a security as defined in section 165(g)(2)(A).

¹⁵ Additionally, appellants' advances of \$1,128,165.81 to the Company, which OTA finds to be equity rather than a bona fide debt, creates an additional stock interest in the Company for appellants. See e.g., IRS Chief Counsel Memorandum 20040301F, available at <https://www.irs.gov/pub/irs-lafa/20040301f.pdf>, noting that where the IRS reclassifies advances characterized by the parties as loans to equity, the advances are generally treated as additional stock in the company and may be considered as "preferred stock" if there were properly executed and enforceable promissory notes. (See also *Gammen v. Commissioner*, (1966) 46 T.C. 1 [the court addressed whether intercompany debt reclassified as equity constitutes a second class of stock; thereby, resulting in the inability of the corporation to elect subchapter S treatment].)

Appellants have the burden of demonstrating their “adjusted basis” in the Company’s stock. (IRC, § 165(b); see *Martin Ice Cream Co. v. Commissioner, supra*, at 220.) It is well-settled that establishing basis is a factual matter. (*Vaira v. Commissioner* (3rd Cir. 1971) 444 F.2d 770, 775.) As described in Issue 1, OTA found that appellants substantiated advances to the Company of \$1,128,165.81 and, as set forth in footnote 15, that those transfers constitute an additional equity interest (stock or capital contributions) in the Company. Accordingly, appellants have established that their adjusted basis in the Company stock is \$1,128,165.81.¹⁶

Next, appellants must establish that their stock in the Company became worthless during the 2003 tax year. (IRC, § 165(g)(1).) As explained above, shares of stock are worthless when they cease to have liquidating value (the corporation has an excess of liabilities over assets) and do not have a potential future value. (*Austin, supra*, at p. 969-970; *Delk, supra*, at p. 986.) A taxpayer has the burden of proving both elements of this two-prong test. (*Delk, supra*, at p. 986.)

Appellants have argued that their shares of Company stock became worthless in the 2003 tax year, as evidenced by the following occurrences, which they have shown took place that year: (1) the Company discovered that its CFO had embezzled funds totaling \$102,000, (2) the Company’s sales negotiations with large distributors such as Walmart “fell through,” and (3) all of the Company’s employees were terminated. The Company effectively stopped operating in 2003. FTB points to quotes Mr. Bagley made to the media, indicating hope for the Company’s future success. Appellants contend that Mr. Bagley’s statements were aspirational and that the news articles contained some inaccuracies.

However, the objective indicators listed above point to an impaired operation by the summer of 2003. As explained above, the continued operation the Company beyond the year of claimed worthlessness does not, itself, prove future value in its equity interests. (*MCM Investment Management, LLC v. Commissioner, supra*.) Therefore, appellants have shown relevant identifiable events which significantly impaired the value of the stock in 2003.

However, appellants have not provided evidence demonstrating the fair market value (FMV) of the Company’s assets at the end of 2003 (or when the Company otherwise allegedly became worthless in 2003) and comparing the FMV those assets to the Company’s alleged

¹⁶ Appellants have not substantiated the claimed advances of \$400,000 and \$431,590 to the Company in 2000. Additionally, OTA has not evaluated whether those advances are a bona fide debt (as appellants contend) or equity. Thus, these amounts are not included in the basis amount computed here on appeal.

liabilities at the time. Thus, based on the record in this appeal, balance sheet insolvency has not been established, and OTA cannot determine whether the Company ceased to have liquidating value (assets over liabilities).¹⁷ During 2003, the Company had assets: the inventory of games held in the warehouse, of unknown amount and value; presumably the intangible rights to the two computer games created by the Company; Catechumen and Ominous Horizons;¹⁸ and presumably office equipment such as computers and office furniture. Any assets with value would be available as liquidating value to the shareholders (with Mr. Scholler being the only remaining shareholder). The evidence in the record of this appeal does not give insight into the remaining amount of inventory and whether it could have been sold at a discounted price, perhaps to a liquidator, rather than donated; whether there were intangible rights to the games, and if so, whether efforts were made to find an interested buyer; and whether there was office equipment or any other assets that could have been sold.

Unfortunately, much of the Company's records were lost to damage caused by the snowstorm. OTA is sympathetic to appellants' circumstances and recognizes that appellants made efforts to try to reconstruct evidence and provided credible witness testimony, but did not provide concrete and objective information as to the exact value of the Company's remaining assets and liabilities in 2003. The value of the stock was significantly impaired, but it is unclear whether it had no liquidating value and OTA cannot speculate as to the actual liquidating value of the Company. To the extent that the questions above remain unanswered by the evidentiary record, appellants have not met their burden of proof to establish that their stock in the Company had no liquidating value and was therefore worthless. Accordingly, appellants are not entitled to a worthless stock deduction for the 2003 tax year.

