BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
GEORGE K. AND ANN H. NAGANO AND )
WILLIAM H. AND MARY NAGANO AND )
PATRICK N. AND ANN NAGANO )

For Appellants: Douglas W. Argue
Attorney at Law

For Respondent: Claudia K. Land
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 George K. and Ann H. Nagano and William H. and Mary Nagano, and Patrick N. and Ann Nagano against proposed assessments of additional personal income tax in the amounts and for the years below.

| | Year | Amount |
|---|---|---|
| George K. and Ann H. Nagano | 1972 | $1,304.50 |
| | 1973 | 30.02 |
| | 1974 | 267.48 |
| | 1975 | 1,406.78 |
| William H. and Mary Nagano | 1972 | $ 300.94 |
| | 1973 | 153.66 |
| | 1974 | 222.90 |
| | 1975 | 494.48 |
| Patrick N. and Ann Nagano | 1972 | $ 322.36 |
| | 1973 | 29.38 |
| | 1974 | 153.13 |
| | 1975 | 323.56 |

The sole issue for determination is whether a corporation's payments of appellants' personal expenses and cash disbursements to appellants constitu-ted distributions of the corporate earnings, or whether these amounts were bona fide loans.

George K. and Ann H. Nagano, William H. and Mary Nagano, and Patrick N. and Ann Nagano, hereinafter jointly referred to as appellants, own, collectively, 85 percent of the shares of Nagano Co., Inc., a closely held family corporation which, until 1970, elected Subchapter S treatment for federal income tax purposes. For many years preceding the years on appeal, as well as throughout the appeal years, appellants received open account "advances" for various personal expenses, including outlays for housing, insurance, auto repairs, and income taxes as well as for the college education of four children of George K. and Ann H. Nagano and one child of William H. and Mary Naqano. In each of these years, retained earnings of the corporation many times exceeded the amounts so disbursed. At times appellants withdrew cash from the corporation and at times the corporation paid appellants' expenses directly. A record of these disbursements was kept in the corporate books as receivables due from shareholders. There were no journal entries made to further explain the disbursements.

No notes or other formal indicia of appellants' indebtness to the corporation were ever executed and no interest was charged upon the advances. Subsequent to respondent's audit, a parcel of real property

was sold, and from the proceeds, some repayment was made on the advances.

Up until June 30, 1970, yearly entries entitled "Distribution of Rents Collected" represented year-end "Subchapter S" income of the shareholders. It was the practice of the corporation to offset each shareholder's share of "Subchapter S" income (on which individual tax was paid) against each shareholder's advance account. Credits varied according to the different stock percentage ownership of each shareholder. In the case of one or more of the employee shareholder(s), repayments were made and credit balances were reflected on the books and records indicating that amounts were due the employee-shareholder(s). However, during the appeal years, only one documented credit was entered.

An additional entry, entitled "Dist. of Inter-Co. Acct.," was made in the corporate books and records each year. Appellants indicate that this entry reflected the year-end net profit of a separate partnership between the shareholders. Appellants state that all income and expenses of the partnership were handled through the corporate bank account. They also state that the partnership's balance remaining in the corporate bank account at the end of the year was left in the corporation and each partner-shareholder was given credit (by way of reduction of his advance account) for his share of such partnership income on which he had paid tax but had not received in cash.

During the years on appeal, appellants received the following amounts from the corporation, which were charged to shareholders' accounts receivable.

George K. and Ann H. Nagano - Balance owing at the close of 1971 - $33,008.19:

| Year | Net Amount Advanced | Indebtedness |
|---|---|---|
| 1972 | $ 9,760.35 | $42,768.54 |
| 1973 | 1,736.25 | 44,018.54 |
| 1974 | 1,735.70 | 46,240.55 |
| 1975 | 11,315.39 | 57,555.94 |

William H. and Mary Nagano - Balance owing at the close of 1971 - $7,734.36:

| Year | Net Amount Advanced | Indebtedness |
|---|---|---|
| 1972 | $5,848.35 | $13,582.71 |
| 1973 | 25.00 | 13,607.71 |
| 1974 | 1,606.34 | 15,214.05 |
| 1975 | 4,736.33 | 19,950.38 |

Patrick N. and Ann Nagano - Balance owing at the close of 1971 - [$26,381.13]

| Year | Net Amount Advanced | Indebtedness |
|---|---|---|
| 1972 | $4,794.90 | $ [21,586.23] |
| 1973 | 482.86 | [21,103.37] |
| 1974 | 2,294.62 | [18,808.75] |
| 1975 | 4,876.15 | [13,932.60] |

In addition to the disbursements recorded as accounts receivable, William and Mary Nagano received $2,650, $2,000, and $2,500 in 1973, 1974, and 1975, respectively, which was recorded in another account entitled college fund. George K. and Ann H. Nagano received $5,103, $5,417, $2,500, and $7,400 in 1972, 1973, 1974, and 1975, respectively, from this college fund account.

