**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

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| In the Matter of the Protest of [redacted] | ) | DOCKET NO. 0-127-362-048 |
| Petitioner. | ) | DECISION |

[redacted] (Petitioner) protested the Notice of Deficiency Determination (Notice) dated March 20, 2024 for tax years 2020, 2021, and 2022. The Tax Commission reviewed the matter and hereby issues its final decision to modify the Notice.

**Background**

Petitioner filed federal and Idaho income tax returns for 2020, 2021, and 2022 using the Single filing status. The Tax Commission's Income Tax Audit Bureau (Audit) selected the 2020 and 2021 returns for examination. On August 3, 2023, Audit sent Petitioner a letter requesting documentation, invoices, and receipts to substantiate the expenses reported on Schedule F, along with general ledgers and depreciation schedules for the same years.

Petitioner appointed a representative/attorney-in-fact (AIF) in late August 2023. Sometime prior to September 7, 2023, the representative provided over 100 documents from 2020 and 2021 including receipts, invoices, cancelled checks, and others.

In a separate but concurrent examination of Petitioner's 2019 income tax returns, Audit issued a Notice on September 22, 2023, which Petitioner also protested. The focus of that Notice was Schedule F expenses. After receiving additional information, Audit issued a modified Notice for 2019 on December 19, 2023. Petitioner did not withdraw her protest after the modified Notice was issued.

On January 26, 2024, Audit sent Petitioner and AIF letters requesting information about activities reported on federal Schedule F for 2020; information about farm implements; depreciation schedules for 2020, 2021, and 2022; and information and documentation regarding a loss claimed on Form 4797 for 2022. Regarding the loss, Audit requested or asked the following:

- Detailed description of the loss.
- A copy of federal Form 4684.
- A copy of federal Schedule K-1.
- Has any law enforcement agency been involved in attempted recovery?
- Has anyone been indicted related to the loss?
- Is there any insurance recovery?
- Will there be recovery through the court system?

On February 9, 2024, AIF provided additional information and documents regarding the Schedule F activities for tax years 2020 and 2021. AIF also provided information regarding the capital loss claimed for 2022:

- The loss came from a convertible note that was intended to be paid back at a 10% annual interest rate or converted to membership interest in the limited liability company (LLC) with which the note was made. The maturity date for the note was December 31, 2022. There was no conversion to LLC membership interest, so Petitioner never had any ownership in the LLC. As such, no K-1 was issued. By the maturity date, "the LLC had already become insolvent and bank accounts had been squandered by the Managing Member."
- Petitioner had filed FBI inquiries, police reports in multiple jurisdictions, SEC filings, and complaints with the Hawaii Bar Association. She had also sent letters in an attempt to encourage prosecution. She had been unsuccessful in recovering any possible restitution. There were no indictments or charges.
- There is no potential for insurance recovery as there was no policy in effect.
- There is no likelihood of court recovery. The managing member had set up the LLC in a complicated manner, such that "the jurisdictional challenges are cumbersome. This is a Colorado LLC, that started in Hawaii before [the managing member] moved to Florida, then there are investors in Hawaii, Colorado, Utah, Idaho, California and Florida." All bank accounts and administrative log-ins were in the managing member's name and control. When investors began asking questions about the company and the money they had invested, the managing member destroyed records, spent all funds, and disappeared.

Audit issued the Notice for tax years 2020, 2021, and 2022 on March 20, 2024. For tax years 2020 and 2021, Audit disallowed deductions for Idaho net operating loss (NOL) carryover[1]. For tax year 2022, Audit increased Petitioner's income by $736,500 for the loss claimed under IRC section 165(c) on Form 4797 and decreased Petitioner's income by $505,805 for the amount reported as "Section 461(l) excess business loss adjustment" on federal Schedule 1, Part I, line 8p. Addressing the section 165(c) loss, Audit determined that the loss was not an ordinary (business) loss, but rather a theft loss. As a theft loss, it was not deductible for tax year 2022 because the *Tax Cuts and Jobs Act of 2017*, *Public Law 115-97*, had removed casualty and theft losses from the list of allowable itemized deductions unless they were the result of a federally declared disaster. Audit did not make any adjustments for Schedule F expenses.

On May 14, 2024, AIF sent Audit an email disagreeing with the determination that the 2022 convertible note was a casualty loss and asking about the status of amended returns that were previously provided to Audit[2]. AIF also provided a written statement analyzing the treatment of the loss and proposing an alternative to both what was claimed on the return and Audit's determination.

