

BEFORE **THE** STATE BOARD OF EQUALIZATION  
OF **THE** STATE OF CALIFORNIA

In the Matter of the Appeal of }  
GEORGE E. NEWTON }

Appearances:

For Appellant: **James G. Fay,**  
Certified **Public Accountant**

For Respondent: Burl D. Lack,  
Chief Counsel

O P I N I O N

This appeal is made pursuant to section **18594** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of George E. Newton against proposed assessments of additional personal income tax in the amounts of \$2-88.21, **\$1,393.49** and \$105.73 for the years **1955, 1956** and **1957**, respectively.

The questions raised by this appeal are: (i) whether appellant George E. Newton's unreimbursed advances to a corporation **in which** he was a **majorit** stockholder are deductible by appellant as a bad debt, and (2) whether appellant is entitled to a deduction for attorneys' fees paid by him in connection with a divorce action.

Appellant was the sole proprietor of **Aircraft** X-Ray Laboratory, a business which was engaged in testing **airplane** and missile parts. In **1951**, appellant decided to form a corporation to manufacture castings for airplane companies.

Airframe Manufacturing Company (hereafter referred to as "the corporation") was incorporated under the laws of California on **October 26, 1951**. The initial paid-in **capital totalled** \$10,000, and appellant acquired **81 percent** of the common stock Issued. The remaining **19 percent** of the stock was held by employees of appellant.

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The corporation commenced business on November 1, 1951. In order to begin operations additional working capital was necessary, and appellant advanced substantial sums of money to the corporation during its early existence. The corporation suffered continued losses and appellant made smaller advances as they became necessary. Corporate operations ceased on August 31, 1955, and the company was subsequently liquidated. A schedule of the corporation's losses and appellant's advances follows:

<u>Income</u> <u>ended</u>	<u>year</u>	<u>Net Loss</u>	<u>Net Balance</u> <u>of Advances</u>
October 31,	1952	(\$13,807.02)	\$53,375.45
October 31,	1953	{ 1,932.46 }	59,923.86
		{ 1,621.44 }	27,332.52
		{ 18,465.00 }	34,565.89

No instruments of indebtedness were created at any time, though the advances were carried on appellant's books as an account receivable and on the corporation's books as an account payable.

The liquidation of the corporation's assets in late 1955 failed to produce funds sufficient to pay all outside creditors of the corporation. Because he dealt with many of those same creditors in connection with his sole proprietorship, and because the two businesses were closely allied, appellant deemed it advisable to avoid bankruptcy proceedings on behalf of the corporation by paying amounts owing to the creditors from his own funds. Accordingly, after cessation of the corporation's business, he paid \$12,682.16, \$7,919.62 and \$3,039.79 to creditors of the corporation and deducted these amounts from his returns for the years 1955, 1956 and 1957, respectively. Respondent allowed the deductions for 1956 and 1957, on the ground that bankruptcy proceedings involving the corporation would have adversely affected appellant's sole proprietorship.

in his 1955 return, appellant deducted \$47,248.05 as "Non Recoupable Advances - Airframe." This amount included the \$12,682.16 paid to creditors of the corporation after its business ceased. Because no such specification was made until this appeal was filed, respondent disallowed the entire amount, concluding that the advances constituted capital investments and not loans to the corporation and were therefore not deductible as bad debts. Respondent does not dispute appellant's contention in this appeal that the sum of \$12,682.16, being in the same class as the sums paid to creditors in 1956

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and 1957, was deductible, (See Allen v. Commissioner, 283 F.2d 785.) Respondent maintains its **position**, however, that the advances made while the corporation was operating-were capital investments,

During the taxable years involved in this appeal **appellant's** former wife, Wilma Estella Newton, sued him for divorce. Mrs. Newton contended that appellant's business constituted community property and that she was therefore entitled to a portion of it upon severance of the marriage. In defense of the action appellant incurred certain legal **fees** of his **own**, and **he was** also obligated under the interlocutory decree of divorce to pay \$10,000 to his **wife's** attorneys. In filing his tax returns appellant deducted all fees paid to his attorney during 1955, 1956 and 1957 for services rendered in connection with the divorce action and \$5,000 paid to his **wife's** attorneys **in 1956**. Respondent disallowed deduction of 25 percent of the amounts paid to **appellant's** own attorney and the entire \$5,000 paid to Mrs. **Newton's** attorneys, Appeal is also made from these disallowances.

Section 17207 of the Revenue and Taxation Code provides for the deduction of debts which become worthless during the taxable year, Only a bona fide debt qualifies for purposes of that section, (Cal., Admin. Code, tit. 18, reg. 17207(a), **subd. (3)**.) Whether advances to a corporation by a principal stockholder are loans or contributions to capital is essentially a question of fact, The taxpayer has the burden of proving that a bona fide debt existed and that he is therefore entitled to a deduction upon its becoming worthless. (Matthiessen v. Commissioner, 194 F.2d 659.)

