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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**
9

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **BRUCE CULVER AND**) Case No. 480448
13 **DONNA TURNER CULVER¹**)
14

	<u>Year</u>	<u>Claim for Refund</u>
	2004	\$875,336.00 ²

16 Representing the Parties:

17 For Appellants:³ Samuel R. Mania, CPA

18 For Franchise Tax Board: Raul A. Escatel, Tax Counsel
19

20 **QUESTIONS:** (1) Whether stock warrants issued to appellant that were exercised in 2004 resulted in
21 any income to appellant under Internal Revenue Code (IRC) section 83.
22 (2) Whether appellant incurred business/nonbusiness bad debt losses and worthless
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24 ¹ Appellants reside in the City of Westlake Village, Ventura County, California.

25 ² This amount represents the entire refund claim identified in respondent's Notice of Action (NOA) on Overassessment,
26 Credit, or Refund dated October 20, 2008. Respondent states that it subsequently issued appellants a partial refund check in
27 the amount of \$195,903.23 for 2004 relating to this claim. A copy of this check was provided in respondent's opening brief
on page three of exhibit P.

28 ³ Although appellants filed a joint return and are therefore the appellants of this appeal, the issues and facts of this appeal are
related to Mr. Culver's activities and transactions. For clarity, all references to "appellant" are to Mr. Culver.

1 stock losses in 2004.

2 (3) Whether appellant was issued a refund check for losses on the sale of stock for
3 2004.⁴

4 HEARING SUMMARY

5 Background

6 *Issue (1) the Taser Warrants*

7 Appellant is an investor and business entrepreneur who began investing in Taser
8 International Incorporated (Taser) in 1994. Beginning in 1994, appellant served on Taser's board of
9 directors and made substantial investments in Taser. Prior to Taser's Initial Public Offering in May
10 2001, appellant was Taser's largest shareholder owning 31.9 percent of its stock.

11 In July 2000, appellant loaned Taser \$1.5 million and Taser issued appellant stock
12 warrants to purchase 136,364 shares in Taser at an exercise price of \$0.55 (the Taser Warrants).
13 Pursuant to the Taser Warrants, appellant was entitled to purchase Taser stock any time between July 31,
14 2000 through July 31, 2005. On appellants' original California resident return for 2004, appellant
15 initially reported \$8,765,412.55 in non-employee compensation related to the Taser. Appellant's
16 reporting was consistent with a Federal Form 1099-MISC issued by Taser to appellant. Appellants
17 subsequently amended their California 2004 return on February 15, 2006, with a corrected Form 1099-
18 MISC from Taser now showing only \$3,531,762.23 in non-employee compensation (*i.e.*, excluding
19 \$5,233.650 from the amount previously reported). Respondent accepted appellants' amended return
20 position and issued a refund on March 28, 2006. On September 5, 2007, appellants again amended their
21 2004 return (the Final Amended Return) claiming that the exercise of the Taser Warrants in 2004 was
22 completely non-taxable (*i.e.*, that the remaining \$3,531,762.23 should not have been treated as income).
23 Respondent disallowed this second refund request.

24 *Issue (2) Pentawave Bad Debts and Worthless Stock*

25 Appellant was a director and investor in Pentawave Incorporated (Pentawave) since 1997.
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28 ⁴ A fourth issue exists in this appeal; namely, whether itemized deductions related to the first three issues were correctly reduced by respondent (due to the mechanical effect of the other three issues on appellant's adjusted gross income (AGI)). The parties appear to agree that this detailed AGI calculation issue will be controlled by the Board's determination regarding the first three issues. For this reason, Board staff has not endeavored to summarize this fourth issue.

