1. ALLOTING INCOME & LO... CONTROLLED BY T... FORM —

2. ALSO BAD DEBT ISSUE

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
H. H. AND IRENE W. GARNER)

Appearances:

For Appellants: Howard C. Alphson
Attorney at Law

For Respondent: Tom Muraki
Associate Tax 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 protests of H. H. and Irene W. Garner against proposed assessments of additional personal income tax in the amounts of $2,155.30, $1,620.27 and $1,686.01 for the years 1958, 1960 and 1961, respectively.

In 1927 Padua Hills, Inc. (hereafter "Padua"), was formed to take overthe property of a real estate trust. H. H. Garner (hereafter "appellant") then owned 50 percent of Padua's stock, but gradually increased his interest to 85 percent. The property held by Padua was located in California near Claremont College and was largely unimproved, with the exception of a theatre and dining facility. From 1928 to 1934 appellant advanced considerable sums to pay the mortgages, interest, and taxes on Padua's property.

In 1934, in order to provide funds to forestall possible loss of corporate real estate due to foreclosures and tax sales, Padua leased all of its property and business operations to appellant. At that time, appellant owned

80 percent of Padua's stock. As rent appellant agreed to pay all operating expenses of the businesses then existing or subsequently developed on the property; to pay all other expenses which might accrue as obligations of Padua, including interest on all indebtedness and taxes on real and personal property; to reimburse Padua for depreciation of buildings, improvements, equipment, and personal property; and to pay Padua 50 percent of the net profits from the operation of all businesses. If any of the property were sold, appellant was to share equally in any gain.

After the lease was entered into, the theatre and dining facility were operated profitably until 1950. Additional businesses, including studio, artcraft, pottery, and water service operations, were developed.

Padua Institute (hereafter "Institute"), a tax-exempt organization, was formed in 1935 and operated as a theatrical group furnishing education on Mexican culture in the theatre building owned by Padua. Appellant was the chairman of the Institute's board of six trustees.

In 1946, appellant subleased the theatre, dining facility, and a dormitory to the Institute.

For the years on appeal, appellant, Padua and the Institute filed returns based upon the provisions of the lease and sublease, reporting net losses from the various businesses. The income and expenses related to the theatre, dining room, and dormitory were reported by the Institute, Appellant reported the income and expenses related to the studio, artcraft, pottery, and water service operations.

Respondent determined that the 1934 lease agreement should be disregarded. It reallocated the reported income and expense items among Padua, the Institute and appellant. As a result, additional losses were attributed to Padua and the Institute and additional income was attributed to appellant.

Respondent relies upon the general principle that substance prevails over form and upon Section 17615 of the Revenue and Taxation Code, which provides:

> In any case of two or more persons, organizations, trades, or businesses (whether or not incorporated, whether or not organized in this State, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such persons, organizations, trades, or businesses, If it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such persons, organizations, trades, or businesses,

Respondent contends that the 1934 lease was not an arm's length transaction and would not have been entered into if appellant had not been the majority stockholder of Padua.

It is well established that the government does not have to acquiesce in the form chosen by taxpayers for doing business and, if the form is unreal or 2. sham, may look to the actualities of the transaction. (Gregory v. Helvering, 293 U. S. 465 [79 L. Ed. 596]; Higgins v. Smith, 308 U. S. 473 [84 L. Ed, 406].) This principle has been applied in cases involving lease agreements. (58th Street Plaza Theatre, Inc., 16 T.C. 469, aff'd, 195 F.2d 724, cert. denied, 344 U.S. 820 [97 L. Ed. 638]; Interior Securities Corp., 38 T. C. 330.)

The record presented leads us to believe that the 1934 lease agreement between Padua and appellant was entered into for legitimate business reasons and that it cannot be regarded as a sham for tax purposes. In 1934 Padua was in serious financial difficulty and the leasing arrangement with appellant enabled it to retain its property. This was the primary motive for the arrangement and the parties have respected their agreement. The lease does not appear to have been unfair or unreasonable at the time it was entered into. Both parties, viewed as independent entities dealing at arm's length, had an opportunity to profit and did profit from the arrangement for a number of years. We hold that the 1934 lease agreement may not be disregarded and, consequently, we cannot sustain respondent's reallocation of income and deductions.

For the year 1959, respondent disallowed a deduction of $521.30 for an alleged bad debt. Appellant stated in his reply brief: "We concur with the agent's disallowance of this item on the basis that it did not become worthless during the year 1959." However, at the hearing appellant urged *that* the amount in question was deductible as an addition to a reserve for bad debts, The addition increased the reserve to an amount equalling the total amount of notes receivable.

Section 17207 of the Revenue and Taxation Code allows a deduction for a "-reasonable addition to a reserve for bad debts," Appellant has not established that the addition claimed by him was reasonable and therefore it cannot be allowed as a deduction.

Appellant has acquiesced in the further disallowance of a deduction of $579.42 in 1961 for alleged professional services,

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 protests of H. H. and Irene W. Garner against proposed assessments of additional personal income tax in the amounts of $2,155.30, $1,620.27 and $1,686.01 for the years 1959, 1960 and 1961, respectively,

be and the same is sustained as to the disallowance of the bad debt and professional service expanse deductions. In all other respects the action of the Franchise Tas Board is revers ed .

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

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Secretary