On May 14, 2024, Audit replied to AIF via email stating, "It appears that we are at an impasse regarding the adjustments in the tax years audited. We will be sending both audits [for 2019 and 2020 through 2022] to our Tax Appeals unit for further review… The amended returns were treated as a protest and have not been processed as they will be included in the Tax Appeals review." On May 15, 2024, Audit sent letters to AIF and Petitioner informing them that the case

[1] This was an issue addressed in the 2019 examination and Notice. In that Notice, Audit disallowed any Idaho NOL carryover into tax year 2019, which resulted in none coming from tax year 2019 as well.
[2] Notes from the related examination of Petitioner's 2019 tax returns indicate that AIF sent amended returns for 2020 and 2021 on December 27, 2023.

was being forward to the Tax Commission's Tax Appeals unit (Appeals) to continue the redetermination process. Neither Audit's notes about the May 14 email nor the May 15 letter indicate whether Audit considered the statement AIF provided regarding the loss.

On July 2, 2024, Appeals sent Petitioner and AIF letters outlining the options available for redetermining a protested Notice. On July 11, 2024, Appeals had a phone conversation with AIF regarding the adjustments. Petitioner and AIF did not choose to schedule an informal hearing. No additional documentation was provided regarding tax years 2020, 2021, and 2022. Therefore, the Tax Commission renders its decision based on an analysis of the information available.

**Law & Analysis**

AIF provided to Audit copies of executed agreements between Petitioner and [redacted] dated January 1, 2020, for $250,000; May 6, 2020, for $150,000; and November 18, 2020, for $210,000. Each *Convertible Promissory Note* states:

> For value received [redacted] a Colorado limited liability company (the "Company") promises to pay to the undersigned holder or such party's permitted assigns (the "Holder") the principal amount set forth above with simple interest on the outstanding principal amount at the rate of ten percent (10%) per annum. Interest shall commence to accrue on the date hereof and shall continue to accrue on the outstanding principal until paid in full or converted as provided herein. Interest shall be computed on the basis of a year of 365 days for the actual number of days elapsed. Unless earlier converted or paid, all unpaid interest and principal shall be due and payable on December 31, 2022 (the "Maturity Date").

The notes contained two possibilities for conversion to ownership interest. In the event the company issues and sells membership interests on or before the maturity date with proceeds to the Company not less than $1,500,000 (not including these notes and presumably others like it), the outstanding principal balance and any unpaid accrued interest would convert to ownership interest equal in basis to "the pre-money valuation set at the date of execution of the note."

Also signed along with each convertible note was a *Warrant to Purchase Class A Membership Interests*, which states in Section 1(a):

> Subject to the terms and conditions set forth herein, the Holder is entitled, upon surrender of this Warrant at the principal office of the Company (or at such other place as the Company shall notify the Holder in writing), to purchase from the Company units of Company's Class A Memberships Interests (the "Units"). The number of Units to be purchased shall be determined by the principal amount of the Holder's Convertible Promissory Note of the Company, dated as of [date] (the "Note"), divided by the Class A Memberships Value at the time of the Note execution or by the lesser of the unit price in a Qualified Financing. "Qualified Financing" is defined in the Note. If there has been no Qualified Financing prior to the time that the Holder desires to exercise this Warrant, then the number of Units shall be determined with reference to pre-monies valuation at the time of the Note execution.

Section 8 of the *Warrant to Purchase Class A Membership Interests* reads:

> Prior to exercise of this Warrant, the Holder shall not be entitled to any rights of a member with respect to the Units, including (without limitation) the right to vote such Units, receive dividends or other distributions thereon, exercise preemptive rights or be notified of membership meetings, and, except as otherwise provided in this Warrant, such Holder shall not be entitled to any member notice or other communication concerning the business or affairs of the Company.

AIF provided Audit with bank statements showing confirmation of wire transfers in the amounts listed above from Petitioner to [redacted]

AIF also provided Audit with a signed copy of a *Loan Agreement Between* [redacted] *and* [redacted] dated September 1, 2021. [redacted] is listed as the Lender and [redacted] is listed as the Borrower. This loan agreement states that the Lender promises to lend the Borrower $160,000, and the Borrower promises to repay this amount with interest payable on the unpaid principal amount at 5% per year. The first repayment of $33,500 was to be made on November 30, 2021, with the remaining balance due on February 28, 2022. This agreement did not contain any provisions for the conversion of principal to ownership interest in [redacted] The agreement is signed by Petitioner as president of [redacted]

