



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
STAYNER CORPORATION)

Appearances:

For Appellant: George A. Andrews, Jr., Attorney at Law
For Respondent: Burl D. Lack, Chief Counsel;
A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Stayner Corporation to proposed assessments of additional franchise tax in the amounts of \$360.59 and \$221.32 for the income years ending April 30, 1953 and 1954, respectively.

The question presented is whether funds advanced to Appellant by its stockholders represented bona fide indebtedness, thus entitling it to deductions for interest accruing during the years under review.

Appellant incorporated under the laws of California and is engaged in the manufacture and sale of drugs. Originally organized to produce a single vitamin product, Appellant shifted to a line of standard pharmaceuticals when its first item proved unsuccessful,

Appellant's history began in 1938 when it issued 200 shares of stock for \$10.00 a share. Appellant also issued approximately \$22,000.00 in notes that year. In 1940, it had 281 shares outstanding while advances from shareholders totaled nearly \$34,000.00 and there was an additional \$12,000.00 payable on other notes. That year Appellant took back its original obligations in exchange for a fixed ratio of stock and Series A notes. The latter, payable in four years, were unsecured promissory notes bearing 6% interest.

When the Series A notes matured in 1944, loans from stockholders had increased to \$79,732.19 and unpaid interest amounted to \$20,512.83. Appellant then issued new Series A notes in exchange for the old and Series B notes for the unpaid interest. These new instruments were also unsecured 6% notes, maturing in 15 and 10 years, respectively. In 1954, the maturity date of the Series B notes was extended another four years.

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Appellant set out to borrow an additional \$50,000.00 in 1946 by permitting its shareholders to contribute pro rata, according to their ownership interests. Because only a few stockholders accepted the arrangement, the bulk of this money came from outsiders. Each lender bought one share of stock for each \$1,000.00 loaned. Series C, unsecured, 6% notes due on October 1, 1961, were issued.

Appellant has made only two payments on its notes. A payment of \$270 was made in 1944 to a retiring shareholder and a payment of \$778.18 was made to a series B noteholder in 1955. No efforts have been made to enforce payment. Interest has been paid only when the financial condition of the corporation permitted it.

As of April 30, 1954, Appellant's records showed the following balances: capital stock - \$9,420.00; notes payable to shareholders - \$150,245.02; interest payable to shareholders - \$41,207.41; deficit - \$44,465.65. There were then 942 shares of stock held by 26 persons. One stockholder with 318 shares held notes in the amount of \$30,932.71, another with 182 shares held notes in the amount of \$23,201.99 and the remaining stock and notes were held in ratios varying from 1 to 11 shares for each \$1,000 in notes.

In computing its income for the years ending April 30, 1953 and 1954, Appellant deducted \$9,014.68 and \$9,067.06, respectively, as interest accrued on loans from shareholders. The Franchise Tax Board disallowed these deductions upon the ground that the shareholders' advances were not true debts, but were contributions to capital.

Whether advances to a corporation may properly be treated as loans for tax purposes depends upon whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture, or were placed at the risk of the business. (Gilbert v. Commissioner, 248 F. 2d 399.) This is a question of fact and the formal designation given the advances must yield to facts which give rise to contrary inferences. (Sam Schnitzer, 13 T.C. 43, Aff'd 133 F. 2d 70, cert. denied 340 U.S. 911.) A disproportionately high debt-to-equity ratio is, at the very least, a suspicious circumstance which calls for careful inquiry to determine whether the indebtedness is really what it purports to be, (Leach Corp., 30 T. C. 563; Isidor Dobkin, 15 T.C. 31, aff'd 192 F. 2d 392; Gilbert v. Commissioner, supra.)

Here, Appellant's ratio of loans to stock reached 16 to 1 during the period under consideration. While no rule automatically classifies a debt as a sham merely because of a high debt-to-equity ratio, the inference raised by Appellant's heavy debt structure is supported by other equally cogent facts.

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With minor exceptions, Appellant's notes have never been paid and there have been no efforts made to enforce payment. The shareholders appear to have been content to let their money ride with the ups-and-downs of Appellant's business, hoping to someday reap the profits of a successful venture. Interest on the loans was paid only when Appellant's profits warranted it, a policy more akin to dividends than interest. Finally, Appellant's notes were usually tied to stock in fixed ratios. Upon careful consideration of all of these facts, we conclude that Appellant's notes did not constitute bona fide indebtedness.

In reaching our conclusion, we have reviewed Appellant's contention that the proportion of the notes held by each of its stockholders was not the same as the proportion of the stock held by them. "Under the circumstances of this case, we attribute to this no greater weight than if [Appellant] had issued disproportionate amounts of common and preferred stock." (Colony, Inc., 26 T.C. 30, 43, aff'd on another issue 244 F. 2d 75, rev'd on another issue 357 U.S. 28. See also, Phil L. Hudson, 31 T. C. 574; American-La France-Foamite Corp., T.C. Memo., Dkt. No. 62520, May 19, 1959, aff'd 284 F. 2d 723, cert. denied ___ U.S. ___, March 10, 1961.)

In the alternative, Appellant urges that at least some of the loans were bona fide debts. There is, however, no evidence in the record which would justify treating any particular portion of Appellant's notes differently from the others. There is no indication of an intent that any of them were to be paid unless profits warranted payment,

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of the Stayner Corporation

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to proposed assessments of additional franchise tax in the amounts of +360.59 and \$221.32 for the income years ending April 30, 1953 and 1954, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of May, 1961, by the State Board of Equalization.

- John W. Lynch _____, Chairman

George R. Reilly _____, Member

Paul R. Leake _____, Member

Richard Nevins _____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary