

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JACK AND JACOBA TURFRYER)

For Appellants: Mr. David R. Shaub
Attorney at Law

For Respondent: Mr. Crawford H. Thomas
Chief Counsel

Mr. Richard C. Creeggan
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Jack and Jacoba Turfryer against proposed assessments of additional personal income tax and delinquent filing penalties in the total amounts of \$378.68 and \$1,937.25 for the years 1963 and 1964, respectively.

During the years in question, appellants were the sole shareholders of Holland Bulb Importers, Inc., a California corporation engaged in the sale of seeds and bulbs. Appellants also operated a sole proprietorship known as Floraland which sold only one product, sponge seed. Floraland was located on the same premises and utilized the same employees as Holland Bulb. Appellant Jack Turfryer was the only salesman for both businesses. In 1962 Holland Bulb, in need of additional capital, borrowed \$60,000 from American Business Capital Corporation (ABC). Appellants guaranteed the loan. Despite this capital infusion, Holland Bulb filed a petition in bankruptcy in 1963 and was adjudicated a bankrupt in 1964.

Anneal of Jack and Jacoba Turfrver

In their 1963 personal income tax return appellants claimed a \$25,000 loss due to the worthlessness of their capital stock in Holland Bulb. Although the loss was initially disallowed by respondent for lack of substantiation, after a protest hearing the entire amount was determined to be deductible as a capital loss. Appellants were also allowed an additional capital loss deduction in the amount of \$30,000 which resulted from a compromise of the \$60,000 loan to Holland Bulb by ABC which appellants had guaranteed and were required to pay. Neither the \$25,000 nor the \$30,000 capital loss are at issue in this appeal.

Appellants also claimed a \$19,778.23 business bad debt loss in 1963 for alleged "Seed and Cash Loans" made to Holland Bulb by the sole proprietorship, Floraland. An additional amount of \$8,907.96 was also deducted in 1963 as a business bad debt resulting from a cash loan by appellants to Holland Bulb. Both amounts were initially disallowed for lack of substantiation. However, at the protest hearing respondent determined that both amounts reflected capital investments in Holland Bulb and were deductible as capital losses in 1963, the year the corporation filed a petition in bankruptcy. Nevertheless, appellants now contend that the entire amount, \$28,686.19, constituted reimbursement for Floraland's share of the overhead and should be deductible as operating expenses of Floraland.

Appellants' losses claimed for 1963 totaled \$83,686.19. Of this amount, \$23,132.36 was used as an ordinary loss to completely offset appellants' 1963 adjusted gross income. The remainder of the losses were carried forward and included on the 1964 return. In addition to the \$60,553.83 carried over from 1963, appellants deducted an additional \$11,860 as an ordinary loss in 1964. The \$11,860 included alleged business bad debts of \$6,660 representing appellants' liability as co-signers on a factoring agreement for Holland Bulb, and \$5,200 resulting from a personal loan upon which appellants claimed joint liability as co-signers with Holland Bulb. The 1964 losses were originally disallowed by respondent for lack of substantiation. However, at the protest hearing, respondent determined that the 1964 losses were, in fact, contributions to Holland Bulb's capital and were deductible in 1964 as capital losses.

Anneal of Jack and Jacoba Turfrver

Appellants' 1963 and 1964 returns were filed three and seven months late, respectively. Accordingly, respondent assessed late filing penalties of 15 percent for 1963 and 25 percent for 1964 pursuant to section 18681 of the Revenue and Taxation Code. Appellants have not contested the validity of the penalties.

The issue for determination in this appeal is whether any of the claimed amounts were properly deductible either as ordinary and necessary business expenses or as business bad debts.

Section 17202 of the Revenue and Taxation Code provides for the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Similarly, section 17207 provides for the deduction of debts which become worthless during the taxable year and distinguishes between business and non-business debts by defining the latter as any 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 incurred in the taxpayer's trade or business. (Rev. & Tax, Code § 17207, subd. (d)(2).)

The distinction between a loss from a business bad debt and a loss from a nonbusiness bad debt is significant, of course, because the former is fully deductible as an ordinary loss while the latter is deductible only as a short term capital loss subject to the capital loss limitations. (Compare §17207, subd. (a)(1) of the Rev. & Tax. Code, with § 17207, subd. (d)(1)(B) and 18152, subd. (a).)

