BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GEORGE E., JR., AND ALICE J. ATKINSON)

Appearances:

For Appellants: George E. Atkinson, Jr., in pro. per.

For Respondent: Joseph W. Kegler
Counse 1

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., Jr,, and Alice J. Atkinson against a proposed assessment of additional personal income tax in the amount of $515.89 for the year 1962.

George E. Atkinson, Jr., (hereafter referred to as appellant) has been engaged in the practice of law in Paramount, California, for some thirty years. When he commenced his practice there, the city of Paramount (then known as Hynes) was the center of the dairy industry in Southern California. Over the years appellant has become a specialist in dairy law with some 90 percent of his practice being directly related to the dairy industry. Prior to 1955 most of the dairies in that area were of the conventional type, i.e., the dairymen shipped their raw milk to large creameries, where it was processed and thereafter sold through grocery stores or on milk routes.

In the late 1950's and early 1960's the dairy business in Southern California underwent a change. During those years there was a tremendous growth in population and home building in that part of the state.

The resulting increase in the value of the land for subdivision and business development purposes was reflected in substantially higher property taxes. The conventional dairy operation became unprofitable and many of the established dairymen in Los Angeles and Orange Counties sold out, relocating their businesses in the Chino and San Joaquin Valleys where land was not at such a premium. As a result of that exodus, appellant lost many of his old clients.

At about this same time, "cash-and-carry" dairies began to be quite prevalent in Southern California. The *term* "cash-and-carry" covers two types of dairy operations:. (1) one where the dairy, the milk processing plant, and the sales outlet are all located at one place; and (2) one where the dairy is at one location, and the processing plant and sales outlet are at another single location. Because of lower costs incurred by cash-and-carry dairies through their direct sales procedure, they were able to continue to operate at a profit in this area in spite of the increased property values.

In February of 1961 appellant formed La Vaquita Corporation (hereafter referred to as La Vaquita) to engage in the cash-and-carry dairy business. Appellant, his wife, and his secretary were the original directors and officers of the corporation. Appellant's initial capital investment in La Vaquita was $1,000. He selected Mr. James Polhemus, an experienced dairyman and cattle salesman, to manage the dairy, and Polhemus subsequently became a 50 percent stockholder in La Vaquita.

On August 21, 1961, appellant advanced $15,000 to the corporation to buy necessary dairy equipment, receiving a promissory note and a chattel mortgage on the equipment as security. Under the terms of the note La Vaquita was to repay the principal amount in monthly installments at 6 percent interest, such payments to commence November 1, 1961. Appellant also advanced $2,000 to La Vaquita on an unsecured one-year note bearing 6 percent interest. There is no evidence that any payments of principal or interest were ever made on either of those notes.

In August 1961, appellant also guaranteed payment of La Vaquita's note to a bank for funds borrowed to purchase dairy cows. La Vaquita then entered into an exclusive marketing agreement with Ready-Fresh Drive-In Pairy, Inc., which operated in the San Fernando Valley.

Under the terms of that contract Ready-Fresh was to process and sell the entire milk output of La Vaquita. During the month of August 1961 La Vaquita commenced its dairy operations on rented premises.

La Vaquita reported an operating loss of $41,549.74 for 1961, and its closing balance sheet for that year listed "loans from stockholders" of $48,174.75 and "notes and mortgages payable" of $48,840.00. In the following year Ready-Fresh filed bankruptcy proceedings. Having lost its processing and marketing outlet, La Vaquita could no longer survive financially and it also went into bankruptcy in 1962. The dairy equipment was sold in that year for $10,500.

On their personal income tax return for 1962, appellant and his wife claimed business bad debt deductions totalling $14,739.76. This amount consisted of: (1) $4,500 remaining unpaid on the $15,000 note payable to appellant by La Vaquita after sale of all the dairy equipment; (2) $2,000, the amount of the unsecured promissory note held by appellant; and (3) $8,239.76, the balance due the bank on the loan to La Vaquita for the purchase of the dairy herd. Respondent disallowed the deductions claimed and reclassified them as capital losses. That action gave rise to this appeal.

Respondent's primary contention is that appellant's advances to La Vaquita and the payment which he ultimately had to make to the bank under the loan guarantee were in reality contributions to his inadequately capitalized corporation rather than loans. That being so, respondent argues, the resulting losses were not bad debts but were worthless security losses which were subject to the capital loss limitations of section 18152 of the Revenue and Taxation Code. In the alternative respondent contends that if the advances and loan guarantee were in fact loans, appellant's losses therefrom were of a non-business nature to be treated as short-term capital losses, rather than fully deductible business bad debts.

