BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
DAVE GARDNER CROSS ASSOCIATES )

For Appellant: Dave Gardner Cross
President

For Respondent: Carl G. Knopke
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 Dave Gardner Cross Associates against a proposed assessment of additional franchise tax and penalty in the total amount of $27,513.81 for the income year ended May 31, 1972.

Appeal of Dave Gardner Cross Associates

Dave Gardner Cross Associates (hereinafter referred to as "appellant"), an architectural services corporation, is wholly owned by its president, Dave Gardner Cross. Mr. Cross was, during the year in issue, and is presently, also president of American Home Industries (hereinafter referred to as "AHI"). AHI, a corporation engaged in the modular home manufacturing industry, was incorporated in November 1969 and became publicly held in 1970. Prior to the transaction in issue, appellant and its president and sole shareholder, Mr. Cross, owned 550,000 shares of AHI's stock. After the subject advance, Mr. Cross continued to own, directly or indirectly through appellant, 440,000 shares (approximately 16%) of the stock in AHI.

In January 1972, AH1 experienced serious cash flow problems resulting in a shortage of working capital to meet factory operating requirements. To alleviate this problem, Mr. Cross caused appellant to sell 110,000 shares of its stock in AH1 to private investors and to lend the proceeds to AHI. The stock was sold for three dollars a share. A promissory note evidencing the loan was given to appellant on February 7, 1972. The sale of stock resulted in a $342,959 taxable gain for appellant. Shortly thereafter, AH1 experienced serious financial difficulties which culminated in its filing for reorganization under Chapter XI of the Bankruptcy Act on June 7, 1972. On its tax return for the income year ended May 31, 1972, appellant deducted, as a bad debt, the entire $330,000 it advanced AH1 on February 7, 1972.

The sole issue presented for determination is whether appellant is entitled to a bad debt deduction in the amount of $330,000 for the income year ended May 31, 1972. Although the assessment includes a delinquent filing penalty, appellant has not disputed the penalty on appeal.

Respondent's primary contention is that appellant's advances to AHI were in reality contributions to AHI's capital 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 advance was in fact a loan, it did not become worthless during the income year in issue.

To support its contention that the amount advanced to AH1 is deductible as a bad debt, appellant apparently relies upon section 24348 of the Revenue and

Taxation Code. That section provides for the deduction of "debts which become worthless within the income 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. 24348(d), subd. (3).) Consequently, the initial question presented for our determination is whether appellant's advance to AH1 constituted a bona fide loan, or whether it was actually a contribution to capital. The secondary issue of whether the advance became worthless during the year in issue arises only if it is determined that appellant's advance was a loan.

The determination of whether advances to a corporation represent loans or capital investment depends upon the particular facts of each case. (See 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, (2d Cir. 1959) cert. den., 359 U.S. 1002 [3 L.Ed.2d 10301 (1959).) Although the courts have stressed a number of factors which are to be considered in determining the nature of such advances, 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. (See Gilbert v. Commissioner, supra; Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.) Whether an advance to a corporation by a principal stockholder is a capital contribution or a loan deductible as a bad debt is a question of fact upon which the taxpayer has the burden of establishing the right to a deduction.. (White v. United States, 305 U.S. 281 [83 L.Ed. 172] (1938); Diamond Bros. Company v. Commissioner, 322 F.2d 725 (3d Cir. 1963).)

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.) While indicia of a debtor-creditor relationship is a major factor in determining whether such a relationship has actually been established, the courts have stressed that the "substance" rather than the "form" of purported loan transactions is determinative. (U.S. v. Henderson, 375 F.2d 36 (5th Cir. 1967); American-LaFrance-Foamite Corp. v. Commissioner, 284 F.2d 723 (2d Cir. 1960).) Accordingly, the

existence of a promissory note is not conclusive in determining whether an advance of the type in issue here is in fact a loan or a contribution of capital. (Erard A. Matthiessen, 16 T.C. 781 (1951), affd., Matthiessen v. Commissioner, 194 F.2d 659 (2d Cir. 1952).)

With respect to the instant.appeal, the record reveals that the advance in issue, while evidenced by an instrument of indebtedness, was unsecured, despite AHI's very tenuous financial condition. While the promissory note from AH1 to appellant fixed a maturity date for repayment of the "loan" and indicated that interest was to be charged on the purported indebtedness, it appears that full repayment of the.supposed'indebtedness was expected only upon the ultimate success of the "debtor" corporation. In this regard, we note that Mr. Cross, as president and sole shareholder of appellant and'presi-. dent of AHI, had complete discretion as to whether and when appellant would press for repayment of the advance. In this position, he could insure that AH1 would not repay the advance if it would jeopardize his investment in that corporation. Additionally, it is significant that appellant advanced money to AH1 even after it became evident that AHI, as it then existed, 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, Cal. St. Bd. of Equal., Feb. 18, 197'0.) In. light of AHI's proven unprofitability, it is unlikely that an objective creditor would have made an unsecured loan to AH1 with the expectation of repayment. (Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962).)

Additional factors supporting respondent's determination that the subject advance to AH1 was a contribution to capital and not a loan are: (i) the fact that the advance was used by AH1 for current operating, expenses; (ii) evidence that Mr. Cross caused appellant to make the advance so as to protect his initial investment in AHI; and (iii) the subordination of the advance to the claims of others. In previous cases these factors have been found to'constitute evidence of an intent to invest capital. (See, e.g., Diamond Bros. Company'v. Commissioner, supra; Appeal of Dudley A. and Sherrill M. Smith, Cal. St. Bd. of Equal., Dec. 15, 1976.)

Under the circumstances described above, and absent persuasive evidence to.the contrary; it is our opinion that the advance in issue constituted working..

capital which Mr. Cross, through appellant, caused to be contributed to AH1 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 it advanced to AHI. (See Fin Hay Realty Co. v. United States, 398 F.2d 694 (3rd 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 advance became worthless during the income year in issue.

## 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 in denying the claim of Dave Gardner Cross Associates for refund of franchise tax and penalty in the total amount of $27,513.81 for the income year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 23rdday of June , 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr. , Chairman

George R. Reilly , Member

William M. Bennett , Member

Richard Nevins , Member

_____ , Member

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ORDER CORRECTING CLERICAL ERROR

It is hereby ordered that the words "in denying the claim of Dave Gardner Cross Associates for refund Of franchise tax and penalty in the total amount of $27,513.81 for the income year 1972," in the order on the sixth page of our opinion of June 23, 1981, be changed to "on the protest of Dave Gardner Cross Associates against a proposed assessment of additional franchise tax and penalty in the total amount of $27,513.81 for the income year ended May 31, 1982,".

Done at Sacramento, California, this 21st day Of June, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis-, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____ Member