BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1875
DAVID G. AND HELEN MENDELSOHN)

For Appellants: Thomas R. Baker
Certified Public Accountant

For Respondent: Jon Jensen
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 David G. and Helen Mendelsohn against proposed assessments of additional personal income tax in the amounts of $886.12, $2,920.00, and $844.00 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.

Appeal of David G. and Helen Mendelsohn

The issue presented by this appeal is whether a series of loan payments made by appellants during the years in question are deductible as business bad debts.

Appellants, husband and wife, were the sole shareholders of a California corporation called Economy Carton Company, which they formed in 1965. Appellants were also employees of the corporation.

By 1974, Economy was in severe financial trouble; In an attempt to save their business, appellants borrowed funds from several parties and, in turn, loaned the money to their corporation. Despite the loans, Economy's failure continued. Finally, appellants sold all of the stock in the company in 1975, resulting in capital gains for that year. In 1976, the company was liquidated. Appellants claimed an ordinary loss deduction on their joint personal income tax return for that year, a loss which included over $65,000 in business bad debts.

Subsequently, appellants began to repay the loans which they had procured in their attempt to save the business. During each of the appeal years, appellants deducted their yearly loan payments on their joint personal income tax returns as business bad debts. Respondent audited appellants' tax returns for the years at issue and agreed that the underlying obligations which generated.the payments were bona fide bad debts. Respondent determined, however, that the character of the underlying debts was nonbusiness. As a result of that determination, the losses arising from the loans were treated as capital losses. Respondent issued assessments for the years at issue reflecting its determination. This appeal followed.

On appeal, respondent has abandoned its original position. Respondent now argues that appellants have failed to show that they were entitled to any deduction for the years at issue because appellants deducted the bad debts in question in full in 1976 as part of the $65,000 business bad debt figure. Respondent notes that it made several requests for a complete breakdown of the business bad debt losses claimed by appellants that year, but appellants did not respond to any of the inquiries.

Respondent's contention on appeal involves a theory which, if adopted by respondent initially, would have resulted in greater deficiencies than those asserted by the original assessments. If respondent's position on appeal either alters the original deficiency or requires the presentation of different evidence, then a new matter has been introduced and the burden of proving that new position shifts to respondent. (Achiro v. Commissioner, 77 T.C. 881 (1981); Falese v. Commissioner, 58 T.C. 895 (1972).) On the other hand, the assertion of a new theory which merely clarifies or develops the original determination without being inconsistent or increasing the amount of the deficiency is not a new matter requiring the shifting of the burden of proof to respondent. (Achiro v. Commissioner, supra: Jayne v. Commissioner, 61 T.C. 744 (1974).) The factual basis and rationale required to establish that the debts were nonbusiness bad debts are entirely different from the factual basis and rationale necessary to establish that appellant has previously deducted the debts in question. (Gulledge v. Commissioner, ¶ 57,029 T.C.M. (P-H) (1957), affd. without discussion of this point, 249 F.2d 225 (4th Cir. 1957).) Consequently, as respondent has raised a new theory in its brief on appeal that does not simply clarify or develop its original position, it is respondent's burden to present new evidence to support its position on appeal. (Achiro v. Commissioner, supra.)

Respondent has not presented any evidence on. appeal to support its new position. Rather, respondent has relied upon an inference that the debts deducted in 1976 are the same debts appellants attempted to deduct during the years at issue. While this is certainly plausible, there is no actual proof that appellants attempted to deduct the same debts twice. The mere failure of appellants to respond to respondent's requests is not the type of new evidence envisioned by the court in Achiro that would support respondent's new-position. (See also Colasurdo v. Commissioner, ¶ 75,274 T.C.M. (P-H) (1975).) Accordingly, we hold that respondent has failed to satisfy its burden of showing that appellants have previously deducted the debts in question.

The fact that respondent has failed in satisfying its burden of proof regarding the new theory on appeal does not, however, relieve appellants of their burden of proving that respondent's original determination is incorrect. (Gulledge v. Commissioner, supra.) It is the burden of the party attacking an assessment to prove that respondent was incorrect in issuing its basic assessment. (Gulledge v. Commissioner, supra.)

Section 17207, subdivision (a)(l), stated, in pertinent part, "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." Business bad debt losses are fully deductible in the year sustained whereas nonbusiness bad debt losses. are regard-ed as short-term capital losses which are deductible to the extent of capital gains plus either taxable income or one thousand dollars ($1,000), whichever is less. (Rev. & Tax. Code, §§ 17207 and 18152.)

To determine the character of a bad debt, we first consider section 17207, subdivision (d)(2), which defined, in pertinent part, a nonbusiness bad debt as a 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.

The definition of "trade or business" in this context includes all means of gaining livelihood by work, (Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).) In contrast, a taxpayer's status as a shareholder of a corporation is capital in nature because a shareholder's rewards are expectative and flow, not from personal effort, but from earnings and appreciation. (United States v. Generes, 405 U.S. 93, 103 [31 L.Ed.2d 621 (1972).) Therefore, while a shareholder who loans money. to his corporation may not deduct any such loans which become worthless as a business bad debt, an employee who makes loans to his employer in order to secure his job can deduct the amount paid as a business bad debt when those loans become worthless. (Trent v. Commissioner, supra.)

The determination of whether losses are business bad debts is a question of fact. (Smith v. Commissioner, 457 F.2d 797 (5th Cir. 1972); Jaffee v. Commissioner, ¶ 67,215 T.C.M. (P-H) (1967).) An employee-shareholder making a loan to his corporation usually acts with two motivations, the one to protect his investment and the other to protect his employment. The question is which of the taxpayer's motivations which gave rise to the bad debt was the dominant, and not merely the significant reason for the loan. (United States v. Generes, supra.) "Dominant motivation" in this context means that we must determine the primary reason the taxpayer advanced funds to hi's corporation. (Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969).) "By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and insignificant, from controlling the tax result at the taxpayer's convenience." (United States v. Generes, supra, 405 U.S. at 104.)

Appellants admit that they procured the loans to avoid forced "liquidation" of the corporation and the subsequent financial problems it would cause. We also note that appellants' concern for their financial troubles was well justified, as is evidenced by the events surrounding the forced sale of the corporation. Appellants' equity interest in the corporation diminished rapidly in the last year of operation when the company lost over $130,000. Appellants had personally guaranteed over '$40,000 in advances from the corporation's largest supplier, thereby placing their personal assets at risk should their corporation fail to repay the advances. Appellants also state that they "subsequently lost almost everything they owned and were forced to sell their corporation and property, . . ." (App. Br. at 2.) By this statement, appellants underscore the fact that they had much more to lose by a failure of their business than their salaries.

From the surrounding circumstances, their actions, and their professed worry that they could, and almost did, lose everything that they owned, it is clear that appellants' dominant motivation in procuring the loans in question was to protect their investment in their corporation as well as their personal assets which were linked to the success of their business. Therefore, we must conclude that the nature of the loans was nonbusiness.

Accordingly, appellants have failed to carry their burden of proving respondent erred in its determination. For the above-stated reasons, respondent's action in this matter will be sustained.

Appeal of David G. and Helen Mendelsohn

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 David G. and Helen Mendelsohn against proposed assessments of additional personal income tax in the amounts of $886.12, $2,920.00, and $844.00 for the years 1978, 1979, and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day Of November , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9