



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BARLAND DEVELOPMENT CORPORATION)

Appearances:

For Appellant: Kenneth Leventhal and Bernard
Lemlech, Certified Public Accountants

For Respondent: Burl D. Lack, Chief 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 protest of Barland Development Corporation to a proposed assesstment of additional franchise tax in the amount of \$421.86 for the income and taxable year ended May 31, 1955.

Appellant was a California corporation whose business was the development of residential subdivisions. It was incorporated on June 4, 1954, with an authorized capital of \$25,000 in common shares and \$50,000 in preferred shares. It-. adopted a fiscal year ending May 31.

Appellant issued stock in the amount of \$5,000 for cash on August 5, 1954. On the same day it issued bonds labelled "Registered Debenture Bonds" due August 5, 1958. The bonds bore interest at 1/2 percent per annum, had a face value of \$40,000, and were issued for a cash consideration of \$30,000, Payment of the bonds was not made to depend upon the existence of either profits or surplus nor did the bondholders have any right to a pro rata share of the profits. The two individuals who purchased the bonds were not stockholders in the appellant nor related to the stockholders. They were given no voice in appellant 's management. Their rights to payment were never subordinated to the rights of any other general creditors,

Appellant next purchased a tract of land for \$30,000 in cash and obtained a construction loan commitment for \$400,000 from a bank, Appellant subdivided the land and built and sold 36 houses.

Early in 1955, after completion of its development of the tract, appellant redeemed its bonds by paying the face amount of \$40,000 plus accrued interest of \$166.66. Appellant reduced its assets to cash and distributed the cash to its stockholders.

At a special meeting of appellant's board of directors on May 4, 1955, it was decided that appellant would wind up its affairs and voluntarily dissolve. Appellant ceased doing business and on September 30, 1955, it was dissolved.

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In its return for the income and taxable year ended May 31, 1955, appellant claimed deductions for interest paid in the amount of \$166.66 and bond discount in the amount of \$10,000. Respondent disallowed the deductions asserting that in reality the amounts represented dividend distributions. Respondent also made another adjustment which appellant has not protested,

Thus, we must decide whether the amounts disallowed represented interest and bond discount on a valid debt or were in fact a distribution of dividends.

Our statute provides for deduction of all interest paid or accrued during the income year on indebtedness of the taxpayer. (Rev. & Tax, Code, § 24344.) A bond discount is deductible, being in the nature of deferred interest. (Pacific Southwest Realty Co. v. McColgan, 53 Cal, App. 2d 549 (128 P.2d 86); Chicago, Rock Island & Pac. Ry., 13 B.T.A. 988, 1033.) The deduction of the interest and the discount, of course, is predicated on the existence of a valid debt,

Respondent's basis for asserting that a valid debt was not created was that there was a "thin" capitalization since the ratio of debt to capital stock could have been as high as 86 to 1. Respondent asserts that in such a case the \$30,000 obtained from issuance of the debentures was in reality risk capital since a loss by appellant would have made it unable to redeem the bonds,

Respondent relies on the case of John Kelley Co. v. Commissioner, 326 U.S. 521, where the court originated the doctrine of "thin" capitalization. It must be noted that the court's language was dictum; both the Kelley case and its companion case were concerned with adequately capitalized corporations. Nevertheless, many federal courts have applied the doctrine since the decision in the Kelley case.

Cases which have applied the doctrine of "thin" capitalization are distinguishable from appellant's case because in them have been present such factors as family relationships, advances made by sole stockholders, proportionate loans by stockholders, subordination of advances to other loans, interest that is payable only from profits and failure to pay the principal when due, (Gilbert v. Commissioner, 248 F.2d 399; Isidor Dobkin, 15 T.C. 31, aff'd per curiam, 192 F.2d 392; Swoby Corp., 9 T.C. 887; P. M. Finance Corp., T. C. Memo., Dkt. Nos. 77725, 84356, May 14, 1961; Zephyr Mills, Inc., T.C. Memo., Dkt. No. 65923, Sept. 28, 1959, aff'd per curiam, 279 F.2d 494.) One case particularly relied on by respondent is distinguishable in that the holders of what purported to be bonds had an agreement under which they were to receive 50 percent of the profits. (Aldon Homes, Inc., 33 T.C. 582,)

As stated in the case of Leach Corporation, 30 T.C. 563, there is no rule of thumb that automatically classifies a debt as a sham merely because of a high debt-to-equity ratio. In that case the enterprise was launched with a debt-to-equity ratio of 400 to 1. The court concluded that the bonds there issued in consideration of the advances represented a genuine indebtedness despite the high ratio and the additional facts that the mortgage security was not fully adequate, that stock was issued to the bondholders and that the indebtedness was temporarily subordinated to an interim loan.

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In appellant's case the following facts, when viewed in the aggregate, support the contention that issuance of the bonds created a valid debt: The bondholders were not stockholders, there were no family relationships between stockholders and bondholders, the rights of the bondholders were never made subordinate to the rights of any other general creditors, no provisions were made for the bondholders to share pro rata in the profits, the bondholders had no voice in appellant's management, the bonds were payable at a fixed date and, finally, the bonds were in fact paid in full.

In essence, respondent's sole reason for disallowing the deduction seems to have been that appellant was inadequately capitalized. We do not think this in itself was a sufficient reason. Appellant properly deducted the amount paid for interest and bond discount.

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 protest of Barland Development Corporation to a proposed assessment of additional franchise tax in the amount of \$1121.86 for the income and taxable year ended May 31, 1955, be and the same is hereby reversed insofar as the action related to the disallowance of deductions for interest and discount on the bonds which are the subject of the opinion on file herein.

Done at Sacramento, California, this 17th day of April, 1963, by the State Board of Equalization,

Paul R. Leake, Acting Chairman
Richard Nevin, Member
Geo. R. Reilly, Member
Alan Cranston, Member
 , Member

ATTEST: Dixwell L. Pierce, Secretary