¹⁷ As noted above, appellants have provided the default letter from Mr. Bagley who states, in part, that the total value of video games in the Company's warehouse was far less than the monies owed to appellants. The default letter, however, does not compare the Company's total assets with the Company's total liabilities. In his testimony, Mr. Bagley reiterates that the Company's remaining asset at this time was the video games that had not sold, which were eventually donated.

¹⁸ In an October 2003 Boston Globe article, the Company is said to have the right to coproduce first computer game based on "Left Behind," and gained the rights to use a game engine in its endeavors. There is no information in the record as to the validity of these specific claims, or if true, whether the Company retained those rights in 2003 and whether the rights had any value.

Issue 3: Whether the accuracy-related penalty may be abated.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the portion of an underpayment of the tax that was required to be shown on the taxpayers' return. The penalty applies to the portion of the underpayment attributable to: (1) negligence or disregard of rules and regulations; or (2) any substantial understatement of income tax. (IRC, § 6662(b).)

FTB imposed the accuracy-related penalty against appellants based on a substantial understatement. An "understatement" of tax is defined as the excess of the amount of tax required to be shown on the tax return for the tax year, over the amount of tax that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A)(i-ii).) For individual taxpayers, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or \$5,000. (IRC, § 6662(d)(1).) However, even if an understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer can show reasonable cause for the underpayment and the taxpayer acted in good faith with respect to that underpayment.¹⁹ (R&TC, § 19164(d); IRC, § 6664(c)(1).)

Treasury Regulation section 1.6664-4(b)(2) sets out the following example of facts and circumstances that may be considered in determining whether a taxpayer acted with reasonable cause and good faith in relying on tax advice:

Example 1. A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that A knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

¹⁹ While IRC section 6662(d) provides other exceptions or defenses to the accuracy-related penalty (such as substantial authority and adequate disclosure), it is not necessary to discuss those exceptions since the reasonable cause exception applies in this case.

Courts have set forth the three factors that may be used to determine whether a taxpayer's reliance on a professional's advice is reasonable. The taxpayer must prove by a preponderance of the evidence that taxpayer satisfies each requirement of the three-prong test: (1) the professional was independent and had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the professional; and (3) the taxpayer relied in good faith on the professional's advice. (*Hewitt v. Commissioner*, T.C. Memo. 2020-89,²⁰ citing *Neonatology Associates, P.A. v. Commissioner* (2000) 115 T.C. 43, 98-99, *affd.* (3d Cir. 2002) 299 F.3d. 221.) The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76, *affd.* (1st Cir. 2011) 652 F.3d 122.)

While a taxpayer generally need not challenge an independent competent adviser, confirm that the advice is correct, or seek a second opinion, a taxpayer is not reasonable in relying on an advisor burdened with an inherent conflict of interest about which the taxpayer knew or should have known. (*Appeal of Steffier*, 2024-OTA-017P; *American Boat Co., LLC v. U.S.* (7th Cir. 2009) 583 F.3d 471, 481.) To be objectively reasonable, the advice must generally be from a "competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment." (*Appeal of Steffier, supra.*)

In this case, the NPA set forth a total California tax liability of \$106,880, but the tax shown on appellants' 2003 California return was only \$6,677. Thus, the underpayment was \$100,203.00, and the accuracy-related penalty was properly calculated as 20 percent of that amount, which is \$20,040.60.

Appellants' primary argument for abatement of the accuracy-related penalty is that FTB should not have disallowed the claimed short-term capital loss of \$1,233,460, which resulted in a net adjustment to income of \$1,020,826. As explained above, appellants have not established that they were entitled to deduct the advances as a short-term capital loss.

At the hearing, appellants also argued that the accuracy-related penalty should be abated because, in taking the bad debt deduction, appellants relied on the advice of a financial advisor. Appellants testified that Mr. Berry was their tax preparer and financial planner, and advised appellants on their tax matters each year. Mr. Scholler testified that Mr. Berry had experience providing financial planning and tax services to executives. Regarding the 2003 tax year, appellants provided Mr. Berry with the default letter and discussed with him the impossibility of the advances being repaid. Appellants testified that Mr. Berry advised them to

²⁰ This case was reversed and remanded on other grounds by the 11th Circuit.

claim the bad debt deduction. Though appellants do not have documentary evidence of Mr. Berry's advice, their testimony is credible and sufficient evidence of that advice.

Appellants have established that they relied on the advice of an independent tax professional with sufficient expertise to justify such reliance. They provided Mr. Berry with the necessary and accurate information in order for him to advise appellants on this matter. The remaining prong of the reasonable reliance test is whether the taxpayer relied in good faith on the professional's advice. The question of whether appellants were entitled to the bad debt deduction required an assessment of funds advanced to the Company, which was referred to as a loan. While OTA ultimately determines that the advances did not constitute a bona fide debt, the assessment of factors distinguishing debt from equity require careful assessment of the facts and circumstances of this case, such that it would be reasonable for appellants to rely on their tax preparer's conclusion that the funds constituted a bona fide debt.