In cases involving comparable federal legislation the courts have stressed a number of factors which are to be considered in determining the nature of an advance made by a stockholder, The basic inquiry appears to be: have the funds been put at the risk of the corporate venture, or is there a genuine expectation of repayment regardless of the success of the business? (Gilbert v. Commissioner, 248 F.2d 399.) The entire factual background must be examined in order to answer this question,

Though the form of the transaction 'is not **conclusive**, **itis** one of the circumstances to be considered in determining whether or not the parties intended to create a bona fide indebtedness, In the instant case, most of the usual formal indicia of indebtedness were absent, No debt Instruments **were** created, no definite date for repayment was specified, no interest was paid and the advances were unsecured, In addition, appellant **subordinated his claims** to the **claims** of outside creditors, **This is another indication of an** equity investment

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rather than a loan, (Gooding Amusement Co., 23 T.C. 408, aff'd, 236 F.2d 159, cert. denied, 352 U.S. 1031 [1 L. Ed. 2d 599].)

The debt-equity ratio of the corporation receiving the advances is another factor which is considered by the courts. An excessive ratio of corporate debt to *net* corporate capital may result in the conclusion that the corporation is inadequately capitalized and that advances by the shareholder in reality constitute additional capital investment rather than loans, (Gilbert v. Commissioner, 248 F.2d 399.) The debt-equity ratio in the instant case was more than 5 to 1 during the first year of operation, Within that year, expenses exceeded the amount denominated as equity capital and the corporation thereafter operated entirely on appellant's advances. These circumstances point toward a finding that the advances made by appellant were contributions to capital. (Dodd v. Commissioner, 298 F.2d 570; Diamond Bros. Co., T.C. Memo., Dkt. No. 87004, May 31, 1962, aff'd, 322 F.2d 725.)

The fact that appellant repeatedly advanced money to the corporation even though **it** was not proving to be a profitable operation is evidence of intent to invest capital. **It** is unlikely under those circumstances that an outside creditor would have-continued to make unsecured loans with expectation of repayment, (Dodd v. Commissioner, supra.)

The record indicates that appellant did recoup a portion of the **advances**. This fact would be of more consequence in a situation where the advancing stockholder was not in control of the corporation, (Diamond Bros. Co., supra.) As president of the corporation and owner of 81 percent of ~~the~~ stock, the rest of which was held by his own employees, appellant was in a position to balance his advances with withdrawals from time to time, at will. Because of **appellant's** dominant position also, we attach little significance to the fact that the advances were not made by all of the stockholders in proportion to the amounts of stock held by them. (Dodd v. Commissioner, supra,)

Appellant relies on the case of Byerlite Corp. v. Williams, 286 F.2d 285. In Byerlite the subsidiary corporation to which the **parent** corporation made advances was not expected to make a profit. Therefore the advancing shareholder could not possibly have had an intent to invest In order to enjoy the **corporation's** chances of profit. The subsidiary was created to **conduct**, for a limited **time**, one aspect of the parent's business and the purpose of the advances was to promote the business of **the** parent. More analogous to the case at hand is Dodd v. Commissioner, supra, where a sole proprietor advanced **money to** start and keep under **way** a new and **under-capitalized**

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corporation in a business similar to but different from that of the proprietorship. On these facts, the court concluded that the advances were loans.

It appears that **appellant's** expectation of repayment was highly, conjectural, even after the business had gotten under way. Recoupment of the advances made was dependent upon the success of the business, Appellant has failed to prove that a debtor-creditor relationship existed between him and the corporation.

Appellant also claims he is entitled to a deduction for legal fees incurred by him and his former wife and paid by him in connection with their divorce action. Section **17252**, subdivision (b) of the Revenue and Taxation Code provides for the deduction of all ordinary and necessary expenses paid or incurred in connection with the management, conservation or maintenance of property held for the production of income. Appellant contends that the attorneys' fees were incurred to protect his business from the claims of **his** former wife, that such business **constituted** community property, and **that such** fees are therefore deductible under section **17252**.

The United States Supreme Court has recently settled this question in an interpretation of comparable federal **legis-**  
**lation**. In **1963** the Court held that legal fees paid by the husband under similar circumstances were not deductible as expenses for the conservation of income-producing property, but were properly characterized as non-deductible personal **or** family expenses, (United States v. Gilmore **372** U.S. **39**  
[**9** L. Ed. **2d** **570**]; United States v. Pat-72 U.S. **53**  
[**9** L. Ed. **2d** **5801**].)

Respondent disallowed as deductions only **25** percent of the fees paid to appellant's attorney for his services in the divorce proceedings. In accordance with the above cited **decisions**, which were handed down after this appeal was filed, all of those deductions should have been disallowed. The statute of limitations prevents increasing the assessments for any of the years involved, (Rev. & Tax. Code, § 18586.) Since the assessment for the year **1955**, however, **will** be reduced by allowing a deduction of **\$12,682.16** for payments to creditors of the corporation, there should be a corresponding offset by disallowing the entire deduction **claimed** for divorce fees for that year. The parties have not specified the amount, **of** the divorce fees deducted for **1955**, but the deduction should be disallowed to the extent that this can **be done** without **increasing the amount of** t h e **assessment**.

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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 George E. Newton to proposed assessments of additional personal Income tax in the amounts of \$2,188.21, \$1,393.49 and \$105.73 for the years 1955, 1956 and 1957, respectively, be modified by allowing for the year 1955 a deduction of \$12,682.16, representing debts of the corporation which were paid by appellant, and by **disallowing as** a deduction the entire amount of divorce fees claimed for 1955. In all other respects the **action** of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 12th day of May, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman  
John W. Lynch, Member  
Paul H. Stein, Member  
Ed Spitz, Member  
\_\_\_\_\_, Member

Attest:

J. Freeman, Secretary