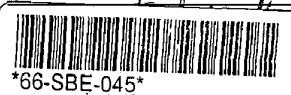


Non-deductible divs on
capital v. deductia
on indebtedness



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
SUNNY HOMES, INC., ET AL.)

Appearances :

For Appellants: **Oven G. Fiore** and **David Greene Lilly**
Attorneys at Law

For Respondent: **A. Ben Jacobson**
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 25867 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of the following appellants against proposed assessments of additional franchise tax in the amounts' and for the taxable years indicated:

<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Chapman Estates, Inc.	7/31/54	\$ 46.97
Chapman Estates, Inc.	7/31/55	-60.31
Chapman Terrace, inc.	1/31/56	67.93
Chapman Terrace, Inc.	1/31/57	67.93
Fairview Terrace Homes	12/31/56	1,100.23
Fairview Terrace Homes	12/31/57	1,466.97
Fairview Terrace Homes No. 2, Inc.	3/31/57	399.17
Fairview Terrace Homes No. 2, Inc.	3/31/58	399.17
Fairview Terrace Homes No. 2, Inc.	3/31/59	771.35
Harbor Park Estates	3/31/56	399.06
Harbor Park Estates	3/31/57	399.06
Harbor Park Estates	3/31/58	102.04

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<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Harbor Park Estates No. 2, Inc.	5/31/56	\$ 33.34 '7
Harbor Park Estates No. 2, Inc.	5/31/57	313.47
Harbor Park Estates No. 2, Inc.	5/31/58	250.14
Harbor Park Estates No. 2, Inc.	5/31/59	307.38
Harbor Park Homes	2/28/55	226.43
Harbor Park Homes	2/29/56	581.68
Harbor Park Homes	2/28/57	488.90
Lambert Homes, Inc.	4/30/54	52.17
Lambert Homes, Inc.	4/30/55	52.17
Lambert Homes, Inc.	4/30/56	21.00
Lincoln Park Estates No. 2, Inc.	3/31/57	191.77
Lincoln Park Estates No. 2, Inc.	3/31/58	191.77
Lincoln Park Estates No; 2, Inc.	3/31/62	100.00
Nutwood Properties, Inc.	3/31/58	72.62
Nutwood Properties No. 2, Inc.	12/31/58	31.55
Nutwood Properties No. 2, Inc.	12/31/61	426.20
Nutwood Properties No: 3, Inc.	8/31/59	463.14
Nutwood Properties No. 3, Inc.	8/31/60	491.32
Nutwood Properties No. 3, Inc.	8/31/61	3,077.23
Sunny Homes, Inc.	6/30/56	2,233.57
Sunny Homes, Inc.	6/30/57	151.88
Sunshine Terrace Homes	3/31/56	36.90
Trask Terrace Homes	2/28/57	372.18
Trask Terrace Homes	2/29/56	372.18
Trask Terrace Homes	2/28/58	387.08
Tustin Terrace Homes	11/30/57	300.93
Valencia Homes, Inc.	5/31/59	
Valencia Homes, Inc.	5/31/60	1,050.93
Valencia Homes No. 2, Inc.	9/30/60	1,025.00
Valencia Homes No. 2, Inc.	9/30/61	1,100.00
Waverly Homes, inc.	5/31/59	25.00
Waverly Homes No, 2, Inc.	3/31/57	726.94
Waverly Homes No. 3, Inc.	2/28/59	25.00
Waverly Homes No. 4, Inc.	11/30/57	40.33
Waverly Homes No. 4, Inc.	11/30/56	40.33
Waverly Homes No. 5, Inc.	11/30/57	61.71

Appellants were affiliated corporations engaged in developing residential subdivisions. They were at all times controlled by their parent corporation, Sunny Homes, Inc., whose stock was owned primarily by three individuals.

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The initial capital of each appellant from issuing stock ranged from \$300 to \$1,200, except for appellant Trask Terrace Homes, whose initial capital was \$20,000.

Additional funds were advanced by certain private individuals, hereafter referred to as "subscribers." These advances are compared with initial capital in the following table:

	<u>Advances</u>	<u>Initial Capital</u>	<u>Ratio</u>
Chapman Estates, Inc.	\$ 20,000	\$ 300	67 to 1
Chapman Terrace-, Inc.	7,000	1,000	7 to 1
Fairview Terrace Homes	120,000	1,000	120 to 1
Fairview Terrace Homes No. 2, Inc.	123,500	1,000	130 to 1
Harbor Pa-rk Estates	41,203	1,000	41 to 1
Harbor Park Estates No. 2	41,200	1,000	41 to 1
Harbor Park Homes	25,000	600	42 to 1
Lambert Homes, Inc.	25,000	600	42 to 1
Lincoln Park Estates No. 2, Inc.	80,000	1,000	80 to 1
Nutwood Properties, Inc.	45,500	1,000	46 to 1
Nutwood Properties No. 2, Inc.	50,250	1,000	50 to 1
Nutwood Properties No. 3, Inc.	45,500	1,000	46 to 1
Trask Terrace Homes	25,000	20,000	1 to 1
Valencia Homes, Inc.	65,750	600	110 to 1
Valencia Homes No. 2, inc.	100,000	1,200	83 to 1
Waverly Homes No. 4, Inc.	5,000	1,000	5 to 1
Waverly Homes No. 5, Inc.	6,500	1,000	7 to 1

The advances from subscribers were obtained pursuant to written agreements each of which recited that the individual agreed to loan a specified sum for a specified percentage of net profits as defined in the agreement and that the principal and share of profit were to be paid on a specified date. The subscriber, however, was given an option to extend the time if it appeared that the profits would increase.

Net profits were defined as profits determined by accepted accounting practices except that there were to be

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no deductions for (1) fees **paid** to builders based on percentages of profit, (2) compensation of officers, (3) entertainment expenses, or (4) shares of profit paid to subscribers.

The agreement also provided:

The sale or issuance of this profit participation is authorized by a permit of the Commissioner of Corporations of the State of California and the profit participation interest assigned herein is subject to all of the terms and conditions set forth in said permit.

A permit was obtained from the commissioner authorizing the issuance or sale of profit participation agreements upon condition that the agreements be deposited with an escrow holder and that no sale or transfer of any interest therein be made without the written consent of the commissioner.

Each appellant's method of conducting business was essentially the same. The initial capital and additional advances by subscribers were used to purchase land. Secured construction loans were then obtained from lending institutions and contractors were employed to build houses on the land. The houses were then sold by appellants. The subscribers were paid according to the agreements.

When sales of the developed property were completed, appellants were liquidated and their remaining assets were distributed to the parent corporation. Most of the distributed assets were interest-bearing notes given by home buyers. One appellant also distributed stock in a federal agency which financed home construction and another distributed an unsold lot.

Appellants contend that the shares of profit paid to the subscribers are deductible as interest on indebtedness. Respondent's position is that these amounts were dividends on invested risk capital and are not deductible.

Interest on an indebtedness is deductible under section 24344 of the California Revenue and Taxation Code.

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No deduction is allowable for a distribution of dividends;

In determining whether the advances represented capital or debt, the basic question is whether the funds were advanced "at the risk of the business" with the expectation of sharing in the profits of the venture or whether a definite obligation was sought payable in any event. (Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182; United States v. Title Guarantees Trust Co., 133 F.2d 990.)

This presents an issue of fact to be determined in the light of all the circumstances. (John Kelley Co. v. Commissioner, 326 U.S. 521 [90 L. Ed. 278].) Appellants have the burden of establishing that the advances of funds are bona fide loans. (Broadway Drive-In Theatre, Inc. v. United States, 220 F. supp. 707.) The formalities of they&ties' agreements are relevant but not controlling. (1432 Broadway Corp., 4 T.C. 1158, aff'd, 160 F.2d 885; Gooding Amusement Co., 23 T.C. 408.)

We have carefully considered the arguments presented and authorities cited by each party. For the reasons hereafter stated we have concluded, except in the case of appellant Trask Terrace Homes, that the funds advanced by subscribers constituted invested capital and that the distributions of earnings thereon are not deductible,

The agreements under which the funds in question were advanced recite that a loan of money is being made, provide for repayment on a certain date, and provide for consideration for the use of the funds. However, other provisions of the agreements describe the consideration as a share of profit and refer to the interest acquired as a "profit participation interest." The agreements have also been qualified as securities with the California Corporations Commissioner. The agreements are ambiguous and no controlling inference may be drawn from them,

The funds advanced were necessary to purchase land which was required to launch appellants' businesses. Where advances are necessary to launch an enterprise, a strong inference arises that they are invested capital. (Sherwood Memorial Gardens, Inc., 42 T.C. 211, aff'd, 350 F.2d 225; Sam Schnitzer, 13 T.C. 43, aff'd, 183 F.2d 70; Merio Builders,

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Inc., T.C. Memo., Dkt. Nos. 85900, 86354, 86355, Feb. 12, 1964.)

With the exception of appellant Trask Terrace Homes, we have concluded that each appellant was inadequately capitalized to accomplish its' corporate purpose.-, Funds obtained from issuing capital stock designated as such varied in amounts from \$300 to \$1,200, scarcely more than sufficient to pay normal organization expenses. The ratios of the advances to designated capital ranged from 5 to 1 to 130 to 1. This corporate "thinness" denotes the risk assumed by the subscribers. When considered with other facts, undercapitalization has often been held sufficient to support a finding that amounts designated as loans are actually invested capital, (Swoby Corp., 9 T. C. 887; The Colony, Inc., 26 T.C. 30, rev'd on other grounds, 357 U.S. 2s [2 L. Ed. 2d 1119]; Sherwood Memorial Gardens, Inc., supra, 42 T.C. 211, aff'd, 350 F.2d 225.)

Appellants contend that goodwill and past business performances of persons actively engaged in appellants' operations should be considered in valuing the capital of appellants. No value can be attributed to goodwill, however, since it has no existence except in connection with a going concern. (Grace Bros. v. Commissioner, 173 F.2d 170.) It would be highly speculative to place a value on the ability of persons engaged in the operations. Successful performance in the past would reduce the subscribers' risk to some extent, but we cannot say that past performances substantially removed the risk,

The risk undertaken by the subscribers is illustrated by comparing their rights with those of acknowledged creditors. Although the rights of subscribers were not subordinated by the terms or their agreements, superior repayment rights existed for all major creditors. The construction loans by institutional lenders were secured and those who provided material and labor had the right to statutory liens. In contrast, the subscribers had to rely entirely upon the success of the business. This was so regardless of the fact which appellants emphasize, the fact that the agreements provided a fixed date for repayment. The secondary nature of the subscribers' rights and their reliance, on the success of the business strongly indicate that their advances were contributions to capital. (Sherwood Memorial Gardens, Inc., supra; Commissioner v. Scholl Fils Associated, 110 F.2d 611; Agulane Shores, Inc. v. Commissioner, 269 F.2d 116; Gardens of Faith, Inc., T. C. Memo., Dkt. Nos. 1362-62,

& peals of Sunny Homes, a.l.c., et

1363-62, June 30, 3.964, aff'd, 345 F.2d 180; Mary-Duerr,
30 T.C. 944.j

In all material respects the interest of a subscriber was indistinguishable from that of a preferred stockholder. A subscriber assumed the full risk of business failure. He could share in business growth and obtain additional profits by exercising his option to extend the date of repayment. His right to earnings on funds advanced was conditioned solely upon the existence of profit and was measured by the amount of profit. He was granted a preference over common stockholders and his right was subordinated to the rights of major creditors. While he had no right to vote or participate in management, these factors are common attributes of preferred stock.

(Jordan Co. v. Allen, 85 F. Supp. 437.) And the analogy to preferred stock is not destroyed by the existence of a fixed date for repayment. (Pac. Southwest Realty Co. v. McCoigan, 53 Cal. App. 2d 549 [128 P.2d 56j].j

A distinction must be drawn with respect to appellant Trask Terrace Homes. The ratio of subscribers' advances to initial capital for Trask Terrace Homes was approximately 1 to 1 and there is no showing that the advances were necessary to launch this appellant's business. We conclude that the shares of profit paid to subscribers by this appellant constituted interest on indebtedness.

Respondent also disallowed the deduction of amounts of profits paid to a few persons pursuant to transactions other than those which we have described. These transactions are mentioned very briefly in the record. They have not been described in sufficient detail to establish that respondent erred. Appellants have failed to sustain their burden of proving that these amounts constituted deductible interest,

A further question is whether distributions by some of the appellants of their businesses or property to their parent corporation in liquidation constituted reorganizations.