The question of worthlessness also requires a careful assessment of the facts and circumstances. Appellants provided evidence of an identifiable event in 2003 and of significant impairment of the stock value in 2003. Moreover, appellants were unaware that years later, the snowstorm that destroyed records would prevent appellants from providing other substantiating evidence. This is further evidence of the reasonableness of appellants' action in relying on their tax preparer and taking the deduction at issue in this appeal.

Appellants have shown that they relied on the advice of an independent, competent advisor, and that appellants' reliance on this advice was objectively reasonable. Both appellants and the Company's executives consistently characterized the advances as debt (as opposed to equity), and the default letter issued to appellants in 2003 indicated that the advances could not be repaid. (See *Appeal of Steffier, supra.*) Based on the facts of this case, it was objectively reasonable for appellants to rely on Mr. Berry's advice. Accordingly, appellants have demonstrated that the accuracy-related penalty should be abated.

Issue 4: Whether any interest can be abated.

Tax is due on the original due date of the return without regard to any filing extension. (R&TC, § 19001.) If a taxpayer does not pay the tax by the original due date of the tax return, or if FTB assesses additional tax, the law provides for charging interest on the balance due. (R&TC, § 19101.) Imposition of interest is mandatory; it is not a penalty, but it is compensation for a taxpayers' use of money after it should have been paid to the state. (*Appeal of Moy, 2019-OTA-057P.*) There is no reasonable cause exception to the imposition of interest. (*Ibid.*)

To obtain relief from interest, a taxpayer must qualify under the waiver provisions of R&TC sections 19104 or 21012.²¹ (*Ibid.*)

FTB may abate all or part of any interest on a deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay committed by FTB in performing a ministerial or managerial act. (R&TC, § 19104(a)(1).) An error or delay shall be taken into account only if no significant aspect of the error or delay is attributable to the appellant and after FTB has contacted the appellant in writing with respect to the deficiency or payment. (R&TC, § 19104(b)(1).) OTA's jurisdiction for interest abatement is limited by statute to a review of FTB's determination for an abuse of discretion. (R&TC, § 19104(b)(2)(B).) To show an abuse of discretion, the appellant must establish that, in refusing to abate interest, FTB exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of GEF Operating, Inc.* 2020-OTA-057P.)

In this case, appellants argue there was an unreasonable delay on FTB's part in issuing the NOA. Appellants contend that though they pursued an audit reconsideration with the IRS and asked FTB for more time, FTB last "checked in with" appellants in 2016, and then took another four years to issue the NOA. FTB argues that appellants significantly contributed to the delay in issuing the NOA by failing to notify FTB when their federal audit reconsideration concluded, and that FTB followed up with appellants but did not receive a response. As a result, FTB argues, interest cannot be abated under R&TC section 19104.

FTB issued the NPA in this matter in November 2009. Appellants filed their protest in December 2009, requesting that FTB defer action on the NPA so that the IRS could review appellants' Form 1040X. In March 2010, appellants requested that the deferral be continued. FTB granted the request. The IRS closed its examination of appellants' 2003 tax year in April 2011. However, appellants did not notify FTB that the federal audit reconsideration had concluded. FTB requested updates from appellants in 2012 and again in 2016 but did not receive a response to either request. In 2020, FTB issued an NOA affirming the NPA.

Because a significant aspect of the delay between 2016, when FTB attempted to contact appellants, (or 2009, when FTB issued the NPA), and 2020, when FTB issued the NOA, is attributable to appellants' failure to notify FTB that the federal audit had concluded, interest

²¹ Under R&TC section 19104, FTB is authorized to abate or refund interest if there has been an unreasonable error or delay in the performance of ministerial or managerial act by an employee of FTB. R&TC section 21012 may apply where there has been reliance on written advice requested of FTB. Appellants do not allege that they relied upon written advice from FTB. Finally, OTA does not have jurisdiction to review FTB's denial of request to waive interest under R&TC section 19112, relating to extreme financial hardship. (*Appeal of Moy, supra.*)


cannot be abated under R&TC section 19104. Consequently, OTA concludes that appellants are not entitled to interest abatement.

HOLDINGS

1. Appellants are not entitled to a bad debt deduction for the 2003 tax year.
2. Appellants are not entitled to a worthless stock deduction for the 2003 tax year.
3. The accuracy-related penalty should be abated.
4. Interest cannot be abated.

DISPOSITION


The accuracy penalty is hereby abated. Otherwise, FTB's action is sustained in full.

DocuSigned by:

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 Amanda Vassigh
 Administrative Law Judge

We concur:

DocuSigned by:

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 Asaf Kletter
 Administrative Law Judge

DocuSigned by:

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 Cheryl L. Akin
 Administrative Law Judge

Dated: 4/23/2025