

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
REAL ESTATE BUY KELLER)

Appearances:

For Appellant: Alvin R. Wohl
Attorney at Law

-For Respondent: Richard C. Creeggan
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Real Estate Buy Keller against a proposed assessment of additional franchise tax in the amount of \$1,131.65 for the income year ended October 31, 1965.

The issue presented is whether appellant is entitled to two bad debt deductions for **the income** year in question.



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Appellant was incorporated in California in 1958, and its principal activity has been real estate sales. All of its stock was owned by John E. Keller, now deceased, and his wife, Margaret, who were also its principal officers. Their son, James R. Keller, was a salesman for appellant from May 22, 1959, until July 31, 1960. On December 14, 1959, appellant issued a check to James R. Keller in the amount of \$4,000. Mrs. Audrain (Margaret Keller's present married name) testified that her son was building an apartment house and the money was loaned to enable him to pay for a lumber shipment. No security was given. No note or other written evidence of the claimed debt or its terms has been produced. In October of 1960 James R. Keller paid \$1,447.55 to appellant, which treated this sum as a partial payment of the alleged loan. In further support of the existence of a loan, Mrs. Audrain testified that 6 percent interest was charged and that a portion of her son's commissions was used to pay interest while he was employed by appellant.

On December 1, 1962, appellant loaned \$23,722.93 to Kelmont, Inc. (hereinafter Kelmont), a California corporation, which was created January 1, 1961. Its business was property development, and its president and principal shareholder was James R. Keller.. This unsecured debt was evidenced by a 6 percent promissory note payable on demand but no later than December 1, 1964. James R. Keller signed this note as corporate president and also guaranteed payment in his individual capacity.

Mrs. Audrain testified Kelmont needed the loan to complete construction of an apartment house, the sale of which would better Kelmont's poor financial condition. However, the apartment house transaction was not completed. Because of Kelmont's financial plight, appellant sought repayment of the loan in 1963. Late in that year, Lee De Lauer, Kelmont's treasurer, showed Mrs. Audrain a schedule of expected receipts from apartment house transactions and of proposed payments to creditors, including appellant. Despite this fact and other assurances, appellant was only repaid \$5,700, all prior to November 1, 1964.

On its franchise tax returns for the income years 1961 and 1962, Kelmont reported operating losses of \$3,524.61

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and **\$17,784.90**. In January of 1962, it was suspended by the Secretary of State for failure to pay the minimum franchise tax. This tax liability was subsequently paid and Kelmont was revived on April 19, 1963. However, it failed to file any franchise tax returns or pay the minimum tax for the income year ended December 31, 1963, and thereafter. Consequently, on January 4, 1965, Kelmont was again suspended pursuant to section 23302 of the Revenue and Taxation Code.

Respondent's investigation revealed that Kelmont was without assets and ceased operating well in advance of November 1, 1964. A decision of the Contractors' State License Board also indicated that Kelmont ceased its activities considerably before that date, although its contractor's license was not formally revoked until June 22, 1965. The revocation resulted from failure to pay numerous materialmen and subcontractors who had supplied materials and performed services from October of 1963 through **early** January 1964.

On August 6, 1965, appellant's former counsel advised Mrs. Audrain that during the past year a federal tax lien, numerous judgments, and other claims had been filed against Kelmont and that any assets available were substantially less than the **tax lien**, preferred wage claims and union fringe benefits, all of which had priority over appellant's unsecured note. She was also advised that James R. Keller, the guarantor, was completely without assets, that a 100 percent penalty for failure to remit payroll taxes had been assessed against him, and that any assets he might later acquire would be subject to the federal government's prior lien for years to come. By 1965, she was also aware that her son had many other creditors, including numerous supply houses and loan companies,

On its return for the income year ended October 31, 1965, appellant deducted the **\$2,552.45** unrepaid by James R. Keller and the **\$18,022.93** unrepaid by Kelmont as worthless bad debts. Respondent disallowed the deductions because appellant failed to establish to respondent's satisfaction that the transfer to James R. Keller was a bona fide loan or that either alleged debt had become worthless within the income year in question.

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We shall first discuss the **\$18,022.93** balance owed appellant by Kelmont. Section 24348 of the Revenue and Taxation Code permits a deduction for "debts which become worthless within the income year;..." This section is the counterpart of section 166 of the Internal Revenue Code of 1954. The burden is upon the taxpayer to establish that a debt became worthless in the very year for which it claims it as a deduction. (Redman v. Commissioner, 155 **F.2d** 319; Cittadini v. Commissioner, 139 **F.2d** 29.) No bad debt deduction may be allowed for a particular year if the debt became worthless prior to that year. (Redman v. Commissioner, supra; Bella Feinstein, 24 T.C. 656.) Since actual worthlessness is the test, the dates of actual ascertainment or eventual giving up by the taxpayer on the possibility of recovery are immaterial. (Appeal of Isadore Teacher, Cal. St. Bd. of Equal., April 4, 1961.)

Appellant contends that the identifying events establishing worthlessness occurred in the income **year** in question, when Kelmont was suspended the second time for failure to pay franchise taxes and its contractor's license was **formally** revoked. These same events, however, are consistent with worthlessness prior to November 1, 1964. **The reason for the second suspension** appears to have been Kelmont's failure to pay tax for the income year 1963. Accordingly, this suspension related to Kelmont's inability or refusal to meet its tax obligation for a period prior to the income year of appellant under consideration. While formal revocation of Kelmont's contractor's license became effective during the income year under review, the facts established during the hearing on that matter indicated Kelmont ceased business activity before November 1, 1964. Respondent's own investigation also disclosed that Kelmont was without available assets and ceased activity before that date..

In addition, appellant has not met the burden of proving that **James R.** Keller's guaranty became worthless during the year ended October 31, 1965. To the contrary, indications are the guaranty was worthless

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before November 1, 1964. The record indicates that James Keller received no salary or dividends from Kelmont during 1961 and 1962, and there is 'no evidence that he received any income from Kelmont in later years. Similarly, there is no evidence that he was engaged in any other **income-**producing activity or had independent means. On the whole the record shows that he was heavily in debt prior to November 1, 1964, and was as unable to pay the debt before that date as thereafter.

We next consider the **\$2,552.45** bad debt deduction relating to the **\$4,000 advanced** to James R. Keller. In view of Mrs. **Audrain's** testimony, we may assume that the advance was a bona fide debt. Nevertheless, for the reasons explained in reviewing James R. Keller's guaranty of the Kelmont obligation, we conclude **appellant has** not established that the debt first became worthless within its income year ended October 31, 1965.

Consequently, we must sustain respondent's action disallowing both deductions.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Real Estate Buy Keller against a proposed assessment of additional franchise tax in the amount of \$1,131.65 for the income year ended October 31, 1965, be and the same is hereby sustained.

Done at Sacramento, California, this 13th day of November, 1973, by the State Board of Equalization.

William B. Zumbach, Chairman
Leo R. Kelley, Member
John W. Lynch, Member
Richard Stein, Member
_____, Member

ATTEST: *W. D. Kemp*, Secretary