Research conducted by Appeals shows that Petitioner filed Articles of Organization for [redacted] with the Idaho Secretary of State on [redacted] as the sole member and has filed annual reports as "President" or "Member" every year through 2024. The IRS regards a single-member LLC as a "disregarded entity," meaning that it is disregarded as an entity separate from its owner. In effect, the entity and the owner are one and the same, so the funds from [redacted] belonged to Petitioner. Bank statements show that [redacted] wired $160,000 to [redacted] While AIF did not provide any documentation showing that any amounts were repaid, he did indicate in his May 14, 2024, written statement that Petitioner "received back $33,500 as a capital recapture." This matches the amount agreed to be repaid on November 30, 2021, in the *Loan Agreement Between* [redacted] *and* [redacted]

Based on the above information, the Tax Commission determined that Petitioner loaned [redacted] $770,000 and was repaid $33,500, leaving a balance of $736,500, and that amount was intended to be repaid with interest or converted to ownership interest as stated in the relevant contracts.

In a document provided to Audit, *Agenda for Meeting with FBI Agent* [redacted] AIF used strong language to describe the actions he accuses the CEO of [redacted] of taking:

> Fraud from inception / securities fraud – raising money on fraudulent licensing and sales information
>
> Embezzlement – used bank accounts (investor funds) for personal/[redacted] enrichment and personal expenses
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> Wire fraud – funds wired from California, Idaho, Hawaii, and Utah based on fraudulent investor decks

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[3] [redacted] dba [redacted] According to AIF, the CEO of [redacted] was heavily involved in this other company as well.

> Bank fraud – bank accounts set up using single-member LLC documentation with Bank of America and Chase Bank, even though there were multiple LLC members. Allowed for unilateral control of the bank accounts and spending.
>
> Material malfeasance – intentionally and deliberately sabotaged the company and stole assets for use by [redacted] and later [redacted]
>
> This was a Ponzi Scheme, except no one received any funds back.

AIF described in detail the CEO's background, how he allegedly misrepresented [redacted] business footprint and future, regulatory issues, civil theft letters, and complaints filed with Orlando police, the Hawaii Bar Association, the SEC, the FBI, and the US Associate District Attorney in Miami, Florida. AIF stated complaints were filed with these entities in April, May and July 2022, but state and federal authorities all declined to investigate the matter.

In the Notice, Audit wrote that the term theft includes larceny, embezzlement, and robbery, but theft losses are not deductible for the years covered by the Notice under the *Tax Cuts and Jobs Act of 2017*. Audit also stated

> …the IRS will deem [a] loss to be the result of theft if: (1) the lead figure was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the lead figure was the subject of a state or federal criminal complaint alleging the commission of such a crime, and (a) either there was some evidence of an admission of guilt by the promoter or (b) a trustee was appointed to freeze the assets of the scheme.

Based on available information, the CEO of [redacted] was not charged with any crime. Although complaints were filed, there is no evidence that there was admission of guilt of the actions in the complaints or that anyone was appointed to freeze assets.

In his May 14, 2024, statement, AIF writes, "The IRS defines theft to be (1) the taking and removal of money or property with (2) the intent to permanently deprive the owner of it (without the owner's consent). (3) The taking must be illegal under the law of the state where it occurred and must have been done with (4) criminal intent." He further states that this is not a theft loss

because there was no "taking," since the note was freely executed and given to [redacted] there was no proven intent to deprive Petitioner of her funds, and there has been no legal determination of criminal intent.

This seems to be a case where AIF wants to "have his cake and eat it, too." He used inflammatory language when describing to the FBI the actions taken by the CEO, which may have encouraged Audit to find that this was a non-deductible loss by theft but then softens his tone after Audit disallowed the loss. In years prior to 2018, taxpayers had to prove several items before a theft loss would be allowed as an itemized deduction, including the fact that a theft occurred, when the theft was discovered, the amount of the theft, and how much was or was reasonably expected to be recovered through insurance or restitution. In multiple cases involving the absence of any or all of these, the IRS has denied the taxpayer a theft loss deduction.

In the current matter, since Audit was claiming that a theft loss was incurred, Audit would bear the burden of proof. The Tax Commission determined that there is insufficient evidence to prove a theft loss and therefore reverses Audit's denial of the loss on the grounds of it being non-deductible.

