BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
RICHARD M. LERNER)

For Appellant: M. Richard Cohen
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

David M. Hinman
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Richard M. Lerner against a proposed assessment of additional personal income tax in the amount of **$1,789.23** for the year 1963.

Richard M. Lerner (hereinafter referred to as "appellant") and his spouse filed separate returns for 1963. One-half of the deductions at issue here were claimed on each return; however, for purposes of simplicity, we will refer to the full amount of the deductions. Respondent has deferred action on the account of appellant's spouse pending resolution of this appeal. Accordingly, only the assessment against appellant is at issue in this appeal.

On his 1963 tax return, appellant deducted $223,500.63 as bad debt losses resulting from advances to Long Beach Marina Shipyard, Inc. (hereinafter referred to as "Shipyard"). Additionally, he deducted $27,760.14 as a business loss arising out of his attempt to establish an engineering firm and $1,326.74 as promotional expenses incurred in the production of income.

It is well settled that deductions are a matter of legislative grace, and the burden of proving the right to a deduction is upon the taxpayer. (Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416] (1940); New Colonial Ice Company, v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Robert J. and Margaret A. Wirsing, Cal. St. Bd. of Equal., Aug. 1, 1974; Appeal of James M. Denny, Cal. St. Bd. of Equal., May 17, 1962.) After a careful review of the record on appeal, and for the specific reasons set forth below, it is our opinion that appellant has failed to carry his burden of establishing his right to any of the three deductions in issue.

Bad Debt Losses

Shipyard was incorporated under the laws of this state on December 3, 1962 for the purposes of repairing and refitting boats and operating a retail marine store. It commenced operations on February 25, 1963. While the facts presented to this board by appellant are not detailed, it appears that, in 1963, appellant received a loan of $220,000 from Personal Property Leasing Company which he in turn advanced to his wholly owned corporation; Shipyard. Personal Property Leasing Company required appellant and his wife to personally guarantee repayment of the $220,000 loan.

Shipyard's financial statements reveal that no capital was contributed to the corporation other than the advances made by appellant. Those advances were characterized in Shipyard's financial statements as

"Notes and Loans Payable to Richard M. Lerner." The "loans", however, were not evidenced by instruments of indebtedness, they were unsecured, fixed maturity dates for repayment of the purported "loans" were not established, and no interest was charged on the alleged indebtedness.

Shipyard reported an operating loss of $19,322.04 for the year December 3, 1962 to November 30, 1963, and an operating loss of $81,930.46 for the ten month period ending September 30, 1964. Shipyard went bankrupt in 1965.

Respondent's primary contention is that appellant's advances to Shipyard were in reality contributions to his completely uncapitalized corporation rather than loans. That being so, respondent argues, the resulting losses cannot properly be characterized as bad debt losses. In the alternative, respondent contends that if the advances were in fact loans, appellant's losses therefrom were of a nonbusiness nature to be treated as short-term capital losses, rather than fully deductible business bad debts.

Appellant's position is that the amounts advanced to Shipyard are deductible as bad debts under section 17207 of the Revenue and Taxation Code. That section provides for the deduction of "any debt which becomes worthless within the taxable year." Only a bona fide debt qualifies for purposes of that section; a contribution to capital does not constitute a debt. (Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 7964.) Consequently, the first question presented for our determination is whether appellant's advances to Shipyard 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.

The determination of whether advances to a closely held corporation represent loans or capital investment depends upon the particular facts of each case. (Gilbert v. Commissioner, ¶ 56,137 P-H Memo. T.C. (1956), 248 F.2d 399 (2d Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958), affd., 262 F.2d 512, cert. den., 359 U.S. 1002 [3 L.Ed.2d 10301 (1959).) Where, as *here,* the advances are made by the taxpayer to his wholly owned corporation, he carries the heavy

burden of proving that bona fide debts were created and that he is therefore entitled to a deduction upon their becoming worthless. (Appeal of George E., Jr.-and Alice J. Atkinson, Cal. St. Bd. of Equal., Fe-b., 1970; Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal., Nov. 6, 1967.) Although the courts have stressed-a number of factors which are to be considered in determining the nature of advances to closely held corporations, the basic inquiry is often formulated in terms of whether the funds were placed at the risk of the corporate venture, or whether there was reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, supra; Appeal of George E. Newton, supra.) 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 investment capital, even though they may be designated as "loans" by the parties. (Sherwood Memorial Gardens, Inc., 42 T.C. 211, affd., 350 F.2d 225 (7th Cir. 1965); Isidor Dobkin, 15 T.C. 31, affd. per curiam, 192 F.2d 392 (2d Cir. 1951); Appeals of Sunny Homes, Inc., et al., Cal. St. Bd. of Equal., Aug. 1, 1966.) In the instant case, Shipyard was organized with no paid-in capital and relied entirely upon 'appellant's advances in order to purchase necessary operating assets and meet required operating expenses. Therefore, the inference that the advances were investment capital clearly arises. (Appeal of George E., Jr. and Alice J. Atkinson, supra.)

An excessive ratio of corporate debt to net corporate capital may result in the conclusion that the corporation is inadequately capitalized and that the advances to that corporation in reality constitute additional capital investment. .(Gilbert v. Commissioner, supra.) Shipyard's financial statements indicate that the corporation continually had a large corporate debt and no paid-in capital. In Appeal of George E. Newton, supra, we determined that a debt-equity ratio of 5 to 1 was excessive, and that the shareholder's advances constituted contributions to capital rather than loans. The inference that appellant's advances were actually investment capital is much more compelling here.

