

COMMONWEALTH OF MASSACHUSETTS

APELLATE TAX BOARD

PAUL D. & LAURA A. OSBORNE v. COMMISSIONER OF REVENUE

Docket No. C266648

Promulgated:
May 5, 2005

This is an appeal under the formal procedure pursuant to G.L. c. 58A, § 6 and G.L. c. 62C, § 39 from the refusal of the appellee Commissioner of Revenue ("Commissioner") to grant an abatement of resident personal income taxes assessed against the appellants under G.L. c. 62, § 4 for the tax year ending December 31, 1998.

Commissioner Gorton heard the appeal and was joined in the decision for the appellee by Commissioners Scharaffa and Egan.

These findings of fact and report are made pursuant to a request by the appellants under G.L. c. 58A, § 13 and 831 CMR 1.32.

Paul D. Osborne, pro se, for the appellants

Kevin M. Daly, Esq., for the appellee

FINDINGS OF FACT AND REPORT

Appellant Paul D. Osborne ("appellant") was a longtime employee of Paul D. Osborne Desk Company, Inc. ("PDODC"), an office supply business started by his grandfather. Working at PDODC from his graduation from college through 1999, he held positions in the company's warehouse, sales force, and as an office manager. During the relevant tax year at issue he served as treasurer of the company.

The business was half-owned by a testamentary trust established for the benefit of appellant and his siblings upon the death of his father in 1990. Appellant's sister, Jane McKnight, served as trustee of the trust, as did his brother Mark Osborne. Meanwhile, Paul Tesserero was owner of a fifty percent stake in PDODC and corporate President.

Appellant timely filed his 1998 Massachusetts Resident Income Tax Return on April 14, 1999. On April 15, 2002, appellant mailed to the Department of Revenue ("Department") a Form CA-6 newly asserting a bad debt deduction in the amount of \$166,000 against his 1998 personal income taxes. The abatement application was received April 22, 2002.

A hearing on appellant's abatement claim was held September 26, 2002 in the Department of Revenue's Office of Appeals. The Office of Appeals issued a letter of

determination dated October 2, 2002, recommending disallowance of the claimed deduction. Denial of abatement by the Department's Customer Service Bureau occurred on October 26, 2002. The instant appeal was commenced with the filing of the Petition Under Formal Procedure at the Appellate Tax Board ("Board") on December 24, 2002.

On September 29, 2003, the Commissioner moved to dismiss for lack of jurisdiction. Relying on evidence that the abatement application was timely mailed, the Board denied the motion to dismiss on October 16, 2003. The foregoing facts establish the Board's jurisdiction.

On October 3, 1995 appellant loaned the sum of \$225,000 to PDODC.¹ This loan obviated the need for a \$300,000 loan from the Hibernia Bank on the same terms and rates: for seven years, and with the interest rate set at two points above the Major Bank Prime Rate as reported in the Wall Street Journal.

The debt had been paid down to the amount of \$166,000 by October, 1998 when PDODC failed to make its payment. Appellant wrote a letter dated December 5, 1998 notifying PDODC of the default. Meanwhile, on September 25, 1998, appellant had advanced to PDODC an additional

¹ The Commissioner did not dispute the character of appellant's advances as debt.

\$100,000, likewise a loan, reflected by appellant's check #328 of even date. This loan, and the preexisting loan were both subjects of a document titled "Loan and Security Agreement" dated October 3, 1998.

The business of PDODC deteriorated in 1999 and beyond. Toward the end of 1999 PDODC stood to lose its leading supplier, Haworth, which announced it was terminating PDODC's account after December 31. Nevertheless, the business's Rhode Island division continued functioning under the name of Creative Office Environments and remained a distributor of Haworth products beyond 1999. Meanwhile, the appellant continued advancing funds to PDODC while it remained open and in business during 1999. He continued drawing a salary from PDODC until it ceased operations in Massachusetts at the beginning of the year 2000.

Creative Office Environments was separately incorporated in Rhode Island around the end of the year 1999. Then, on January 5, 2000, the appellant and President Tesserero filed a "Trust Indenture and Security Agreement" (referred to by the appellant at trial as a "Trust Mortgage") for protection from creditors, in recognition of the company's insolvency. Appellant was instrumental in undertaking this step, which he understood as tantamount to a bankruptcy filing. He termed the "Trust Mortgage" a "kind

of a poor man's Chapter 11" and said this route was chosen because it was less expensive than a proceeding in bankruptcy court. Contemporaneously PDODC's business operations discontinued in Massachusetts and appellant lost his employment. Creative Office Environments continued to operate after the insolvency of PDODC.

In subsequent proceedings arising out of the insolvency of PDODC, Mr. Osborne was held liable for repayment of \$98,000, the amount representing his salary from October, 1998 through December 31, 1999. The Form CA-6 filed April 13, 2002 stated that "[t]he [proposed] change in total deduction amount is due to a bad debt for loans made to Paul D. Osborne Desk Co., Inc. from 1993-1998. The company ceased operations in Jan. 2000, leaving the debt uncollectible."