In the Notice, Audit also addressed the loss in terms of relating to a trade or business. Petitioner's 2022 tax return reported the loss as an ordinary loss, which typically would be reported by a business to its owners. However, as was discussed earlier, Petitioner never had an ownership interest in the business because the *Warrant to Purchase Class A Membership Interests* was never executed. Therefore, the Tax Commission agrees that the loss must be denied as an ordinary loss and the $230,695 Audit adjustment must stand.

The question now becomes what the proper treatment of the loss is. IRC section 166(a)(1) states, "There shall be allowed as a deduction any debt which becomes worthless within the taxable

year." Treasury Regulation section 1.166-1(c) states that only bona fide debt qualifies for the deduction under IRC section 166. A bona fide debt is one arising from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money. The bad debt does not have to be due at the time of the deduction to be allowable under IRC section 166.

IRC section 166(d)(1) provides that, for an individual, the deduction for a nonbusiness debt that becomes worthless within the tax year is not from ordinary income but is considered a loss from the exchange or sale of a capital asset held not more than one year (a short-term capital loss). Nonbusiness debt is defined in IRC section 166(d)(2) as debt other than debt created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. To qualify as a business bad debt, the debt must have been created or acquired in connection with a trade or business of the taxpayer[4], or the loss must have been incurred in petitioner's trade or business[5]. If the interest of the lender is predominantly that of an investor, the debt will be characterized as a nonbusiness bad debt, because management of one's own investments, no matter how extensive, does not constitute a trade or business[6]. Based on this, the Tax Commission determined that Petitioner did have a bona fide debtor-creditor relationship with [redacted] and that the debt was nonbusiness in nature. Petitioner was an investor/lender in the business, not an owner, and was not involved in the day-to-day operations of the business.

The loss for nonbusiness bad debt is claimed in the year when the debt becomes worthless. The determination of when that occurs must be based on all pertinent information. Petitioner's

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[4] IRC section 166(d)(2)(A)
[5] IRC section 166(d)(2)(B)
[6] *Higgins v. Commissioner*, 312 U.S. 212, 218 [25 AFTR 1160] (1941)

four loans were provided during 2020 and 2021. According to statements provided by AIF, the Company's CEO essentially funneled the funds which Petitioner believed would be used to develop products under the name of [redacted] to a different company, and [redacted] was insolvent by the end of 2022. Since there was no policy in place, there is no potential for recovery through an insurance claim. While complaints were filed with local police departments and federal authorities in 2022, the investigations have not resulted in any arrests or charges, which means there is no potential for recovery through the court system, either. After a thorough search, the Tax Commission can find no online presence of [redacted] later than 2021. The business filed initial formation documents with the State of Colorado in 2019 and was delinquent in follow-up filings as of March 2022. Based on this information, the Tax Commission determined that a short-term capital loss of $736,500 was realized in tax year 2022 and Petitioner is eligible to recognize $3,000 of capital loss in that year.

Regarding Audit's disallowance of deductions for Idaho NOL carryover for tax years 2020 and 2021, in Appeals Docket 0-449-143-808 the Tax Commission determined that Petitioner had no Idaho NOL balance to carry forward from 2019. Therefore, the adjustments for this issue must stand.

The Bureau added interest to Petitioner's tax deficiency. The Tax Commission reviewed this addition and finds it to be appropriate and in accordance with Idaho Code section 63-3045.

**Conclusion**

Petitioner did not incur an ordinary business loss as was reported on her 2022 income tax return. Instead, she suffered a capital loss due to the recognition of nonbusiness bad debt in 2022. Petitioner did not have any Idaho NOL balance to carry into 2020 or 2021.

THEREFORE, the Notice dated March 20, 2024, and directed to [redacted] is hereby MODIFIED and MADE FINAL.

IT IS ORDERED that Petitioner pay the following tax, penalty, and interest:

| YEAR | TAX | PENALTY | INTEREST | TOTAL |
|---|---|---|---|---|
| 2020 | $363 | $0 | $31 | $394 |
| 2021 | 216 | 0 | 14 | 230 |
| 2022 | 5,922 | 0 | 176 | 6,098 |
| | | | | $6,722 |

DEMAND for immediate payment of the foregoing amount is hereby made and given. Interest is calculated in accordance with Idaho Code section 63-3045.

An explanation of Petitioner's right to appeal this decision is enclosed.

DATED this _____ day of _____ 2025.

IDAHO STATE TAX COMMISSION

**CERTIFICATE OF SERVICE**

I hereby certify that on this _____ day of _____ 2025, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

Receipt No.

_____

_____

[redacted]

[redacted]