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

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10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **JAROSLAV MARIK AND JIRINA MARIK¹**) Case No. 547265
13 _____)

14 Year Claim
15 2004 For Refund
16 \$93,000

17 Representing the Parties:

18 For Appellants: Ward R. Nyhus, Jr., JD, CPA
19 For Franchise Tax Board: Raul A. Escatel, Tax Counsel
20

21 QUESTION: Whether appellants have substantiated that they are entitled to a bad debt deduction (or
22 alternatively, an investment loss) for the 2004 tax year.

23 HEARING SUMMARY

24 Background

25 In 2008, appellants filed an amended 2004 California return, reporting a loss of \$1
26 million in relation to an “uncollectible loan” to “University Village, LLC” (UV-LLC). (App. Ltr, Ex 4.)
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28 ¹ Appellants currently reside in Los Angeles County, California.

1 *UV-LLC and UVH-LLC*

2 UV-LLC was formed by individuals named Michael Keele (Keele) and Peter Henman
3 (Henman) in 2002 to facilitate the acquisition and development of certain real property in the City of
4 Riverside. (FTB OB p 1.) In order to pay for the real property and its development, Keele and Henman
5 solicited persons—including appellant-husband—to invest capital in UV-LLC and/or related entities.
6 (*Id.*) One related entity was named University Village Housing, LLC (UVH-LLC).² (App. Reply Br.
7 p 2.) As discussed below, appellants assert on appeal that they loaned (or alternatively invested)
8 \$1 million in UVH-LLC and no part of that \$1 million has been returned to them. (App. Ltr. p 2;
9 App. Reply Br. pp 2-3.)

10 *Lawsuit/ Arbitration*

11 In March 2005, appellant-husband filed a complaint against Keele, Henman, and various
12 entities controlled by them for, among other things, fraud and breach of fiduciary duty to recover
13 appellants’ \$1 million loan/investment. (See FTB OB p 2.) The case was ultimately submitted to
14 arbitration, and on February 10, 2009, the arbitrator, Honorable Robert M. Letteau, Judge (retired),
15 issued a final arbitration award, finding that Keele, Henman, and the entities controlled by them, were
16 not liable to appellant-husband for the loss of his \$1 million “investment.” (*Id.* Ex B.)

17 *Appellants’ 2004 amended tax return and the FTB’s audit*

18 Upon audit of appellants’ 2004 amended return, the Franchise Tax Board (respondent or
19 FTB) determined that appellants had not substantiated their claimed bad debt loss of \$1 million.
20 (FTB OB p 4.) Accordingly, the FTB denied appellants’ claim for refund. In response, appellants filed
21 this timely appeal. (*Id.*)

22 Contentions

23 Appellants

24 Appellants argue that they *loaned* \$1 million to UVH-LLC and they are entitled to take a
25 bad debt deduction of \$1 million in 2004 because their \$1 million loan (allegedly) became worthless in
26

27 ² As discussed below, the final arbitration award sets forth the following entities: “University Village Building K” and
28 “University Village Housing K.” As noted below, at the oral hearing, appellants should be prepared to discuss whether these
entities are different than UV-LLC and UVH-LLC.

1 2004. (App. Ltr. 2.) Alternatively, appellants argue that they *invested* \$1 million in UVH-LLC and they
2 are entitled to take a deduction of \$1 million in 2004 because their \$1 million investment (allegedly)
3 became worthless in 2004. (*Id.*; App. Reply Br. pp 2-3.)

4 In support of their contentions, appellants provided the following documents:

- 5 • A cancelled check dated March 31, 2003, payable to University Village Housing, LLC, for the
6 amount of \$250,000. (App. Reply Br. Ex 1.)
- 7 • A cancelled check dated June 7, 2003, payable to University Village Housing, LLC, for the
8 amount of \$250,000. (*Id.* Ex 2.)
- 9 • A bank wire transfer application dated February 26, 2004, payable to “University Village,” for
10 the amount of \$500,000. (*Id.* Ex 3.)
- 11 • A document that purports to be a “general ledger” of University Village Housing, LLC.
12 (*Id.* Ex 4.)

13 Appellants also assert that UVH-LLC has never filed returns with the FTB and has
14 “never accounted” to appellants for the disposition of appellants’ \$1 million loan/investment. (App. Ltr.
15 pp 1-2.) In addition, appellants contend that the FTB has never required that UVH-LLC file a return.
16 (*Id.* p 2.)

