

Appeal of Milton and Helen Brucker

The issue for determination is whether respondent properly disallowed theft and capital loss deductions for lack of substantiation.

Helen Brucker is a party to this appeal solely because she filed a joint personal income tax return with Milton Brucker, her husband, for the year in issue. Accordingly, only the latter will be referred to as "appellant."

Prior to and during 1973, appellant Milton Brucker loaned substantial sums to at least nine corporations promoted by one Donald E. Gandy and by various individuals associated with Gandy. Appellant also guaranteed, and was required to make payments on, loans that the Bank of America issued to some of the Gandy corporations. In addition, he purchased stock in a few of the corporations. Sometime between 1973 and 1975, appellant came to believe that Gandy and others were using some of his loans for fraudulent activities. In December 1974, Gandy and four associates were indicted on charges of conspiracy to commit grand theft.

On his 1973 California personal income tax return, appellant claimed a \$1,740,363 deduction for business bad debts, and in computing his capital gain income, he deducted a loss of \$485,000 for worthless stock. These deductions all stemmed from loans to, and investments in, nine Gandy corporations. Respondent denied the deductions for lack of substantiation. However, respondent changed the business bad debt deductions to nonbusiness bad debt deductions, and allowed him to take the bad debt and the worthless stock loss deductions in 1975. Respondent says that it allowed the losses in 1975 because to do so had a minimal effect upon appellant's 1975 tax liability.

At a hearing before this board, appellant indicated that the accountant who prepared his 1973 return lost the financial records to support that return. Recognizing this, the taxpayer chose to confine his arguments to those in support of a theft loss, and to limit his appeal to losses respecting only four of the original nine companies. We agree with him that there is insufficient evidence to support bad debt deductions for any of the nine companies. The four entities now at issue, and their asserted deductions, are:

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Clearlight	\$ 200,188
Frozen Natural Foods	308,632
Weswec	625,200
World Ecology Corp.	65,054
Total	<u>\$1,199,074</u>

He claims that all four were bankrupt in 1973, and notes that their corporate powers were all subsequently suspended by the Franchise Tax Board under Revenue and Taxation Code section 23301 et seq.

Appellant contends that Gandy and associates "were of questionable character", and that by making "false representations [to Mr. Brucker] ... with the intent to deceive and defraud, induced" him to make or guarantee loans to the Gandy corporations and to acquire stock in them. Appellant further claims that Gandy, et al. misappropriated the assets and defrauded the creditors of the corporations. Brucker says he became aware of the alleged thefts in 1973. He therefore argues that the \$1,199,074 deduction should be allowed in 1973 as a theft loss or a capital loss. He claim; that a theft is shown by the facts that "[t]he same cast of questionable characters intertwined each" of the four corporations involved in this case, and that these individuals "fraudulently and through false misrepresentations appropriated his monies." He says there is no prospect of recovery, because he had no insurance to cover the losses and because his debtors had no assets.

Respondent argues that there was no theft, rather, appellant simply gave money to legitimate business concerns, some of which floundered due to general market conditions. Respondent acknowledges that Gandy and his associates were indicted for fraud and grand theft, but argues that the indictments were unrelated to appellant's transactions with these people. Respondent says appellant cannot document any of his losses. Finally, it contends that even if a theft by fraud or false pretenses did occur, appellant did not discover it until 1975 or later.

Revenue and Taxation Code section 17206 permits a taxpayer to take an ordinary loss deduction for an uncompensated loss due to theft which is greater than one hundred dollars. (Rev. & Tax. Code, § 17206, subs. (a) & (c).) It is deductible only in the year the taxpayer discovers the loss. (Rev. & Tax. Code, § 17206, subd. (e); Appeal of Orlo E., Jr., and Marian M. Brown, Cal. St. Bd. of Equal., May 4, 1976.) In order to claim the loss, "the appellant must establish the elements of

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the [theft] ... under the law of the jurisdiction where the loss was sustained, i.e., California" (Appeal of Donald D. Harwood, Cal. St. Bd. of Equal., July 26, 1978), and must provide some evidence, such as a police report, of the value of the property lost. (Appeal of John E. VanDerpool, Cal. St. Bd. of Equal., Oct. 6, 1976.) Thus, a taxpayer must prove three elements in order to claim a theft loss deduction: (i) that the taxpayer suffered a theft of property in excess of \$100; (ii) the amount of the loss sustained; and (iii) that the year for which the loss is claimed is the year in which the taxpayer either discovered the loss, or first determined that recovery or compensation would not be had. (Appeals of Don A. and Diane H. Cookston, Cal. St. Bd. of Equal., Sept. 29, 1981.)