Appellants now contend that the 1963 losses in issue were incurred for the purpose of reimbursing Holland Bulb for the expenses it incurred in paying certain overhead expenses benefiting Floraland and therefore should be allowed as ordinary business expenses. In reaching this conclusion appellants rely on the close business relationship between Floraland and Holland Bulb, pointing out that Holland Bulb paid a substantial portion of Floraland's operating expenses. However, appellants have failed to establish that there was any oral or written agreement between the two separate entities concerning reimbursement for operating expenses.

Appeal of Jack and Jacoba Turfryer

Furthermore, although requested to do so, appellants have failed to come forward -with evidence to establish what the expenses were or when they were incurred. It is well settled that deductions are a matter of legislative grace and that taxpayers have the burden of clearly showing their right to the claimed deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]; Appeal of James M. Denny, Cal. St. Bd. of Equal., May 17, 1962.) Upon the record before us we must conclude that appellants have completely failed to meet their burden of substantiating the claimed ordinary and necessary business expenses.

Originally, the 1963 losses in issue were claimed as business bad debt losses. However, appellants have at no time attempted to support those losses as business bad debts. As stated above, section 17207 of the Revenue and Taxation Code provides for the deduction of debts which become worthless in the taxable year. However, only a bona fide debt qualifies for the deduction. Whether advances to a closely held corporation by a shareholder are loans or capital contributions is a question of fact. The taxpayer has the burden of proving that a bona fide debt, in fact, existed. (Matthiessen v. Commissioner, 194 F.2d 659; Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal., Nov, 6, 1967.) In view of its precarious financial condition and the need for additional capital evidenced by the \$60,000 loan in 1962, as well as the total lack of substantiation by appellants, the amounts in question must be characterized as contributions to the capital of Holland Bulb, the closely held corporation. As such, they were properly treated by respondent as deductible capital losses subject to the limitations of section 18152, subdivision (a) of the Revenue and Taxation Code.

Next, we turn to appellants' claims for 1964. On their 1964 return appellants carried forward an ordinary loss of \$60,553.83 which represented the unused portion of the ordinary loss claimed in 1963. The claimed deduction was properly disallowed by respondent in its entirety since there is no provision in California law authorizing a carryover of ordinary losses. (Appeal of Henrietta Swimmer, Cal. St. Bd. of Equal. Dec. 10, 1963.) Additionally, appellants deducted \$11,860 as business bad debts composed of \$6,600 representing appellants' liability on the factoring agreement and \$5,200 representing the loan to Holland Bulb which

Anneal of Jack and Jacoba Turfrver

appellants co-signed. Appellants apparently contend that these items were either ordinary and necessary business expenses or business bad debts.

In arguing that the 1964 expenses were deductible as ordinary and necessary business expenses appellants made the same arguments as they did with reference to the 1963 expenses. Here again appellants offered no evidence in support of their position and have completely failed to carry their burden of proof. Therefore the claimed deductions were properly disallowed. Although not entirely clear, appellants apparently argue in the alternative that the expenses were business bad debts. In support of their position appellants, although urged to do so, have offered nothing more than their naked allegation that "both obligations were owing jointly by taxpayers and the corporation." They have neither submitted copies of the notes and financing agreements nor established that the amounts were in fact paid. Here, as in the case of other income tax deductions, appellants bear the burden of establishing their right to claim a bad debt deduction. (Appeal of Hans Kleger, Cal. St. Bd. of Equal., Apr. 24, 1967.) This they have not done and respondent properly refused to allow the amounts claimed as business bad debts.

Accordingly, for the reasons set forth above, respondent's action in this matter must be sustained.

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 Jack and Jacoba Turfryer against proposed assessments of additional personal income tax and delinquent filing penalties in the total amounts of \$378.68 and \$1,937.25 for the years 1963 and 1964, respectively, be and the same is hereby sustained.

Appeal of Jack and Jacoba Turfryer

Done at Sacramento, California, this' 6thday of
February, 1973, by the State Board of Equalization.

William G. Sprague, Chairman
John W. Lynch, Member
Paul J. ..., Member
_____, Member
_____, Member

'ATTEST: W. W. ... Secretary