Appellant contends that he made the advances to La Vaquita and guaranteed its bank loan for the direct and primary purpose of making contact with cash-and-carry dairy operators and obtaining their legal business, thereby salvaging his specialized law practice which was threatened when his established clients began to relocate their dairies in other areas. He argues that since the moneys were loaned or advanced by him for the purposes of saving and promoting his professional career, those amounts were properly

deductible as business bad debts, whether they be characterized as loans or contributions to capital.

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); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964). That being so, the first question for decision in the instant appeal is whether appellant's advances to La Vaquita and his payment under the loan guarantee constituted bona fide loans, or whether they were actually contributions to capital. The secondary issue of whether appellant's losses were deductible as business or nonbusiness bad debts arises only if it is determined that appellant's advances were loans,

At the outset it should be noted that by requiring appellant to guarantee the loan to the newly formed La Vaquita Corporation, the bank could at all times look to appellant for repayment of the loan. The transaction in substance amounted to a loan to the appellant who, in turn, advanced the funds to La Vaquita. (See Appeals of Agate Construction Co., et al., Cal. St. Bd. of Equal., Mar. 7, 1961.) We shall treat the bank loan accordingly for purposes of this opinion.

Whether advances to a closely held corporation by a stockholder are loans or contributions to capital is a question of fact. The taxpayer-stockholder has the burden of establishing that a bona fide debt existed and that he is therefore entitled to a deduction upon its becoming worthless. (Matthiessen v. Commissioner, 16 T.C. 781, aff'd, 194 F.2d 659; Appeal of George E. Newton, supra.) Although the courts have stressed a number of factors which are to be considered in determining the nature of a stockholder's advance to the corporation, the basic inquiry appears to be whether the funds have 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, on remand, T.C. Memo., Jan. 23, 1958, aff'd, 262 F.2d 512, cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030].) The entire factual background must be examined in order to answer this question.

Where advances are necessary to launch an enterprise, a strong inference arises that they are

invested capital, even though they may be designated "loans" by the parties. (Sherwood Memorial Gardens, Inc., 42 T.C. 211, aff'd, 350 F.2d 225; Isidor Dobkin, 15 T.C. 31, aff'd per curiam, 192 F.2d 392; Appeals of Sunny Homes, Inc., et al., Cal. St. Bd. of Equal., Aug. 1, 1966.) In the instant case, La Vaquita was organized with a paid-in capital of only $1,000. The evidence clearly indicates that this was inadequate for the purpose of commencing a dairy business. Certainly essential to such a business are a herd of cows and dairy equipment, neither of which could be acquired with a mere $1,000. Appellant's advances to La Vaquita were for the purpose of purchasing those necessary operating assets, and the inference that the advances were investment capital therefore clearly arises.

An excessive ratio of corporate debt to net corporate capital may result in the conclusion that the corporation is inadequately capitalized and that the shareholder's advances to that corporation in reality constitute additional capital investment rather than loans. (Gilbert v. Commissioner, supra, 248 F.2d 399, on remand, T.C. Memo., Jan. 23, 1958, aff'd, 262 F.2d 512, cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030].) The debt-equity ratio in the instant case was 97 to 1 as of December 31, 1961, at the close of La Vaquita's first year of operation. In the Appeal of George E. Newton, Cal. St. Bd. of Equal., decided May 12, 1964, we determined that a debt-equity ratio of only 5 to 1 was excessive, and that the shareholder's advances constituted contributions to capital rather than loans. Certainly the inference of equity capital is much stronger here.

An examination of La Vaquita's balance sheet indicates that either or both appellant and Mr. Polhemus made substantial additional advances to the corporation from the time the business was commenced until December 31, 1961, apparently in order to keep the dairy in operation. There is no evidence of any security for those advances. In spite of that financial assistance, La Vaquita reported an operating loss of $41,549.74 for 1961. A stockholder's repeated advances of money to a corporation even though it is not proving to be a profitable enterprise constitute evidence of an 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, 298 F.2d 570.)

Upon review of all the facts we must conclude that appellant has failed to prove that a debtor-creditor

relationship existed between him and La Vaquita. Al though formal instruments of indebtedness were executed, there is no evidence that La Vaquita ever made any payments of principal or interest to appellant. The advances which appellant made, both in cash and by means of his guarantee of La Vaquita's bank loan, were for the purpose of getting a new, under-capitalized business under way. Recoupment of those amounts was entirely, dependent upon the success of La Vaquita's dairy operation. We are of the opinion that all of the advances were contributions to capital and the losses which appellant ultimately sustained therefore constituted capital losses rather than bad debts. This conclusion makes it unnecessary to consider the subsidiary question of whether those advances should be characterized as business or non-business bad debts.

ORDER

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., Jr., and Alice J. Atkinson against a proposed assessment of additional personal income tax in the amount of $515.89 for the year 1962 be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of February, 1970, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Secretary