



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
RAFAEL E. MENDOZA) No. **85A-38-PD**

For Appellant: Arnold C. Libman
Certified Public Accountant

For Respondent: **Lorrie K.** Inagaki
Counsel

O P I N I O N

This appeal is made pursuant to section **18593^{1/}** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Rafael E. Mendoza against proposed assessments of additional personal income tax and penalties in the total amounts of **\$2,238.60** and **\$3,836.00** for the years 1979 and 1980, respectively.

1/ Unless otherwise specified, all section references **are** to sections of the Revenue and Taxation Code as in effect for the years in issue.

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In 1978, appellant, an anesthesiologist, entered into an oral agreement with a Salvatore Pisello to act as financier for a restaurant. The restaurant, which was located in Los Angeles and incorporated as the S/S Restaurant Company, Inc., operated under the name Roma di Notte and was managed by Pisello. Appellant stated that he went into the restaurant business because he suffered an injury which might have affected his ability to continue his medical profession. However, appellant did continue his practice **and earned** \$45,000 and \$52,000 from his professional medical corporation for 1979 and 1980. He is still currently employed as an anesthesiologist.

During 1978, for the stated purpose of starting and operating the restaurant, appellant issued six checks totaling \$146,000. Five of the checks were payable to Pisello and one check was payable to S/S Restaurant Company, Inc. Pisello executed two promissory notes to appellant, one for \$65,000 on April 1, 1978, and one for \$60,800 on September 8, 1978. Both notes bore 10 percent interest per year and were due three years from their dates. S/S Restaurant Company, Inc., executed a promissory note to appellant for \$127,000 on May 17, 1978.. That note bore 10 percent interest per year, was due upon demand, and was signed by Irving N. Rubinstein, M.D., president, and **Mal** Sigman, secretary. No information has been offered to relate the amount of the notes to particular payments by appellant. **None of the notes were** secured. Appellant understood that the amounts of the notes were to be repaid when the restaurant started making money and that the security for the notes would be the assets of S/S Restaurant Company, Inc. Appellant was also one of the shareholders in that corporation.

In 1979, Pisello disappeared without making any payments on the notes. In November 1979, appellant hired an attorney to locate Pisello, who was apparently suspected of being involved in fraudulent activities and was being sought by the U.S. Department of Justice, the Federal Bureau of Investigation, the Internal Revenue Service, and the Los Angeles County District Attorney's Office. Appellant's attorney claims that he was unable **to** locate Pisello, although appellant's representative has indicated that Pisello was still available in 1980. The assets of S/S Restaurant Company, Inc., have disappeared. No action was taken against the corporation. Appellant has not been repaid any of the amounts.

Appellant began, deducting amounts expended as loans and guarantee payments to Mr. Pisello and the

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corporation in 1979. For 1979, appellant deducted \$20,000, which he now considers a bad debt loss.

For 1980, appellant deducted \$60,000 as a business bad debt loss. In the same year, appellant also deducted \$5,970 as a partnership loss for S/S Restaurant Company, Inc. Appellant now characterizes this as an additional \$5,970 bad debt loss.

Respondent audited appellant's tax returns for 1979 and 1980. For 1979, respondent disallowed the \$20,000 **bad debt** loss since appellant did not provide any evidence to support a bad debt deduction. For 1980, respondent disallowed appellant's business bad debt deduction of \$60,000 but allowed a nonbusiness bad debt deduction in that amount, which was treated as a **short-term** capital loss. For 1980, respondent also allowed a nonbusiness bad debt deduction for the \$5,970 originally taken as a partnership loss. Penalties were also assessed for taxable years 1979 and 1980 for delinquent filing.

Appellant protested the disallowance of the bad debt deduction for 1979 and the disallowance of the business bad debt deduction for 1980 on the basis that all these amounts were losses suffered as a result of **business** bad debts. After due consideration, respondent affirmed its assessments after some revisions relating to items not here in issue and issued notices of action for these years. This appeal followed.

It is appellant's contention that all these losses represent bad debt losses stemming from loans made to Mr. Pisello and S/S Restaurant Company, Inc. Consequently, the only issues on appeal are whether appellant is entitled to a bad debt deduction for 1979, and whether the losses are properly characterized as nonbusiness or business bad debts for 1980.

