



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MARGO LEAVIN GALLERY, INC.)

For Appellant: Stephen A. Gershman
Attorney at Law

Gary B. Ross
Associate Tax Counsel

For Respondent: James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of **Margo** Leavin Gallery, Inc., against proposed assessments of additional franchise tax in the amounts of **\$720.00** and \$720.00 for the income years ended September 30, 1975, and September.30, 1976, respectively.

Appeal of **Margo** Leavin Gallery, Inc.

Appellant was 'formed as a California corporation on October 1, 1973. The business assets and liabilities of **Ms. Margo** Leavin, who had been operating an art gallery as a sole proprietorship, were immediately transferred to appellant. The assets transferred to appellant included store equipment valued at \$12,000 and inventory of prints and paintings valued at \$206,000. **In exchange for these assets, Margo** Leavin received all of appellant's stock with a stated value of \$25,000. She also received an unsecured demand note from appellant **for \$100,000**, dated October 16, 1973, bearing interest at the rate of 8 percent per annum commencing October 1, 1974, and a credit on appellant's books of approximately \$34,000 for loans payable. **As a part of the transaction, appellant also assumed Margo** Leavin's liability for notes payable to a bank for \$15,000 and to **Margo** Leavin's father for \$44,000.

During the years in question, appellant paid off the \$15,000 bank loan which it had assumed on behalf of its sole stockholder. Although in the appeal years appellant did pay interest on the \$100,000 demand note payable to Ms. Leavin, as of September 30, 1977, no payment on the **principal** of that note had ever been made. Appellant's earnings during the years in question were apparently used to **maintain** its inventory of art works. Furthermore, when additional operating funds were needed by appellant, the lending bank apparently required **Margo** Leavin to guarantee the loan.

Upon audit; respondent **determined that** the **\$100,000** demand note received by Ms. Leavin in exchange for a portion of the gallery assets represented a contribution to capital rather than a loan. **In accordance with this determination, the interest paid by** appellant on the purported loan in the appeal years was disallowed as a deduction and a deficiency assessment was proposed.

The question presented for determination is whether a demand note issued by appellant to its sole stockholder constituted a true indebtedness so that 'purported interest payments made thereon during the appeal years were deductible by appellant.

Section 24344 of the Revenue and Taxation Code provides for the deduction by a corporation of interest paid or accrued during the income year on indebtedness of the corporation. The provisions of this section are substantially identical to those of section **163(a)** of

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the Internal Revenue Code. Consequently, federal law is persuasive in determining the proper interpretation and application of the corresponding California law.

(Holmes v. McColgan, 17 **Cal.2d** 426 [110 P.2d 428] (1941).)

In order to deduct interest paid or accrued, it must be shown that a bona fide debt existed. Thus, in order to be entitled to the interest expense deductions claimed, appellant has the burden of establishing that the relationship of debtor-creditor actually existed between it and its sole shareholder, **Margo Leavin**. (Jewell Ridge Coal Corp. v. Commissioner, 318 **F.2d** 695 (4th Cir. 1963).)

It is well-settled that the nature of advances to a closely held corporation is a question of fact. (Gilbert v. Commissioner, 248 **F.2d** 399 (2nd Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958) affd., 262 **F.2d** 512 (2nd Cir. 1959), cert. den., 359 **U.S.** 1002 [3 L.Ed. 2d 10301 (1959); Appeal of Kim Lighting and Manufacturing Co., Inc., Cal. St. Bd. of Equal., June 2, 1969.) When attempting to establish the nature of advances to a closely held corporation, the basic inquiry is whether the funds were placed at the risk of the corporate venture, or whether there was a reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, supra; Appeal of Kim Lighting and Manufacturing Co., Inc., supra.) The federal courts have developed numerous **guidelines** for answering this debt versus equity question. (See, e.g., O. H. Kruse Grain & Milling v. Commissioner, 279 **F.2d** 123 (9th Cir. 1960).)

Unfortunately, in this case we have only limited facts. All we really know is that a demand note was given by appellant to its sole shareholder at the time appellant was formed, in return for assets transferred to the corporation which were essential to its business operations. No demand for payment of that note was ever made by **Ms. Leavin**, although other corporate obligations apparently were paid. It also appears that **Margo Leavin** was required to guarantee a \$15,000 bank loan on behalf of appellant. In evaluating these facts, we are reminded that transactions between a corporation and its sole shareholder must be subjected to special scrutiny because of the fact that, as is the case here, the sole shareholder is in a position of absolute control. (See Gooding Amusement Co., 23 T.C. 408 (1954), affd., 236 **F.2d** 159 (6th Cir. 1956), cert. den., 352 **U.S.** 1031 [1 L.Ed. 2d 599] (1957).)

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After reviewing the record, we are forced to conclude that appellant has failed to sustain its burden of proving that a bona fide debt existed. The facts, sketchy as they are, seem to support the conclusion that at the time Margo Leavin transferred all of the business assets of her gallery to appellant, her expectation of the purported loan being repaid was dependent upon the success of appellant's business. Under those circumstances, the assets in question appear to have been placed at the risk of the corporate venture, and therefore to constitute a capital contribution, as respondent concluded, rather than a bona fide loan. Certainly there has been no affirmative showing by appellant that this was not the case. Accordingly, respondent properly disallowed the interest expense deductions claimed.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Margo Leavin Gallery, Inc., against proposed assessments of additional franchise tax in the amounts of \$720.00 and \$720.00 for the income years ended September 30, 1975, and September 30, 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of October, 1980, by the State Board of Equalization, with Members Nevins, Reilly, Dronenburg and Bennett present.

<u>Richard Nevins</u>	, Chairman
<u>George R. Reilly</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>William M. Bennett</u>	, Member
<u></u>	, Member