BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-1409-KP
NATHAN F. AND SHIRLEY W. MARTIN)

Appearances:

For Appellants: John W. Harris
Attorney at Law

For Respondent: Grace Lawson
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 Nathan F. and Shirley W. Martin against proposed assessments of additional personal income tax in the amounts of $1,440.65, $9,570.04, and $4,916.00 for the years 1978, 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.

The issues presented by this appeal are whether respondent properly disallowed a deduction for the cost of worms purchased from their son in 1978, and whether respondent improperly denied several nonbusiness deductions for'1979 and 1980.

Appellants are husband and wife, and each is a practicing physician. This appeal revolves around several transactions conducted between appellants, their son Gerald, and a closed corporation Gerald operated.

In 1975, Gerald entered into a partnership with another individual in an effort to raise and sell earthworms. At a later date, Gerald bought his partner's share of the business. On May 15, 1978, Gerald incorporated the worm business under the name Agri-Worm Farm Corporation. Nathan Martin was named to the board of directors of the new corporation.

On December 28, 1978, Nathan Martin entered into a "Sales and Management Agreement," wherein Gerald sold to appellants 6,000 pounds of "bed run red worms" for $10,000. Whiie appellants were the legal owners of the worms, Gerald agreed to keep, feed, manage, end maintain the worms on his corporation's property. The worms were ultimately lost during the winter of 1978 when they were drowned during a series of severe rainstorms. On their joint tax return for 1978, appellants claimed a $10,800 loss representing the cost of the worms. Respondent audited appellants' tax return for 1978 and determined that appellants had failed to prove that they were entitled to a loss in 1978 as they did not show that the purchase of the worms was an activity engaged in for profit.

While it is unclear from the record precisely which code section appellants are using to justify their deduction, it is clear that they are claiming that the purchase of the worms was an activity they engaged in for profit. Therefore, to qualify for a deduction, appellants must meet the requirements of section 17202 or section 17252, subdivisions (a) or (b). (Rev. & Tax. Code, § 17233, subd. (c).)

Section 17202, subdivision (a), allows a deduction for all ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business. Both appellants are doctors by profession, a profession that does not ordinarily include the ownership of worms. To qualify for this deduction, therefore, appellants must show 'that they were engaged in a second trade or business, in this instance worm farming. (See Richard W. and Hazel R. Hill, Cal. St. Bd. of Equal., May 19, 1981.) In determining whether a taxpayer is actively engaged in a trade or business, the most important factor to be considered is the freauency and substantiality of sales. (Beidenharn Realty Co., Inc. v. United States, 526 F.2d 409 (5th Cir. 1976); Appeal of Richard A. and Diana S. Vorne, Cal. St. Bd of Equal., June 27, 1984.) A single purchase is not enough to establish a trade or business, there must be a continuity of activity. (Appeal of Richard A. and Diana S. Vorne, supra.) Under this rationale, appellants' single purchase of the worms cannot be seen as continuing in a trade or business. If anything, the single purchase was in preparation of entering the trade or business of worm farming, and such preparatory expenses are not deductible under section 17202. (Richard W. and Hazel R. Hill, supra.) The fact that the corporation had been in business for one year is irrelevant. We are focusing upon appellants' activities, and it is admitted that neither appellants had been engaged in the worm-farming business prior to the purchase of the worms.

Since appellants purchased the worms to create a new business interest for themselves, they are also precluded from deducting the cost of the worms under section 17252. (See Appeal of Howard and Margaret Richardson, Cal. St. Bd. of Equal., Feb. 2, 1976.) The restriction on deducting expenses for establishing a new business is based upon the distinction between allowing deductions for the expense of producing or collecting income, in which one has an existing interest or right, and an expense incurred in an attempt to obtain income by the creation of some new interest. (Appeal of Howard and Margaret Richardson, supra.)

As an alternative argument, appellants contend that they should be allowed to deduct $9,900 as a casualty loss under former section 17206, subdivision (c)(3). It is established law that a taxpayer may deduct as a casualty loss only the lesser of either the amount of the actual fair market value of the property or the amount of the taxpayer's adjusted basis in such property. (Appeal of-Charles McDaniel, Jr., Cal. St. Bd. of Equal., Oct. 10, 1984; see also Treas. Reg., § 165-7(b) (1986).)

Appellants-have alleged that they suffered from a casualty loss but have failed to provide any evidence to satisfy either of the tests listed above. In fact, we have never even been provided with the dates of the alleged storms. This latter fact is especially disturbing in light of the revelation that appellants purchased the worms on December 28, just three days prior to the close of 1978. Therefore, due to the lack of evidence, we find that appellants have failed to satisfy their burden of proving that they were entitled to a casualty loss in 1978.

We next consider a series of deductions claimed as a result of the end of Gerald's worm-farming business. Due to the loss of the worms as described above, Gerald abandoned his Agri-Worm business in 1979. On September 22, 1980, Gerald and his corporation filed for bankruptcy. Gerald received a discharge in bankruptcy on January 21, 1982. Appellants were named creditors in Gerald's bankruptcy petition pursuant to the following series of events.