1 In 2000, he assumed the role of chairman taking on both a funding role and executive management role.
2 One of Pentawave's business activities was producing real estate advertising management software
3 (AMS). In 2000, a third-party company named Homestore entered into a three-year contract whereby
4 Pentawave would develop AMS for Homestore. Homestore reneged on the deal and Pentawave and
5 appellant subsequently filed suit against Homestore in superior court on December 27, 2001. Further
6 business negotiations continued between Pentawave and Homestore. However, in 2004, it became clear
7 that Homestore would not move forward with Pentawave's AMS software. The parties disagree as to
8 whether 2004 or 2005 should be the tax year in which (1) appellant's stock in Pentawave became
9 worthless, and (2) appellant's loans to Pentawave qualified for business/nonbusiness bad debt
10 deductions. During the protest of appellant's refund claim, respondent disallowed the refund claim
11 losses related to Pentawave stating that they were allowable for the 2005 tax year.

12 *Issue (3) Refund Check*

13 Appellant does not recall receiving a check from respondent resulting from a loss
14 deduction in connection with the sale of certain stock. Respondent provided a copy of a check in the
15 amount of \$195,903.23 that was issued to appellants on October 22, 2008, indicating a portion of this
16 refund was related to the loss deduction agreed upon by respondent. Appellant should be prepared at the
17 hearing to discuss whether a copy of this check and respondent's corresponding payment transcript (both
18 provided in exhibit P of respondent's opening brief) satisfied appellant's protest inquiry.

19 Upon the subsequent protest of appellant's refund request, respondent disagreed with
20 appellant's contentions and issued its NOA on October 20, 2008. This timely appeal followed.

21 Contentions

22 *Issue (1) the Taser Warrants*

23 Appellant contends that the Taser Warrants were not received as compensation for
24 services, but were issued to him as an investor which he held and then exercised in 2004. Appellant
25 contends therefore that IRC section 83 does not apply and that the transaction in 2004 was not taxable
26 under the reasoning of *Centel Communications Co., Inc. v. Comm'r*, (1989) 92 T.C. 612, *aff'd* (7th Cir.
27 1990) 920 F. 2d 1335.

28 Respondent contends that IRC section 83 applies because the Taser Warrants were issued

1 in connection with the performance of services; namely, appellant's directorship activities and financing
2 assistance made on behalf of Taser. Respondent also points out that Taser issued appellant a Form
3 1099-MISC for \$3,531,762.23 which shows that Taser clearly treated the amount related to the Taser
4 Warrants as resulting in "non-employee compensation" paid to appellant.⁵ For these reasons,
5 respondent contends this amount should have been treated as income to appellant for 2004.

6 *Issue (2) Pentawave Bad Debts and Worthless Stock*

7 Appellant contends that his loans to Pentawave became bad debts and his Pentawave
8 stock became worthless in 2004. Appellant contends that Pentawave became illiquid in the fall of 2000,
9 after a failed round of venture funding. Appellant contends that as chairman of Pentawave, he
10 reorganized the company in October 2000 for sale and/or merger. From 2001 through 2004, appellant
11 maintained the AMS software in working, demonstrable order in order to sell AMS to the real estate
12 industry. In 2002, Homestore demonstrated interest in AMS, and in the summer of 2004, appellant
13 presented Homestore management with a final proposal to utilize AMS. Appellant claims that in July
14 2004, Homestore lost interest in AMS. Appellant states that this identifiable event represented the end
15 of Pentawave as a viable business. Appellant states that from 2001 through 2005, there was separate
16 litigation between Pentawave and appellant as plaintiffs against Homestore for breach of contract. This
17 case was settled in December 2006. Appellant agrees that he received proceeds from this 2006
18 settlement.

19 Respondent contends that credible evidence has not been offered showing that there was
20 no chance of Pentawave repaying its loan to appellant in 2004. Appellant contends that the litigation
21 between Pentawave and Homestore was related to Homestore's renegeing on a contract negotiated with
22 Pentawave in February 2001.⁶ Respondent appears to agree with appellant that the Homestore business
23 negotiations collapsed in the summer of 2004, but that litigation continued between Pentawave and
24 Homestore into 2005. Respondent claims that the identifiable event when the loans from Homestore to
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26 ⁵ Board staff presumes that based on the issuance of this Form 1099-MISC, respondent is claiming that since Taser claimed a
27 deduction for this payment, appellant should be required to take this amount into income.