Upon audit of the corporation's books, respondent determined that the above described advances to appellants constituted taxable dividends and proposed its assessments accordingly. Appellants protested respondent's proposed assessments at a formal hearing at which appellants claimed that the disbursements were considered by both the corporation and its shareholders to be loans. After due consideration of appellants' position, respondent affirmed its proposed assessment and this appeal followed.

Whether withdrawals from a corporation by a stockholder represent loans or taxable dividends depends on all the facts and circumstances surrounding the transactions between the shareholder and the corporation. (Harry E. Wiese, 35 B.T.A. 701 (1937), affd., 93 F.2d 921 (8th Cir.), cert. den., 304 U.S. 562 [82 L.Ed. 1529] rehg. den., 304 U.S. 589 [82 L.Ed. 1549] (1938); Elliott J. Roschini, 29 T.C. 1193 (1958), affd., 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 10211.) A determination that the withdrawal constitutes a loan depends upon the existence of an

intent at the time the withdrawal was made that it should be paid back. (Atlanta Biltmore Hotel Corp., ¶ 63,255 P-H Memo. T.C. (1963), affd., 349 F.2d 677 (5th Cir. 1965); Clark v. Commissioner, 266 F.2d 698 (9th Cir. 1959).)

Special scrutiny is given where the withdrawer is in substantial control of the corporation (Elliott J. Roschini, supra; W. T. Wilson, 10 T.C. 251 (1948); Ben R. Meyer, 45 B.T.A. 228 (1941)), and 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.) Furthermore, family control of a corporation invites careful examination of transactions between shareholders and the corporation. (William C. Baird, 25 T.C. 387 (1955); Ben R. Meyer, supra.)

In support of their contention that the advances made to them constituted loans, appellants stress several factors. As outlined below, we find none of them persuasive.

The first factor upon which appellants rely is the contemporaneous treatment of the transactions on the books as loans and amounts receivable. They argue that this is sufficient documentation that the disbursements were originally intended as loans. Appellants are incorrect in this conclusion. As is pointed out by respondent, this board has stated in the Appeal of Albert R. and Belle Bercovich, decided March 25, 1968, that the treatment of withdrawals as loans on the corporate books is not conclusive evidence of their ultimate character, but "merely one fact to be considered within the total factual picture."

The Bercovich case also addresses another one of the factors upon which appellants have placed reliance, namely, the fact that the disbursements were not in proportion to stock ownership. Appellants contend that this factor should be weighed highly in their favor as an indication that the disbursements should be taken as loans. Our response to this argument was clearly delineated in Bercovich, supra, wherein we stated, "Neither is it decisive of the existence of loans that the withdrawals by appellant and his two brothers from the corporation were not in proportion to their stockholdings, or that the brothers agreed to the larger withdrawals made by appellant." (See also Lincoln Nat'l

Bank v. Burnet; 63 F.2d 131 (D.C., Cir. 1933); William C. Baird, supra.)

Another factor which appellants view as indicating that the disbursements at issue were loans is that throughout the corporate history repayments and credits were made to the shareholder accounts. We disagree. First, almost all of the cited credits occurred prior to the period under review. Second, there was only one documented credit during the appeal years and that was only for $500.00 in 1975. Consequently, there is no history or pattern of repayments or credits lending support to appellants' claim.

Another of the factors cited by appellants relates to an apparent credit balance of $26,381.13 owing to Patrick N. and Ann Nagano at the close of 1971. Appellants maintain that it is illogical to treat subsequent cash disbursements to them as anything except loans in view of this credit balance. Again, we disagree. The $26,381.13 credit balance apparently resulted from the debiting of earned surplus and the crediting of accounts receivable during the years prior to this appeal when the corporation was still in Subchapter S status for federal tax purposes. As is noted; by respondent, appellants have not provided evidence that income credited to them in this manner was reported by them or taxed to them individually by the State of California. Furthermore, even if Patrick and Ann were owed money by the corporation, this is not determinative of the nature of the advances at issue. In the Appeal of Joel Hellman, decided by this board February 2, 1976, appellant, as well as his wife and son, had made loans to the corporation, which the appellant proposed should be offset against his withdrawal. In deciding that the advances should be characterized as dividends, this, board emphasized that no rule exists which forbids the treatment of corporate distributions as dividends merely because the shareholder may also be a creditor of the corporation. Appellants' position on this point is, therefore, without support.