From December 7, 1975, to May 22, 1979, appellants advanced funds to Gerald in varying amounts at varying intervals, for a total of $77,414. From 1977 to 1979, Gerald signed four separate promissory notes in favor of appellants, the total of which corresponded with the total amount of advances. All of the notes were interest bearing, but they did not include a due date, schedule of repayment, or provide for any security. No payment was ever made on any of the notes. Other than a demand note sent to Gerald dated November 5, 1979, no attempt was made by either-appellant to collect on the notes.

On their 1979 return, appellants claimed nonbusiness bad debts in the total amounts of $85,414, which included the $77,414 for the promissory notes executed by Gerald. Upon audit of appellants' joint return, respondent determined that they had failed to prove that the advances to their son were loans and were not gifts.

Former section 17207 allowed a deduction for "any debt which becomes worthless within the taxable year." Only a bona fide debt, a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money, qualified for purposes of section 17207. (Appeal of Seymour and Jeanette Lewis, Cal. St. Bd. of Equal., Dec. 13, 1983.) We have, in the past, looked with particular scrutiny at loans or advances made to family members. (See Appeal of Seymour and Jeanette Lewis, supra, and cases cited therein.) No deduction for a bad debt based upon such a transaction is allowed unless there is an affirmative showing by the taxpayer that there existed at the time of the advance a real expectation of repayment and an intent to enforce collection. (Appeal of Seymour and Jeanette Lewis, supra.)

Applying the same close scrutiny to the instant case, we must conclude that the advances made by appellants to their son do not constitute bona fide loans. Gerald's "borrowing" occurred at irregular intervals over a three-year period. During the period of "borrowing," no attempt was made to repay any of the advances. Even with his history of nonpayment, appellants kept advancing more funds to their son. Although Gerald did sign notes in appellants' favor, the notes did not provide for security and they did not contain repayment schedules or due dates. Finally, there was no attempt by the appellants to regain any of the advances until the end of the third year of lending. In sum, due to the length of time involved in the lending and the lack of payment and lack of enforcement, we find that there has not been an affirmative showing by the taxpayers that there existed at the time of the advances a real expectation of repayment or an intent to enforce collection. (See Appeal of Seymour and Jeanette Lewis, supra.)

Since we find that respondent was justified in finding that the advances were a gift to their son, and due to the lack of corporate records to prove that the advances were actually used in Gerald's business, we need not consider appellants' argument that the advances were contributions to capital in Agri-Worm. Consequently, we find that appellants have failed to demonstrate error with regard to respondent's determination in this matter.

On January 3, 1978, appellants co-signed for a loan from Crocker National Bank to Gerald. By the following January, that loan was delinquent. As a result of Gerald's nonpayment, the bank made demands for payment on appellants as guarantors of the loan. Apparently, appellants made some payments to the bank.

On their 1979 return, appellants claimed nonbusiness bad debts in the total amounts of $85,414, which included an $8,000 payment to Crocker Bank as a result of their guarantee. On their 1980 return, appellants deducted $3,000 as payment on the guarantee that year.

Upon review of the two returns, respondent requested proof of payment on the guarantee. Appellants could only produce evidence of one payment to Crocker Bank in 1979 for $5,000. Respondent disallowed the amounts of the unsubstantiated payments.

The taxpayer has the burden of proving that he is entitled to the bad debt deduction. (Appeal of James C. and Monablanche A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975.) As appellants have been given ample opportunity to produce evidence of the unsubstantiated payments and have failed to come forth with cancelled checks or copies of bank records, we find that they have failed to satisfy their burden of proving they are entitled to a deduction greater than that allowed by respondent. (See Appeal of James C. and Monablanche A. Walshe, supra.)

In a separate transaction on an unknowndate, appellants allegedly co-signed with Gerald another promissory note in the amount of $1,678.62. In a further, unrelated, transaction in 1979, Shirley Martin purchased a used truck which she allegedly allowed Gerald to use in his corporate work.

On their 1980 return, appellants deducted, as nonbusiness bad debts, the $1,678.62 paid as a result of the co-signed loan and the $4,788.51 paid for the used truck. Respondent denied the bad debt deduction after appellants failed to produce evidence of the existence of the $1,678.62 loan. Furthermore, respondent determined that appellants did not prove that they contributed or loaned the truck to their son's corporation rather than giving it to Gerald as a gift. Appellants failed to produce evidence to contradict respondent's determinations.

Therefore, we find that they have failed to carry their burden of proving that respondent incorrectly denied those deductions.

For the above-stated reasons, respondent's determination with regard to these matters will be sustained.

Appeal of Nathan F. and Shirley W. Martin

ORDER

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 Nathan F. and Shirley W. Martin against proposed assessments of additional personal income tax in the amounts of $1,440.65, $9,570.04, and $4,916.00 for the years 1978, 1979, and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of October , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

Anne Baker*, Member

________________, Member

*For Gray Davis, per Government Code section 7.9