Appellant has provided this board with numerous documents in an attempt to substantiate his claimed deductions. Much of the information they contain is irrelevant to this case, and the information that is relevant is lacking in vital dates and specifics; yet the documents taken together provide a rough outline of appellant's association with various Gandy corporations. We shall examine the evidence that appellant chose to provide us, keeping in mind that respondent's disallowance of a deduction is presumed correct, and the burden is on the taxpayer to prove his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).)

Cleartight

Respondent's records show that Cleartight was incorporated in 1971, and that its president and co-founder, Robert R. Rogers, filed its last state tax return in September 1972. Appellant's auditor found that Cleartight's assets totaled \$200,189 by December 1972. Appellant presents a pledge agreement signed by himself and the president of Frozen Natural Foods Corporation (FNF) on December 23, 1972. The agreement stated that Cleartight owed \$200,188.76 to FNF, FNF owed a greater sum to Brucker, and FNF was therefore assigning the Cleartight debt over to Brucker. There is some indication that this loan might not have been paid. However, it is not clear when the loan became due or what its terms were. The evidence also shows that appellant did not lend Cleartight any money before 1973, and that he lent Cleartight either \$21,837 or \$22,637 in 1973. Respondent's records state that the corporation was suspended February 1, 1974.

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For alleged misappropriation of his loans to Cleartight, appellant claims a \$200,188 deduction, which approximates the amount in the 1972 pledge agreement. However, there is no evidence that the agreement remained unpaid, or that any theft occurred here.

Frozen Natural Foods

FNF was incorporated in December 1971; Robert G. Smith was its founder and president. Donald Gandy and William Tate became associated with the company in early 1972. Gandy, Smith and Tate were all indicted for grand theft in December 1974. FNF filed its last return in December 1973, and was suspended in March 1974. Appellant's primary financial associations with this company involve a \$169,130 lease and a \$308,632 promissory note. We will discuss each of these.

The lease was arranged between FNF and a company that had previously employed William Tate, called Heritage Leasing. FNF President Robert G. Smith testified about the lease in December 1976 in a declaration he made for a lawsuit brought by Brucker and others against Heritage Leasing. Smith stated that in 1972 Gandy and Tate had FNF lease equipment at inflated prices from Heritage Leasing. The total price of the equipment was approximately \$169,130. Gandy and Tate persuaded Brucker, who did not know that the equipment was overvalued, to sign the lease as guarantor for FNF. Smith testified that the goal of Gandy, Tate and Smith was to obtain for FNF as much money or property as possible over Brucker's signature. FNF apparently received some but not all of the equipment. According to Smith, Heritage discounted the lease to Bank of America, and in 1973 a company called Airco paid Bank of America \$100,000 to buy some or all of FNF's assets.

An engineer named Ronald J. Matika, who had **been hired to test products developed by** some of the Gandy corporations, testified for appellant in 1979. He stated that in 1973, **he "discovered** someone had sold all the Frozen Natural Foods machinery in Oregon and El Centro, California." He so informed appellant in June 1973. It is unclear whether this sale encompassed all of FNF's assets, or just part of them, and whether this sale related to Airco's 1973 purchases.

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It is not clear that appellant paid any of FNF's obligation to Bank of America. The fact that Airco paid \$100,000 to purchase FNF's assets indicates that he did not fulfill his guarantee on the lease. Although some questionable activity may have occurred here, the record indicates neither whether appellant lost any money on the arrangement, nor the year in which appellant discovered any alleged theft. A theft loss deduction is therefore not warranted.

The second transaction with FNF that is at issue in this case concerns a promissory note. It seems that in 1973, FNF president Robert Smith signed a note according to which FNF promised to pay appellant \$308,632.47 with interest. The interest was to be paid quarterly starting June 30, 1973; the principal was payable in installments in April 1975 and April 1976. If any payments were in default, appellant had a right to accelerate and demand payment of the entire sum of principal plus interest. The note was secured, by Airco stock. The record does not reveal the extent to which FNF fulfilled its obligations on this note. Although FNF was suspended in March 1974 and possibly defaulted on the promissory note, there is no evidence of any theft in connection therewith.