28 ⁶ It appears to Board staff that respondent believes the Homestore litigation was related to the AMS contract and was related
to Pentawave's final business venture (the operation/sale of AMS). Appellant stated that this was a separate litigation matter
related to a contract that was performed on, but not paid by Homestore.

1 appellant became bad debts and appellant's stock in Pentawave became worthless was when appellant
2 received a litigation settlement on December 15, 2005, with Homestore agreeing to pay \$1.75 million to
3 Pentawave and appellant. Respondent claims that as a result of this settlement, appellant received
4 \$325,487. Respondent contends that this settlement and appellant's continued efforts to pursue this
5 action in court establishes that appellant had some hope that Pentawave still had value and it was not
6 until 2005 (at the conclusion of the litigation against Homestore) that the loans to appellant became bad
7 debt and appellant's stock in Pentawave became worthless.

8 *Issue (3) the Refund Check*

9 The contentions/questions surrounding this issue were discussed above.

10 Applicable Law

11 *Issue (1) the Taser Warrants*

12 IRC section 83(a) provides that when property (here Taser Warrants) is transferred in
13 connection with the performance of past, present, or future services, the excess of the fair market value
14 of the property over the amount paid is includible as compensation in the gross income of the taxpayer
15 that performed the services. California conforms to IRC section 83. (*See Rev. & Tax. Code, §§ 17081*
16 *and 24379.*)

17 Treasury Regulation 1.83-7 provides that in the case of a taxpayer who receives a
18 nonqualified stock option in connection with the performance of services, that such compensation
19 income is includible when the option is exercised.

20 In *Centel Communications Co., Inc. v. Comm'r*, relied on by appellant *supra*, the Seventh
21 Circuit elaborated on the application of IRC section 83 with respect to situations when property is
22 transferred in connection with the performance of services. In *Centel*, the Internal Revenue Service
23 (IRS) made claims against the corporation and certain individual shareholders to determine the proper
24 treatment of stock warrants issued by the corporation and later exercised by the shareholders.⁷ The
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26 ⁷ The Taser Warrants issue of this appeal is directly analogous to the issue in *Centel*. In procedural contrast, however, Taser
27 is not a party in this appeal. The IRS took the step of involving the corporation in *Centel* to make sure that the underlying
28 corporation and the shareholders would not be able to whipsaw the IRS by taking contrary positions (*e.g.*, the corporation
could have deducted the payments for issuances of stock to its shareholders, while the shareholders avoided taking the
amounts into income). Alternatively, if the corporation did not make such deductions, then perhaps the shareholders did not
have income to report.

1 *Centel* Court determined the following:

- 2 1. IRC section 83 only applies if warrants are issued in connection with services.
- 3 2. The question of whether warrants were issued in connection with services is a question of fact.
- 4 3. "Services" for these purposes usually connotes an act performed by an employee or independent
5 contractor rather than "aid" lent to the company by a shareholder.
- 6 4. Financial "aid" to a corporation, through a shareholder's assumptions of additional financial risk
7 (through loan guarantees made on behalf of the corporation) did not constitute services under
8 IRC section 83.

9 Revenue Ruling 78-182, 1978-1 C.B. 265 appears to apply in situations where a warrant
10 is not obtained in connection with the performance of services. This ruling provides that the holder of a
11 warrant recognizes no income on the receipt of stock in exchange for the warrant upon exercise.
12 Instead, the holder's basis in the warrant is added to the exercise price to determine his basis in the stock
13 received upon exercise. Revenue Ruling 78-182 is technically limited to publically traded
14 options/warrants, but seems to be supported as a general proposition by *Helvering v. San Joaquin Fruit*
15 *and Investment Co.* (1936) 297 U.S. 496, where the Supreme Court held that the exercise of an option to
16 purchase real property did not constitute an exchange of the option and the option premium for the real
17 property, but rather should simply be treated as an acquisition of the property on the date the option was
18 exercised.