As noted above, appellants also claim that funds from a separate partnership were handled through the corporate bank account and that year-end balances of these partnership funds were left in the corporation to be credited against the corporate advances. This claim has not been substantiated. The documents before us do seem to show the existence of a "partnership" account. However, the entries to such account show only corporate

disbursements in favor of such partnership. There is no evidence of any balances having been transferred to the corporation. Without more, we cannot accept appellants' contention on this point.

From the foregoing, it appears that this appeal involves a steady pattern of withdrawals by appellants from their family corporation. This was also the case in Bercovich, supra. Appellants emphasize that the purpose of these withdrawals was for college education and insurance. They stress that such purposes placed an inherent ceiling upon the amounts to be withdrawn. However, the documents presented by respondent indicate that sporatic withdrawals were also made for other, more personal purposes such as car repairs, liquor purchases, etc., which had no such ceiling. In addition, other relevant factors outlined in Bercovich for finding of a dividend are present here. For example, no indicia of debt were ever executed, and there is no objective evidence that a definite time and manner of repayment was specified. No interest was paid or specified, and apparently, no dividends have been declared, despite the existence of earned surplus. Appellants allege that the corporation and the shareholders intended that the disbursements would be repaid from the sales proceeds of an asset owned by the shareholders, which intention they maintain was satisfied when jeopardy sales proceeds were in fact paid to the corporation in reduction of the accounts receivable. However, the record on appeal indicates that the asset mentioned was sold on June 1, 1977, a substantial time after the time of respondent's audit and resulting proposed assessment. As we indicated in the Appeal of Richard M. and Beverly Bertolucci, decided May 4, 1976, loan repayments made after commencement of an audit are weak persuasive evidence of a pre-existing intention to repay the withdrawn funds. (See also, Gurtman v. United States, 237 F.Supp. 533, 536 (D.N.J.), affd. per curiam, 353 F.2d 212 (3d Cir. 1965); George R. Tollefsen v. Commissioner, 431 F.2d 511 (2d Cir. 1970).)

Appellants also suggest that the withdrawals cannot be characterized as dividends because the disbursements were funded by bank loans to the corporation. This assertion averts the basic issue, which is, whether the corporation had sufficient retained earnings and profits to support dividends in the amount determined by respondent for the relevant years. A taxpayer has the burden of proving the insufficiency of earnings and profits to support the dividends claimed by respondent

(Max P. Lash, ¶ 56,087 P-H Memo. T.C. (1956), rev'd in part on other grounds, 245 F.2d 20 (1st Cir. 1957)) and appellants have not met that burden.

Finally, we have closely examined all the cases cited by appellants. Each of those cases was decided on its own particular facts, and is distinguishable from the instant appeal for that reason.

After a careful assessment of the record, including appellants' remaining arguments, we are of the opinion that appellants have not met their burden of establishing that the withdrawals of funds from Nagano co., Inc. were in fact, bona fide loans, and not taxable dividends.

Accordingly, we must sustain respondent's action in this matter.

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 George K. and Ann H. Nagano, William H. and Mary Nagano, and Patrick N. and Ann Nagano against proposed assessments of additional personal income tax in the amounts of and for the years listed below, be and the same is hereby sustained.

| | Year | Amount |
|---|---|---|
| George K. and Ann H. Nagano | 1972 | $1,304.50 |
| | 1973 | 30.02 |
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| | 1975 | 494.48 |
| Patrick N. and Ann Nagano | 1972 | $ 322.36 |
| | 1973 | 29.38 |
| | 1974 | 153.13 |
| | 1975 | 323.56 |

Done at Sacramento, California, this 10th day Of December , 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett, Mr. Nevins and Mr. Cory present.

Ernest J. Dronenburg, Jr. , Chairman

George R. Reilly , Member

William M. Bennett , Member

Richard Nevins , Member

Kenneth Cory , Member