17 Appellants state that they instituted litigation (hereinafter an “arbitration proceeding”)
18 against UVH-LLC (and various individuals) in an effort to obtain an accounting and return of their
19 \$1 million loan/investment. (App. Ltr. p 1.) Appellants state that during the arbitration proceeding it
20 was determined that their loan/investment of \$1 million in UVH-LLC was “used by another entity,
21 University Village, LLC . . . to improve its real estate which was sold in 2004.” (*Id.*) Furthermore,
22 appellants state that “University Village, LLC sold its real estate and the improvements without giving
23 credit to the taxpayers for the \$1,000,000 of their funds that had been used to improve the real estate that
24 was sold.” (*Id.*)

25 Finally, appellants state that when they filed their 2004 amended return, they claimed
26 their loss of \$1 million as an “uncollectible loan” and “[t]he term ‘uncollectible loan’ was used in this
27 respect to describe the relationship of University Village, LLC to the Appellants’ \$1,000,000 in funds.”
28 (App. Reply Br. p. 4.) And in this respect, appellants assert that whether the \$1 million at issue is

1 described as a “loan” or a “capital contribution,” the fact remains that the \$1 million at issue has not
2 been repaid to them. (*Id.*) Accordingly, appellants argue that they were entitled to deduct a loss of \$1
3 million on their 2004 amended return.

4 The FTB

5 The FTB argues that appellants have not provided sufficient evidence showing the
6 existence of a bona fide debt. (FTB OB p 5.) Accordingly, the FTB argues that appellants have not
7 shown that they are entitled to a deduction of \$1 million (or any other amount) for a “bad debt” under
8 Internal Revenue Code (IRC) section 166. (*Id.* p 6.) The FTB asserts that (a) appellants did not provide
9 any objective evidence of a debt, such as a note or other documents, (b) there is nothing in the record as
10 to the terms of any kind of debt arrangement and there is no evidence of the terms of the alleged debt
11 arrangement, (c) appellants did not provide any indication they received payment of principal or interest
12 on a loan, (d) even though appellants made the argument (apparently during protest stage of the
13 proceedings) that a bona fide loan existed—as allegedly evidenced by the accounting records of UV-
14 LLC—the “mere indication of a note is not sufficient to evidence a valid loan,” and (e) nowhere in any
15 of the court documents furnished by appellants is the \$1 million at issue referred to as an indebtedness.
16 (*Id.* pp 5-6.) Finally, the FTB asserts that the LLCs at issue were properly classified a partnerships for
17 tax purposes, and the fact that Schedule K-1s were issued to appellants supports a finding that the
18 \$1 million at issue was not a loan. (FTB OB, p. 8.)

19 The FTB also argues that appellants have not proven that they are entitled to take a
20 deduction of \$1 million (or any other amount) with respect to their capital contribution because they
21 have not shown it became worthless. In support of its contention, the FTB notes the following:

- 22 • Appellants instituted an arbitration proceeding to recover their alleged \$1 million investment;
23 thus, they are not entitled to take a deduction for worthlessness until the year their arbitration
24 proceeding was finalized—which happened in 2009. (FTB OB p 9.)
- 25 • The 2004 Schedule K-1 from UV-LLC shows that appellants had beginning negative capital
26 account balance of \$686,119 in 2004 (see FTB OB, Ex F.), which the FTB argues shows that
27 appellants possibly sustained losses prior to 2004 and “therefore no longer had the \$1,000,000
28 basis in the LLC” in 2004. (FTB OB p 8.) The FTB concludes that it cannot determine, without

1 additional information, whether (in 2004) appellants had any remaining adjusted basis in either
2 UVH-LLC and/or UV-LLC. (*Id.*)

- 3 • Appellants have not provided Schedule K-1s (or other information) for years prior to 2004; for
4 that reason, the FTB states that it is unaware of any amounts appellants reported as income or
5 loss prior to 2004; accordingly, the FTB asserts that it is unable to determine appellants' "gains
6 and losses as members based on their capital account(s)." (*Id.* pp 8-9.)