19 *Issue (2) Pentawave Bad Debts and Worthless Stock*

20 R&TC section 17201 provides that itemized deductions such as bad debts and worthless
21 stock are allowable in conformity with IRC sections 166 and 165, respectively.

22 *a. Bad Debt Issue*

23 Under IRC section 166(a), a business bad debt is deductible against ordinary income in
24 the year the obligation becomes partially or totally worthless. A wholly worthless nonbusiness bad debt
25 is treated as a short-term capital loss. (Treas. Reg. § 1.166-1(a)).⁸ Treasury Regulation section 166-
26 5(a)(2) provides that a loss on a non-business debt shall be treated as sustained only if and when the debt
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28 ⁸ It is unclear to Board staff whether appellant agrees with respondent's characterization of the bad debt as a non-business bad debt.

1 has become totally worthless.

2 No precise test for determining worthlessness within the taxable year exists.
3 (*Minneapolis, St. Paul & Sault Ste. Marie R.R. Co. v. U.S.* (1964) 164 Ct. Cl. 226.) A determination as
4 to whether debt is worthless is a question of fact to be determined by the evidence available from all of
5 the objective circumstances. (*Estate of Mann v. U.S.* (5th Cir. 1984) 731 F. 2d 267.) The subjective
6 good faith opinion of the taxpayer alone is not sufficient to meet this burden. (*E.g., Fox v. Comm'r*
7 (1968) 50 T.C. 813.) The taxpayer must also exhaust all the usual reasonable means of collection to
8 establish worthlessness. (*Newman v. Comm'r*, T.C. Memo 1982-61.) The burden of proving
9 worthlessness can generally be met by showing that some identifiable event occurred which effectively
10 demonstrates the absence of potential value; however, insolvency by itself does not establish
11 worthlessness. (*LeLanda v. Comm'r*, T.C. Memo 1976-345.) Finally, in *Buchanan v. U.S.* (7th Cir.
12 1996) 87 F. 3d 197, the Seventh Circuit held that allowance for a nonbusiness debt that becomes
13 worthless within the taxable year is unavailable if even a modest fraction of the debt can be recovered,
14 irrespective of the source of repayment, unless the source, and therefore the repayment, are
15 unforeseeable.

16 *b. Worthless Stock Rules*

17 Under IRC section 165(g)(1), if a security becomes worthless during the taxable year, the
18 loss is treated as a loss from the sale or exchange of a capital asset on the last day of that taxable year. A
19 security for these purposes includes a share of stock in a corporation. (Int.Rev. Code § 165(g)(2)(A).)
20 In order to obtain a worthless stock deduction under IRC section 165(g), the taxpayer has the burden of
21 showing that the security was worthless in the year claimed. (*Osborne v. Comm'r*, T.C. Memo 1995-
22 353).⁹ To establish worthlessness, the taxpayer must demonstrate: (1) balance sheet insolvency
23 (liabilities exceeded assets in the year of worthlessness) (*Greenberg v. Comm'r*, T.C. Memo 1971-220);
24 and (2) a complete lack of future potential value, usually through the occurrence of an identifiable event
25 or series of events showing both current and future worthlessness. (*E.g., Richards. v. Comm'r*, T.C.

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28 ⁹ IRC section 165(g) also requires that the taxpayer has the burden of showing that the security had a basis and that it was not
worthless in a prior year. However, these requirements are not at issue in this appeal.