On the basis of the foregoing, the Board finds that the appellant made a series of loans to PDODC continuing through 1999. The business of PDODC was carried on, and the business continued its distributorship of the product line of Haworth, its principal supplier, through 1999. While PDODC was experiencing financial difficulties in 1999, the operation was continuing and appellant remained employed and still drew his salary.

With the filing of the "Trust Mortgage" and the discontinuation of Massachusetts business operations in early 2000, appellant's loans reached the point of being "wholly worthless". Because the PDODC debt was not "wholly worthless" as of December 31, 1998, the year for which appellant sought to take his deduction, his claim fails. Abatement must be denied, and this case decided for the appellee.

OPINION

At issue was appellant's entitlement to bad debt deductions on account of unrepaid loans he made to PDODC from 1995-99, which he sought to take against his 1998 Massachusetts personal income taxes. Appellee contested the appellant's claim on the grounds that the loans lacked the "trade or business" relationship required for deductions under G.L. c. 62, § 2(d); and that the debt at issue was not eligible for deduction in the year claimed. Because the Board found the latter issue dispositive, it did not reach the former question.

As was explained in *Sturdy v. Commissioner of Revenue*, 2003 ATB Adv. Sh. 580, 587 (No. C260289, October 1, 2003),

Part B adjusted gross income is defined as "Part B gross income less the following deductions:- (1) [t]he deductions allowable under section sixty-two ... of the [Internal Revenue] Code. G.L. c. 62, § 2 (d). Section 62 of the Code allows deductions for expenses which are "attributable to a trade or business carried on by a taxpayer, as long as such trade or business does not consist of the performance of services by the taxpayer as an employee." I.R.C. § 62(a)(1).

The **Sturdy** case involved the deduction allowable for business-related interest expense at I.R.C. § 163(a). Another allowable deduction, which is at issue here, applies to business bad debt losses. I.R.C. § 166(a).

To avail himself of the deduction, "a taxpayer must prove that on January 1 of the taxable year the debts had some intrinsic or potential value, and that by December 31 the debts had lost all such value." **Estate of Mann**, 731 F.2d 267, 275 (5th Cir. 1984). Courts have been exacting in requiring proof of worthlessness: "[t]he taxpayer must usually show identifiable events to prove worthlessness in the year claimed." **American Offshore, Inc. v. Commissioner of Internal Revenue**, 97 T.C. 579, 593 (1991). Debts are wholly worthless when "there are reasonable grounds for abandoning any hope of repayment in the future, and it

could thus be concluded that they have lost their 'last vestige of value.'" **Estate of Mann**, 731 F.2d at 276 (citations omitted.)

Nonpayment of a debt, without more, "does not render the debt worthless for purposes of determining deductibility." **Rondeau v. Commissioner of Revenue**, 22 Mass. App. Tax Bd. Rep. 9, 11 (1997). In **Rondeau**, the Board held that the debt at issue, a second mortgage, did not become "worthless" until the first mortgage-holder foreclosed on the subject property, yielding proceeds insufficient to cover the appellant's loan. **Id.** In **Hood Sailmakers, USA, Inc. v. Commissioner of Revenue**, 25 Mass. App. Tax Bd. Rep. 398 (1999), the finding that the taxpayer was continuing to loan money to the debtor thwarted the taxpayer's showing that the debt was, at the same time, worthless.

In the instant case, the Board was of opinion that the debt PDODC owed appellant did not lose all value upon the nonpayment of the amount due in October of 1998. The business continued operating, employees continued to draw salaries, and the business retained its distributorship

rights for suppliers whose products it sold. "The subjective good faith opinion of [appellant, voiced at trial] alone is insufficient" to support the claim. **Hubble v. Commissioner of Internal Revenue**, T.C. Memo 1981-625 (1981).

There was no objective basis for the necessary finding of worthlessness until 2000. First, PDODC ceased operating in Massachusetts upon losing its principal supplier relationship on January 1, 2000. Moreover, in January, 2000, PDODC took formal legal action to protect itself from creditors given its insolvency, with the filing of the "Trust Indenture and Security Agreement" on January 5, 2000.

Proof of worthlessness requires clear-cut, identifiable circumstances establishing that the debt at issue is finally beyond recovery. Events like a declaration of insolvency or a foreclosure satisfy this standard. See generally **Rondeau**, 22 Mass. App. Tax Bd. Rep. at 11.

Appellant attempted to take bad debt deductions at a time when PDODC was paying his salary, and he was continuing to advance additional funds to the

business. Because his loans had not lost all vestiges of value in 1998, his claimed deductions and the abatement they would generate must be denied. Therefore, the Board issued a decision for the appellee.

APPELLATE TAX BOARD

By: _____ Chair

_____ Commissioner
_____ Commissioner
_____ Commissioner
_____ Commissioner

A true copy,

Attest: _____
Assistant Clerk of the Board