It is well established that the taxpayer who claims a deduction has the burden of proving that he is entitled to it. A determination by respondent that a deduction should be disallowed is supported by a presumption that it is correct. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Nake M. Kamrany, Cal. St. Bd. of Equal., Feb. 15, 1972.)

Section 17207 allows a deduction for "any debt which becomes worthless within the taxable year." In order to be deductible, the debt must be bona fide, that is, it must arise "from a debtor-creditor relationship

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based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Former Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3), repealer filed Apr. 18, 1981 (Register 81, No. 16).) In addition, to be deductible, the debt must have become worthless during the year in which the deduction is claimed. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976.) In order to show this, the taxpayer must prove that the debt had some value at the beginning of the year in which the deduction is claimed, and that some event occurred during that year which caused the debt to become worthless. (Appeal of Frank and Enedina Leon, Cal. St. Bd. of Equal., May 8, 1984; Appeal of Sam and Dina Hashman, Cal. St. Bd. of Equal., June 29, 1982.) The burden of proving that the debt was bona fide and that it became worthless during the taxable year rests on the taxpayer. (Appeal of Alfred J. and Margaret J. Ersted, Cal. St. Bd. of Equal., Dec. 19, 1962; Appeal of Isadore Teacher, Cal. St. Bd. of Equal., Apr. 4, 1961.)

In this case, none of the checks or notes amount to \$20,000, the amount of the deduction claimed in 1979. Nor are there any documents which evidence that the claimed loss relates to any debt or even to any particular transaction. Accordingly, there is no basis upon which to conclude that the claimed deduction relates to a certain debt which had value at the beginning of 1979 and which was rendered worthless by a particular event which occurred during the year. Appellant contends that the \$20,000 was deductible in 1979 because Pisello disappeared in that year, and for that reason the loan became uncollectible in that year. But appellant has not documented the connection of the claimed \$20,000 loss to any certain debt owed appellant by Pisello. Furthermore, appellant's representative indicated that Pisello was still available in 1980, the year after the deduction was claimed.

For 1980, appellant's claimed bad debt deduction was disallowed as a business bad debt but allowed as a nonbusiness bad debt. Under section 17207(d), nonbusiness bad debts are treated as short term capital losses, which are deductible only to the extent of capital gains, plus taxable income or \$1,000, whichever is less. Business bad debts are fully deductible against taxable income in the year the losses are sustained. Section 17207(d)(2) defines a nonbusiness bad debt as a debt other than: "(A) a debt created or acquired ... in connection with a trade or business of the taxpayer: or (B) a debt the loss from the worthlessness of which is

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incurred in the taxpayer's trade or business." Section 17207 is substantially similar to section 166 of the Internal Revenue Code of 1954. Thus, federal authority is persuasive of the proper interpretation of that section of California's Personal Income Tax Law. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

Appellant's position is that he was an employee of S/S Restaurant Company, Inc. Employment by a company may be a trade or business of the employee for bad debt purposes. Thus, a loan to the employing company might be a loan in connection with the creditor-employee's trade or business. (Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).) But there is no evidence that appellant provided any services to the corporation. He received no salary or other compensation from that corporation. He was then, as now, employed full time as an **anesthesiologist**. Mr. Pisello was the appointed manager of the restaurant business. Appellant's allegation that he was protecting possible future employment by the company does not make the necessary demonstration that any loans or guarantees he may have made to the corporation were in **the course** of his then existing trade or business.

Since appellant has not sustained his burden of proving respondent's assessments were in error, we have no choice but to sustain respondent's action in denying the claimed deductions. Furthermore, since appellant has **presented no** argument in opposition to the penalties, respondent's action in this regard must also be sustained. (Appeal of Clyde L. & Josephine Chadwick, Cal. St. Bd. of Equal., Feb. 15, 1972.)

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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,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Rafael E. Mendoza against proposed assessments of additional personal income tax and penalties in the total amounts of **\$2,238.60** and **\$3,836.00** for the years 1979 and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of February , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman
Conway H. Collis , Member
William M. Bennett , Member
Ernest J. Dronenburg, Jr. , Member
Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9