1 Memo 1959-64; *Jessup v. Comm'r*, T.C. Memo 1977-289; *Egly v. Comm'r*, T.C. Memo 1988-223.)¹⁰
2 The mere fact that a corporation ceased operations did not necessarily establish worthlessness of the
3 corporation's underlying stock. (*DeJoy v. Comm'r*, T.C. Memo 2000-162.) Stock may not be
4 considered worthless even if there is no liquidation value, if there is a reasonable hope and expectation
5 that it will become valuable at some future time. (*Morton v. Comm'r* (1938) 38 B.T. A. 1270, *aff'd* (7th
6 Cir. 1940) 112 F. 2d 320.) In one case, a worthless stock deduction in a financially distressed
7 corporation that had no liquidation value in 1989 was denied for the 1989 tax year, because the stock
8 had potential future value due to outstanding litigation with a third-party. (*Terri L. Steffen v. U.S.* (April
9 30, 2009 US Dist. Ct.) No. 8:08-cv-2337, available on Lexis at 2009 TNT 141-24.) The worthless stock
10 claim was allowed for the 1993 tax year when the litigation was settled. (*Id.*)

11 STAFF COMMENTS

12 *Issue (1) the Taser Warrants*

13 Issue (1) appears to be a question of fact, *i.e.*, whether appellant received the Taser
14 Warrants in connection with the performance of services or as an investor for financially aiding Taser.
15 The parties should be prepared to provide evidence supporting their respective positions. In weighing
16 the evidence, the Board may wish to inquire why Taser (of which appellant was a director during the
17 relevant tax year) apparently has taken a position contrary to appellant by treating \$3,531,762.23 as non-
18 employee compensation and whether Taser in fact deducted the amount as a compensation to appellant.

19 *Issue (2) Pentawave Bad Debts and Worthless Stock*

20 Issue (2) also appears to be a question of fact, *i.e.*, whether the identifiable event that led
21 to appellant's loans and stock in Pentawave becoming worthless was the collapse of the Homestore
22 negotiations in 2004 or the final settlement of the Homestore litigation in December 2005. The parties
23 should be prepared to provide evidence supporting their respective positions. In weighing the evidence,
24 the Board may wish to inquire why appellant held out hope in litigation (through 2005) that Homestore
25 would eventually provide some litigation settlement value, which it eventually did (as opposed to simply
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27 ¹⁰ The identifiable event or events requirement of the worthless security test resembles the identifiable event or events
28 requirement of the bad debt test discussed above. In both cases, appellant points to the collapse of negotiations with
Homestore (summer of 2004) as the identifiable event; while respondent points to the December 2005 settlement with
Homestore as the identifiable event.

1 dropping the litigation). Clarification regarding the precise nature of the litigation would also be
2 helpful. For example, appellant claims "the lawsuit had nothing to do with the worthlessness of the
3 company, as Mr. Culver was attempting to recover value with respect to a contract that was performed
4 on and not paid by Homestore."¹¹ It appears from this statement that someone (either Mr. Culver or
5 Pentawave, or both) were pursuing an accounts receivable from Homestore that was eventually settled
6 for approximately \$1.75 million in 2005. In addition, it may be helpful for the Board to understand
7 whether appellant, as a creditor and shareholder of Pentawave, had any creditor priorities for amounts
8 potentially recoverable by Pentawave (such as any receivables) in the Homestore litigation and what
9 steps did appellant take to collect on his debts against Pentawave.

10 Finally, after the close of briefing in this appeal, Board Proceedings received from
11 appellant a copy of the federal audit report for the tax years ended December 31, 2003, 2004 and 2006.¹²
12 Since the briefing was closed in this appeal and appellant made no contentions with respect to this
13 submission, Board staff will treat this submission as an exhibit. At the oral hearing, the parties should
14 be prepared to discuss how this federal audit report supports their respective positions.

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28 ¹¹ App. Opn. Brief, p. 3 "California Protest for Bruce & Donna Culver"

¹² It is unclear to Board staff why the IRS skipped 2005 in this audit/report.