Weswec

Respondent's records show that Weswec was incorporated in April 1971 and that appellant filed Weswec's last return in December 1972. Appellant provided Weswec with loans of \$400,000 in 1971, \$225,000 in 1972, and \$200 in 1973, for a total of \$625,200. At a hearing before this board, appellant stated that in 1973 he was "culminating certain affairs involving Weswec Corporation," but did not expand upon this statement. The company was suspended in June 1974.

We cannot permit appellant's theft loss deduction for his loans to this company, since he has proffered no evidence showing that a theft occurred, the amount of money he allegedly lost, or the year in which he discovered any supposed deceit.

World Ecology Corporation

Respondent's records show that World Ecology Corporation (WEC) was incorporated in July 1971, appellant filed WEC's last return in December 1972, and WEC was suspended in June 1974. Appellant apparently

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made loans to WEC of \$60,000 in 1971 and \$5,054.80 in 1973.

WEC owned 'an electronic fertilizer plant or composting system and the land on which the plant was located. In February 1972, WEC sold the plant to Selbern Leasing Corporation of Brooklyn, New York. Selbern then leased the plant at an inflated price to appellant, who was an officer of WEC. In March 1972, the lease was assigned to Union Bank to secure it; Union Bank recorded a financing statement naming Brucker as the debtor and Selbern as the secured party. In June 1973, Weswec, which had acquired WEC, sold the plant and the underlying real property to World Ecology Resources, Inc., a separate company.

In April 1976, a bankruptcy judge made the findings of fact summarized in the above paragraph, and also found that the transfer from WEC to Selbern had been accomplished with neither recorded notice, delivery, nor change of possession. The transfer was therefore presumed fraudulent and void. The judge then adopted a memorandum decision rendered in November 1975, holding that the WEC-Selbern sale and the Selbern-Brucker lease were invalid, that World Ecology Resources, Inc. rightfully held sole title and interest in the property, and that appellant had no interest at law in the property he had rented.

Ronald J. Matika, a product-testing engineer who had been hired by Gandy and who in 1979 testified against him, said that in 1973 he had discovered "equipment, systems, and buildings grossly misrepresented and sold to Selbern Leasing Corporation and then leased back at dollar values far in excess of their intrinsic value". He also discovered that some of the products WEC was developing, as well as one of its plants, were ineffective and useless. Matika so informed appellant before July 1973.

Although there may be evidence here of some form of theft, and a suggestion that appellant discovered it in 1973, the record does not reveal how much, if anything, he lost on the lease. He has provided no information as to the value of the lease agreement and the amount of his payments with respect to that agreement. Appellant therefore cannot deduct these loans as theft losses for 1973.

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Appellant submits five additional documents to bolster his theft loss claims. We now analyze each of these.

Los Angeles Times Article

In December 1974, a San Diego grand jury indicted Donald F. Gandy, Robert G. Smith, William C. Tate, and two other men in connection with a bank loan fraud involving between \$250,000 and \$2,000,000. According to a Los Angeles Times article dated December 12, 1974, they allegedly used

phony financial statements and restricted securities--that could not be sold or ~~traded~~--as collateral for the \$250,000 loan which Smith intended to use in his various business ventures.

The investigation uncovered several additional schemes involving bogus loans, financial manipulations, and fraudulent transactions

As we have discussed, other documents reveal that appellant had numerous associations with Smith, Tate, and Gandy.

None of the schemes described in the Times article about the indictment can be clearly or directly linked to appellant's financial involvement with the individuals indicted. Although Brucker may have been a victim of some of the allegedly fraudulent activities of Gandy, et al., these do not seem to be the same activities that were mentioned in the article. The article mentions none of the companies with which appellant was associated. It also lists various banks involved in the bogus loan schemes; yet Bank of America and Union Bank, the banks whose loans to Gandy were guaranteed by appellant, are not mentioned among them.

Investigator's Report

Appellant's second piece of evidence is an investigator's report of twenty individuals, prepared privately for Brucker in 1979 and 1980. Only three of the individuals are relevant to this case: Donald F. Gandy, Robert G. Smith, and William C. Tate. The report states that Gandy was sentenced in 1976 for the misdemeanor of making a false financial record entry,

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Smith was charged with grand theft: and was placed on probation in 1977, and Tate was found not guilty in 1977.