7 Applicable Law

8 Deductions – General Rule

9 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a
10 deduction has the burden of proving by competent evidence that the he or she is entitled to that
11 deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*,
12 2001-SBE-001, May 31, 2001.)³

13 IRC section 166 – Bad Debts

14 R&TC section 17201 adopts IRC section 166, relating to bad debts. IRC section
15 166(a)(1) allows a deduction for any debt that becomes worthless within the taxable year. The debt
16 must arise from a bona fide debt, i.e., "a debtor-creditor relationship based on a valid and enforceable
17 obligation to pay a fixed or determinable sum." (Treas. Reg. § 1.166-1(c); *Appeal of Gordon and*
18 *June K. Fraser*, 86-SBE-157, Spt. 10, 1986.) A gift or contribution to capital is not a debt. (Treas. Reg.
19 § 1.166-1(c).)

20 The time of actual worthlessness must be fixed by an identifiable event or events which
21 furnish a reasonable basis for abandoning any hope of future recovery. (*Appeal of Parabam, Inc.*,
22 82-SBE-100, June 29, 1982.) No deduction is allowed for a particular year if the debt became worthless
23 before or after that year. (*Appeal of Peter I. and Inga M. Kune*, 84-SBE-106, June 27, 1984.) The
24 question of whether a debt is worthless depends on the facts and circumstances of each case. (Treas.
25 Reg. § 1.166-2(a).) The standard for determining worthlessness is an objective standard. (*Appeal of*
26 *Peter I. and Inga M. Kune, supra; Appeal of Myron E. and Daisy I. Miller*, 79-SBE-106, June 28, 1979.)
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28 ³ Board of Equalization cases are generally available for viewing on the Board's website (www.boe.ca.gov).

1 The financial condition of the debtor is a factor in determining whether a debt is worthless. (*Id.*) Mere
2 nonpayment of a debt does not prove its worthlessness, and the taxpayer must prove that reasonable
3 steps were taken to enforce collection of the debt, or that those steps would have been futile. (*Appeal of*
4 *Myron E. and Daisy I. Miller, supra.*) Legal action is not required as evidence of worthlessness of a
5 debt if the surrounding circumstances indicate the debt is uncollectible, and the action would in all
6 probability not result in satisfaction of the debt. (Treas. Reg. § 1.166-2(b).)

7 IRC section 165 Losses

8 IRC section 165(a) provides that “there shall be allowed as a deduction any loss sustained
9 during the taxable year and not compensated for by insurance or otherwise.”⁴ IRC section 165(c) limits
10 an individual’s deduction for losses pursuant to IRC section 165(a) to: (1) losses incurred in a trade or
11 business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade
12 or business; and (3) losses of property not connected with a trade or business, if such losses arise from
13 fire, storm, shipwreck, or other casualty, or from theft.

14 To the extent a taxpayer has adjusted basis in a partnership interest, the taxpayer may be
15 allowed to take a loss (to the extent of adjusted basis) under IRC section 165(a) if the partnership
16 interest became worthless.⁵ (See *Echols v. Commissioner* (5th Cir. 1991) 935 F.2d 703.) A
17 determination of worthlessness requires both a subjective determination as to when the taxpayer
18 determines the partnership interest to be worthless and an objective determination as to whether the
19 partnership interest was without value at that time. (*Echols v. Commissioner, supra*, at 707.) A
20 reasonable prospect of recovery of a loss will postpone the loss deduction until such time as the prospect
21 of reasonable recovery no longer exists. (See Treas.Reg. 1.165-1(d)(3).) The determination of whether
22 a taxpayer has a reasonable prospect of recovery is based on all facts and circumstances. (See *Estate of*
23 *Scofield v. Commissioner* (6th Cir. 1959) 266 F.2d 154, 159; *Vincentini v. Commissioner*, T.C. Memo
24 2009-255.) One factor to consider in determining whether there is a reasonable prospect of recovery is

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26 ⁴ The relevant portions of IRC section 165 have been incorporated into California law at R&TC section 17201.

27 ⁵ To the extent a limited liability company (LLC) elects to be tax as a partnership, the same rules will apparently apply to an
28 LLC membership interest. (See Christine R. W. Quigley, *Knowing When To Walk Away; Abandoning A Partnership*
Interest, ABA Trust & Investments, p. 10, Mar./Apr. 2010.) On appeal, the parties do not state that passive loss rules or
capital loss rules are at issue. Accordingly, we will not address those rules herein.