Debt, as distinguished from capital investment, may be defined for tax purposes as "an unqualified obligation to pay a sum certain at a reasonably close

fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." (Gilbert v. Commissioner, supra, 248 F.2d 399, 402.) With respect to the instant appeal, the record reveals that the advances in issue were unsecured and were not evidenced by instruments of indebtedness, fixed maturity dates for repayment of the "loans" were not established, and no interest was charged on the purported indebtedness. Furthermore, it appears that full repayment of the supposed indebtedness was expected only upon the ultimate success of the particular business venture which the "debtor" corporation had undertaken. In this regard, we note that appellant,, being the only person to have contributed to Shipyard, apparently had complete discretion as to whether and when the advances would be repaid. Additionally, it is significant that appellant advanced money to his wholly owned corporation even after it became evident that Shipyard was not a profitable enterprise. Advances made under such circumstances constitute evidence of an intent to invest capital. (Appeal of George E., Jr. and Alice J. Atkinson, supra.) In light of Shipyard's proven unprofitability, it is unlikely that an objective creditor would have continued to make unsecured loans to appellant's corporation with expectation of repayment. (Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962).)

Appellant has advanced two arguments in support of his position that he is eligible for the bad debt loss deduction. Initially, appellant contends that Shipyard was not a corporation but rather a partnership or joint venture and that, as such, he may ignore the existence of the corporation and deduct its expenses as individual business expenses. Aside from the fact that appellant fails to identify the other persons involved in this alleged "partnership" or "joint venture," and despite the fact that he admits he owned 100 percent of the business, appellant's argument is utterly without merit. As noted above, Shipyard was incorporated under the laws of this state on December 3, 1962. California law specifically provides that a corporation begins its existence upon the filing of its articles of incorporation. (Former Corp. Code, § 308, repealed January 1, 1976; currently Corp. Code, § 200, subd. (a).) Given this statutory provision, appellant's contention that Shipyard was not a corporation is completely unfounded.

Appellant's second argument to support the propriety of the bad debt deduction is equally untenable. Appellant here takes the inconsistent position of

arguing that Shipyard was indeed a corporation and that his "dominant motivation" in making advances to his corporation was that of protecting his job as a corporate officer. Consequently, appellant argues, the loans were business bad debts and are deductible in full. Appellant's contention, however, is contradicted by his subsequent statement that he made the advances for the purpose of "attempting to salvage some money from the operations so that he would not be personally liable on the guarantees ... with Personal Properties [sic] Leasing Company." That statement alone is sufficient to show that appellant's "dominant motivation,, was not that of protecting his job. While it is true that where a creditor-stockholder who is also an employee of the debtor-corporation makes loans to the corporation with the dominant motivation of protecting his job, such loans may be viewed as business bad debts and be fully deductible (see, e.g., Appeal of Estate of Lewis Havens Avery, Deceased, Cal. St. Bd. of Equal., June 30, 1980), it is evident from appellant's own statement that such was not his dominant motivation.

Under the circumstances described above, we must conclude that appellant has failed to prove that the advances he extended to his wholly owned corporation were bona fide debts. Rather, the evidence presented in this appeal clearly establishes that appellant's advances constituted working capital which he contributed to Shipyard in order to protect his investment in that corporation. Consequently, appellant is not entitled to a bad debt loss deduction with respect to the funds he advanced to Shipyard. (See Fin Hay Realty co. v. United States, 398 F.2d 694 (3d Cir. 1968); Dodd v. Commissioner, supra; Motel Corp., 54 T.C. 1433, 1436-1439 (1970); Lewis L. Culley, 29 T.C. 1076, 1087-1089 (1958); Appeal of Armored Transport, Inc., Cal. St. Bd. of Equal., Feb. 2, 1976.) This conclusion makes it unnecessary to consider the subsidiary question of whether the advances should be characterized as business or nonbusiness bad debts..

Business Loss

On the schedule of capital gains and losses attached to his 1963 tax return, appellant deducted $27,760.14 as business losses. Appellant claims to have incurred these losses while attempting to establish himself in an engineering business as a sole proprietor. Appellant states that he abandoned this project when it became obvious that he did not have the capital necessary to establish the business.

Despite ample time to do so, appellant has failed to offer any tangible evidence to substantiate this deduction. As earlier observed, deductions are a matter of legislative grace, and the burden of proving the right to a deduction is upon the taxpayer. (Deputy v. du Pont, supra; New Colonial Ice Company v. Helvering, supra; Appeal of Robert J. and Margaret A. Wirsing, supra; Appeal of James M. Denny, supra.) In view of the above, we must sustain respondent's action in disallowing the business loss deduction claimed by appellant on his 1963 return.

Promotional Expenses

In addition to the other deductions claimed by appellant on his 1963 return, he also claimed a deduction in the amount of $1,326.74, allegedly incurred as promotional expenses. Appellant has made no attempt to explain how these expenses were incurred and which of his enterprises he was attempting to promote when he allegedly incurred them. Appellant readily acknowledges that he is unable to substantiate this deduction. Given appellant's failure to prove his right to the deduction, we must sustain respondent's action in disallowing this deduction.

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 protest of Richard M. Lerner against a proposed assessment of additional personal income tax in the amount of $1,789.23 for the year 1963, 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.

Richard Nevins, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

_____, Member