



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
GOODWIN D. AND BESSIE M. KEY)

Appearances:

For Appellants: John Alden Doty
Attorney at Law

For Respondent: Peter S. Pierson
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 1859^{1/2} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Goodwin D. and Bessie M. Key against a proposed assessment of additional personal income tax in the amount of \$2,201.27 for the year 1963.

The sole question presented for decision is whether amounts withdrawn by Goodwin D. Key (hereafter "appellant"), from his wholly owned corporation constituted loans to him by the corporation or whether they were taxable to appellant as dividends. A second issue concerning whether appellant constructively received a bonus from the corporation in 1963, as respondent contended, or whether that sum constituted income in 1964 when paid to appellant, as appellant argued, has been conceded by respondent since the filing of this appeal.

Key Pipe and Supply Co. (hereafter "the corporation") was incorporated by appellant under California law on December 23, 1959. Appellant and his wife own all of its capital stock,

Since the corporation's formation appellant has made frequent withdrawals of cash from the corporation for personal purposes, including the financing of his own

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investments and payment of his personal debts. These withdrawals were recorded as debits in an account in the corporation, s general ledger entitled "Note Payable-- Goodwin D. Key." Appellant also made occasional repayments to the corporation, and those amounts were recorded as credits to this same account.

None of appellant's withdrawals were evidenced by notes, there were no due dates for repayment, and no interest on those amounts was ever paid by appellant. The corporation has never paid a dividend., although its earned surplus has increased each year since the corporation was formed, as follows :

1960	\$ 77,550	1962	\$165,241
1961	126,419	1963	197,514

In the years 1960 through 1964, appellant's total withdrawals, repayments, and the net balances according to the "Note Payable" ledger account were:

<u>Year</u>	<u>Withdrawals</u>	<u>Repayments</u>	<u>Balance Outstanding</u>
1960	\$ 77,135.65	\$ 43,500.00	\$ 33,635.65
1961	26,894.40	31,690.00	28,840.05
1962	37,760.28	44,000.00	22,600.33
1963	54,733.00	34,800.00	42,533.33
1964	31,587.81	20,000.00	54,121.14

Respondent determined that the -difference between the total amount withdrawn by appellant during 1963 (\$54,733) and his repayments during that year (\$34,800) , or \$19,933, constituted -a constructive dividend paid to appellant by the corporation. Appellant acquiesces in respondent's treatment of a separate amount as a dividend, an amount of \$1,804.52 which had been treated by the corporation as a business expense. He contends, however, that the net withdrawal of \$19,933 under the "Vote Payable" account constituted a loan.

Whether withdrawals from a co-rporation by a stockholder represent loans or taxable distributions depends on all the facts and circumstances surrounding the transactions between the shareholder and the corporation. (Harry E. Wiese, 35 B.T.A. 701, aff'd, 93 F.2d 921, cert. denied - U.S. 562 [82 L. Ed. 1529]; ren. denied, 304 U.S. 589 [82 L. Ed. 1549]; Elliott J. Roschuni, 29 T.C. 1193, aff'd per curiam, 271 F.2d 267.) When the withdrawer is in substantial control of the corporation, such control invites a special scrutiny of the situation (Elliott J. Roschuni, supra; W. T. Wilson, 10 T.C. 251, aff'd, 170 F.2d 423; Ben R. Meyer, 45 B.T.A. 228); and

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withdrawals under such circumstances are deemed to be dividend distributions unless the controlling stockholder can affirmatively establish their character as loans. (W. T. Wilson, supra, 10 T.C. 251, aff'd, 170 F.2d 423.)

The record in the instant case reveals a steady pattern of withdrawals by appellant, the sole stockholder of the corporation. The withdrawals were entirely for his personal use and there was no apparent ceiling on the amount which he could withdraw for such personal purposes. No indicia of debt were ever executed and there was no definite time specified for repayment of the withdrawals. In no instance did appellant pay any interest for his use of the corporation's money. In addition, the corporation had never paid a corporate dividend, notwithstanding the fact that in each year of its existence its earned surplus increased, substantially.

In support of his contention that his withdrawals constituted loans to him from the corporation, appellant relies primarily on the facts that all such withdrawals were recorded on the corporate books as notes payable to the corporation, and that in each year he made substantial repayments to the corporation. Appellant contends that this factual pattern demonstrates that the withdrawals were intended to be loans.

The fact that appellant's withdrawals and repayments were treated on the corporation's books as loan transactions is not conclusive, since book entries may not be used to conceal reality. (William C. Baird, 25 T.C. 387; Ben R. Meyer, supra, 45 B.T.A. 228.) Nor do we consider the repayments made by appellant to be controlling, when the fact of repayment is viewed with all other facts and circumstances. Appellant was under no legal obligation to repay the amounts which he withdrew from the corporation. In addition, despite the repayments which he did make, at the close of each taxable year there was always a substantial balance which remained unrepaid. The Board of Tax Appeals, in considering a similar case stated:

From the facts before us we are convinced that [the controlling stockholders? used their control of [the corporation] to withdraw from [the corporation] whatever funds they desired at such times and in such amounts as they chose, very much in the manner of a sole proprietor appropriating the proceeds of the business in which he is engaged to supply his personal needs and recording the transactions as charges to his personal account without any specific requirement for repayment, except if, as, and when he chose. (Ben R. Meyer, supra.)

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The board there concluded that under those circumstances the withdrawals constituted dividends to the stockholders rather than loans,

Upon review of all the facts it is our opinion that appellant's withdrawals from the corporation in the instant case were in the nature of dividend distributions rather than bona fide loans from the corporation, and respondent's determination on that question must therefore be sustained,

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 protest of Goodwin D. and Bessie M. Key against a proposed assessment of additional personal income tax in the amount of \$2,201.27 for the year 1963 be modified by excluding from appellants' gross income in that year the sum of \$14,400, the amount of a bonus received by him from the corporation in 1964. In all other respects the action of the Franchise Tax Board is sustained,

Done at Sacramento, California, this 15th day of December, 1966, by the State Board of Equalization,

_____, Chairman
Paul R. Leake, Member
John W. Lynch, Member
Arthur D. ..., Member
_____, Member

ATTEST: [Signature], Secretary