1 whether the taxpayer has filed a claim or lawsuit against third parties to recover the loss. (*Julicher v.*
2 *Commissioner*, T.C. Memo 2002-55.) The filing of a lawsuit to recover a loss may give rise to an
3 *inference* of a reasonable prospect of a recovery. (*Id.*) The Sixth Circuit has stated:

4 Normally where a taxpayer is in good faith willing to go to the trouble and expense of
5 instituting suit to recoup a *** loss, there is as a matter of fact sufficient chance of at
6 least part recovery to justify that taxpayer in deferring the claim of a loss deduction ***
7 until litigation in question is concluded. This is not to suggest that in some cases the facts
8 and circumstances will not show such litigation to be specious, speculative, or wholly
9 without merit and that the taxpayer hence was not reasonable in waiting to claim the loss
as a deduction. However, in the absence of such circumstances, a taxpayer who feels that
change of recovery is sufficiently probable to warrant bringing a suit and prosecuting it
with reasonable diligence to a continuation is normally reasonable in waiting until the
termination thereof to claim a *** deduction. (*Estate of Scofield v. Commissioner, supra*,
at 159.)

10 STAFF COMMENTS

11 Additional Evidence

12 If appellants have any additional evidence that they wish to submit, pursuant to California
13 Code of Regulations, title 18, section 5523.6, appellants should provide their evidence to the Board
14 Proceedings Division at least 14 days prior to the oral hearing.⁶

15 Bad Debt

16 As noted above, appellants' first argument is that they loaned \$1 million to UVH-LLC
17 and they are entitled to take a "bad debt" deduction of \$1 million in 2004 because their \$1 million loan
18 (allegedly) became worthless in 2004. At the oral hearing, appellants should be prepared to show that
19 (i) the \$1 million at issue is properly classified as a debt (as they allege), and (ii) the alleged debt
20 became worthless in 2004.

21 Staff notes that appellants have not provided copies of promissory note(s) or evidence
22 that appellants received payments of principal or interest on the alleged debt totaling \$1 million. Also,
23 staff notes that the final arbitration award refers to appellants' loss of \$1 million as a "capital
24 contribution"—not a loan. Accordingly, at the oral hearing, appellants should be prepared to show that
25 the \$1 million at issue was a loan.

26 Next, even if appellants can show that the \$1 million at issue was a loan, appellants must
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28 ⁶ Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of
Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

1 then show that the \$1 million loan became worthless in the 2004 tax year. As noted above, the question
2 of whether a debt is worthless depends on the facts and circumstances of each case. (Treas. Reg.
3 § 1.166-2(a).)

4 **Investment Loss—Worthlessness**

5 If the Board finds that the \$1 million at issue was an investment—not a loan—then the
6 Board should address appellants’ argument that they “invested” \$1 million in UVH-LLC and they are
7 entitled to take a deduction of \$1 million in 2004 because their investment (allegedly) became worthless
8 in 2004. As indicated above, to the extent appellants have adjusted basis in their LLC interest(s),
9 appellants may be allowed to take a loss (to the extent of their adjusted basis) under IRC section 165(a)
10 because their LLC interest(s) became worthless. (See *Echols v. Commissioner, supra.*)

11 Thus, at the oral hearing, the parties should first be prepared to discuss whether
12 appellants had adjusted basis in their LLC interest(s) in 2004, such that appellants might be eligible for a
13 deduction in 2004 based on worthlessness (up to the extent of their basis). In this respect, appellants
14 should be prepared show their adjusted bases in UV-LLC and UVH-LLC.⁷

15 If the Board finds that appellants had adjusted basis in their LLC interest(s) in 2004, then
16 the Board should consider whether appellants established that their LLC interest(s) became worthless in
17 2004. In this respect, the parties should discuss whether the filing of the arbitration proceeding delayed
18 any possible deduction for worthlessness until the tax year 2009 (i.e., the year the final arbitration award
19 was issued).

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28 ⁷ Staff notes that the final arbitration award sets forth the following entities: “University Village Building K” and “University Village Housing K.” Thus, at the oral hearing, appellants should be prepared to identify their adjusted bases in University Village Building K and/or University Village Housing K *if* such entities are different from UV-LLC and/or UVH-LLC.