As appellant himself acknowledges, it does not appear that any of the criminal activities with which these people were charged bore any relevance to appellant's transactions with them.

Appellant's Statement to District Attorney's Office

The third document presented is a statement that Brucker made on February 26, 1975, to the San Diego County District Attorney's office in connection with the December 1974 indictment against Gandy and his associates. In the statement, appellant described how Gandy and others defrauded him in the WEC-Selbern Leasing arrangement. He also reported that FNF president Robert Smith used \$6,250 of appellant's money to buy International Hydrolines stock, which Smith then used to guarantee a personal loan. There is no correlation, however, between the \$6,250 and any of the sums appellant deducted on his tax return. Although more information would be helpful, the lengthy statement offers some indication that Gandy's promotional activities were less than straightforward, and that he may have deceived appellant in connection with some of the loans. However, the statement provides very few dates, so that we are unable to determine in which year appellant discovered any alleged deceit, and very few dollar amounts, so that we cannot determine the extent or existence of any losses.

Rose Letter

The next document is a letter to Brucker from one Mason Rose, written March 8, 1973. Rose, one of the founders of WEC, was apparently accused of "blocking negotiations" for some arrangement. In his letter he denied this charge, and said that his statements could be confirmed by three individuals named Braid, Tugwell and Bardella. In appellant's statement to the San Diego District Attorney, however, he said that these three had cheated him on two earlier deals. In the letter, Rose called Gandy irrational and dishonest, and accused him and his associates of "chicanery and fraud." Appellant offers the letter to show that appellant's negative suspicions about Gandy's character were aroused as early as March 1973. However, the letter only shows that

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someone, who may or may not have been a confidant of appellant's, and who associated with three persons who had allegedly cheated appellant, entertained a low opinion about Gandy. Furthermore, the letter's contents do not indicate what particular theft, if any, is at issue.

Matika's Statement

The final document is a statement by Ronald J. Matika made December 7, 1979. Candy hired him in 1971 or 1972 "to work in an engineering capacity on various projects." He tested certain products and systems developed by WEC and two other companies, and found them ineffective, unusable and/or unpatentable. When he presented his results to Gandy, the latter told him "not to divulge [sic] results of the test as it would have an adverse effect on our financial backer,... Mr. Brucker." Matika then discovered evidence of inflated expense accounts and of employee business trips that were actually vacations. He told appellant of his findings in early 1973. Appellant "announced he was ceasing all operations of all companies connected with Mr. Gandy and would no longer make any payrolls." Appellant also asked Matika to "close down all the offices, put everything in storage, and accumulate all corporate records and send them to his accountants." He was unable to obtain all the records because some individuals refused to surrender them, and because some records were apparently lost. Matika discovered that some of the companies were paying for auto rentals, houses, insurance and equipment for friends of Gandy's who were not employees; that equipment had been leased or purchased for sums vastly exceeding their dollar values; that other equipment purchased either did not exist or had disappeared; and that "many personal expenses ... had been paid for through the various corporations." He also found that someone had sold the FNF assets in two locations, and that the WEC-Selbern sale and lease arrangement was a fraud. Matika concluded, "I documented all my findings and presented them to Mr. Bruckers [sic] agents along with all corporate records in my possession approximately in June of 1973."

Matika mentions FNF, WEC, and other entities in his statement, but it is not clear what suspicious activities were associated with each of the corporations, whether actual theft occurred as opposed to general carelessness or business mismanagement, and how

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any of the above-cited shenanigans affected appellant. Matika does provide a helpful indication that appellant may have become suspicious about FNF, Selbern, and WEC in 1973. However, mere suspicion does not provide the evidence or detail necessary to prove a theft. (Michele Monteleone, 34 T.C. 688 (1960).)

As we stated earlier, to claim a theft loss, the taxpayer must establish all of the circumstances which clearly indicate the occurrence of a specific theft, the taxpayer's earliest awareness of the theft in the year for which the deduction is claimed, and the amount of the loss. An examination of Matika's statement and of the other documents discussed herein leads us to the conclusion that appellant has not presented enough evidence to substantiate his claimed theft loss deductions for any of his loans to the four companies at issue. There is no evidence to suggest any theft-related or fraudulent activity at all in connection with Cleartight or Weswec. Concerning FNF, the only transaction that seems at all questionable was FNF's agreement with Heritage Leasing, where appellant guaranteed FNF's rental of equipment. Nevertheless, a review of the evidence sheds no light on whether appellant suffered any loss at all on this agreement, and if he did, then how much he lost. As to WEC, it seems that Matika informed appellant in 1973 of the fraudulent leasing arrangement with Selbern; as we noted earlier, however, there is no information as to the extent of his loss. We also note that he did not file criminal charges against anyone.