Normally, the income of a corporation for its final year is not included in the measure of the franchise tax since the tax for each year is based on income of the preceding year. If the corporation transfers its business or property pursuant to a reorganization, however, the transferee must pay tax measured by the income derived in the transferor's final year from the business or property transferred. (Rev. & Tax. Code, § 23253.)

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Section 23251, subdivision (d), of the Revenue and Taxation Code provides that a reorganization include's:

... a **distribution in** liquidation . . . by a bank or corporation of **all** or a substantial portion of its business or property to a bank or corporation stockholder, and the bank or corporation stockholder continues all or a substantial portion of the business of the liquidated bank or corporation....

Respondent's, position is that collecting on notes was part of each subsidiary's business of subdividing land and building and **selling** houses and that reorganizations resulted because the parent continued the collections. Appellants contend that no **reorganizations** resulted because **the major business** of each subsidiary vanished with the completion of the construction and **sale** of homes.

We believe that appellants' contention is correct. Although collecting on notes was part of each subsidiary's business of subdividing land and building and selling houses, it was not "all or a substantial. portion of the business." The bulk of the business formerly carried on by each subsidiary ceased upon liquidation. The fact that the parent continued the collections is not sufficient to bring the liquidating distributions within the **terms of section 23251, subdivision (d), of the Revenue and Taxation Code.**

O R D E R

Yursuant to the **views** expressed in the opinion of the board on file in this proceeding, and good cause **appearing therefor,**

IT IS HEREBY ORDERED, AD JUDGED 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 following appellants against proposed **assessments of additional**

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franchise tax in the amounts and for the taxable years indicated, be modified in that the subscribers', advances to **Trask Terrace Homes** are to be treated as loans and the distributions in liquidation of the appellants are not to be treated as reorganizations, In all other respects the **action** of the Franchise Tax Board is sustained.

<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Chapman Estates, Inc.	7/31/54	\$ 46.97
Chapman Estates, Inc.	7/31/55	60.31
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Chapman Terrace, Inc.	1/31/57	67.93
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Fairview Terrace Homes No. 2, Inc.	3/31/58	399.17
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Harbor Park Estates	3/31/57	399.06
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Lincoln Park Estates No; 2, Inc.	3/31/62	100.00
Nutwood Properties, Inc.	3/31/58	72.62
Nutwood Properties No. 2, Inc.	12/31/58	31.55
Nutwood Properties No. 2, Inc.	12/31/61	426.20
Nutwood Properties No. 3, Inc.	8/31/59	463.14
Nutwood Properties No, 3, Inc.	8/31/60	491.32
Nutwood Properties No. 3, Inc.	8/31/61	3,077.23
Sunny Homes, inc.	6/30/56	2,233.57
Sunny Homes, Inc.	6/30/57	151.88
Sunshine Terrace Homes	3/31/56	36.93

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<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Trask Terrace Homes	2/28/57	\$ 372.18
Trask Terrace Homes	2/29/56	372.18.
Trask Terrace Homes	2/28/58	387.08
Tustin Terrace Homes	11/30/57	44.93
Vglencia Hones, Inc,	5/31/59	309.21
Valencia Homes, inc.	5/31/60	1,050.93
Valencia Homes No, 2, Inc.	9/30/60	1,025.00
Valencia Homes No. 2, inc.	9/30/61	1,100.00
Waverly Homes, Inc.	5/31/59	25.00
Waverly Homes No. 2, Inc.	3/31/57	726.94
Waverly Homes No. 3, Inc.	2/28/59	25.00
Waverly Homes No. 4, Inc.	11/30/57	40.33
Waverly Homes No. 4, Inc.	11/30/56	40.33
Waverly Homes No. 5, Inc.'	11/30/57	61.71

Done at Sacramento, California, this 1st day
of August, 1966, by the State Board of Equalization.

Geoff Healey, Chairman
Alan Brantley, Member
John W. Lynch, Member
Paul D. Leake, Member
Richard G. Green, Member

ATTEST: M. J. [Signature], Secretary