In short, the information appellant has presented consists primarily of vague, unsupported or nonspecific allegations which raise suspicions about the behavior of Gandy and others, but which are insufficient to sustain a finding of a theft loss. (Appeal of Donald D. Harwood, supra.)

Capital Loss

Appellant contends on appeal that if his deductions are not accepted as theft losses, then they may alternatively be construed as capital losses under Revenue and Taxation Code section 17206, subdivision (g)(2). This rule permits the deduction of securities which become worthless in the taxable year, and defines "security" as :

(A) A share of stock in a corporation;

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(B) A right to subscribe for, or to receive, a share of stock in a corporation; or

(C) A bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation ... with interest coupons or in registered form.

If the worthless security was a capital asset, the loss is deductible as a capital loss subject to the limitations of section 18152; if the security was not a capital asset, the loss is fully deductible as an ordinary loss. (Former Cal. Admin. Code, tit. 18, § 17206(e), subds. (2) & (3), repealer filed Jan. 15, 1981; Register 81, No. 3.) The loans that appellant claims to have made to the various companies involved could, under certain circumstances, fall under definition (C) above. Nevertheless, out of all the loans that he allegedly made, he has provided this board with evidence of only one note from one corporation. Appellant has made no attempt to show either that the note was a capital asset, or that it fell within the definition of "security" provided above.

Definition (A) in subdivision (g)(2) above permits a deduction for the loss resulting from a stock becoming wholly worthless during the taxable year. S u c h losses are deductible to the extent that capital losses are deductible. (Rev. & Tax. Code, §§ 17206, subd. (f), & 18152.) On his 1973 tax return, appellant claimed such a stock loss deduction for \$250,000 worth of stock purchased in Weswec Corporation. This may be the "capital loss deduction" that he asserts on appeal.

Respondent's regulations on worthless stock loss deductions, effective during the year in issue, stated that in order for a taxpayer to take this deduction, the "loss **must be** evidenced by **closed and** completed transactions, fixed by, identifiable events, and actually sustained during the taxable year." (Former Cal. Admin. Code, tit. 18, § 17206(a), subds. (2) & (4)(A), repealer filed Jan. 15, 1981; Register 81, No. 3.) No deduction is permitted if the stock's value diminishes due to market fluctuations, or if the stock has retained any value as of the claimed date of loss. (Former Cal. Admin. Code, tit. 18, § 17206(d), subd. (1), repealer filed Jan, 15, 1981; Register 81, No. 3.)

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In order for appellant to obtain his stock loss deduction for 1973, he must point to some identifiable occurrence which caused the stock to become worthless in that year. (Appeal of Harry E. and Mildred J. Aine, Cal. St. Bd. of Equal., April 22, 1975; Appeal of William C. and Lois B. Hayward, Cal. St. Bd. of Equal., Oct. 3, 1967.) Although appellant has informed us that he was "culminating certain affairs involving Weswec" in 1973 and that Weswec was suspended in 1974, these observations are not sufficient evidence either that such an isolated "identifiable event" occurred within Weswec, or that the stock's value was totally destroyed in 1973. Furthermore, the record (aside from appellant's tax return) does not mention his having purchased any stock in Weswec at all. We realize that it may be difficult for appellant to provide more detailed evidence to support his allegations; however, this does not relieve him of his burden of proving entitlement to the deductions he claims. (Burnet v. Houston, 283 U.S. 223 [75 L.Ed. 991] (1931).) We must therefore reject for lack of proof his claimed worthless stock loss deduction, as we rejected his other claimed loss deductions.

For the reasons stated above, we will sustain respondent's action.

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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 Milton and Helen Brucker against a proposed assessment of additional personal income tax in the amount of \$103,639.82 for the year 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett _____, Chairman
Ernest J. Dronenburg, Jr. _____, Member
Richard Nevins _____, Member
_____, Member
_____, Member