



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
JOSEPH L. AND ELAINE M. PARDINI, et al,)

Appearances:

For Appellants: **Brice A. Sullivan**
Attorney at Law

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Joseph L. and Elaine M. Pardini against proposed assessments of additional personal income tax in the amounts of **\$4,455.84, \$5,159.59, and \$1,186.01** for **the** years 1973, 1974, and 1975, respectively, and of Joseph L. and Sharon K. Pardini against a proposed assessment of additional personal income tax in the amount of **\$1,902.27** for the year 1576.

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"Appellants" herein refers to Joseph L. and Elaine M. Pardini for the years **1973, 1974, and 1975**, and to Joseph L. and Sharon K. Pardini for the year **1976**. "Appellant" refers to Joseph L. Pardini.

The first question presented by these appeals is whether appellants are entitled to deductions claimed for expenses of rental property for the **years 1973, 1974, and 1975**.

In 1972, appellants purchased, for **\$100,000**, a parcel of land near Lake Tahoe on which there were two **houses**. The main house comprised approximately 4,900 square feet, and the guest house, 1,200 square feet. Although appellants used the main house for vacations, they apparently did not use the guest house themselves, but rented it to others for varying periods of time. From January 1973 through December 1975, it was rented for a total of 21 months and never for less than six months during any calendar year.

On their joint personal income tax returns for 1973, 1974, and 1975, appellants reported total rental income from the guest house of **\$5,590.00** and expenses of **\$17,266.00**, for total net losses of **\$11,676.00** over the three years. The expense figures were arrived at by attributing either 40 or 50 percent of the total expenses for both houses to the guest house. Respondent determined that the guest house was not held primarily for the production of income and disallowed the expenses which exceeded allowable expenses under Revenue and Taxation Code section 17233. ^{1/}

1/ Section 17233 limits deductions allowable for **individuals** in connection with activities not engaged in for profit. An individual may claim deductions otherwise allowed to individuals (e.g., interest), regardless of whether the activity is engaged in for profit, but other expenses of an activity not engaged in for profit are limited to the extent that the gross income **derived from** such activity for the taxable year exceeds those deductions which are otherwise allowed to individuals. The term "activity not engaged in for profit" means any activity other than one for which deductions are allowed under either section 17202 (ordinary and necessary expenses of a trade or business) or subdivision (a) or (b) of section 17252. (Continued on next page.)

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Appellant contends that the guest house was held primarily for the production of income and their expenses should be allowed as deductions pursuant to Revenue and Taxation Code section 17252. Respondent maintains that appellant's primary purpose was not to produce income, and the guest house was held merely to reduce the expenses of operating the main house.

Respondent relies on the part of the regulations under section 17252 which prohibits deductions for expenses of carrying on a transaction primarily as a sport, hobby, or recreation. (Cal. Admin. Code, tit. 18, reg. 17252, subd. (c) (Repealer filed April 16, **1981**, Register 81, No. 16).) It apparently takes the position that since the guest house was purchased along with the main house and the main house was used by appellants for recreational purposes, the lot as a whole was used primarily for recreational purposes.

Given the circumstances of this appeal, we find respondent's reasoning fallacious; The guest house was entirely separate from the main house. Appellant's assertion that the guest house was never used by him or his family for their own recreation is uncontested. The guest house was never rented for less than six months of the year during the period at issue. We **see** no reason why the guest house should not be considered separately from the rest of the property. So considered, we

1/ (Continued)

Section **17252** provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

(a) For the production or collection of income;

(b) For the management, conservation, or maintenance of property held for the production of income: or

(c) In connection with the determination, collection, or refund of any tax.

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believe the guest house falls clearly within another provision of the regulations which respondent has ignored.

Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. (Cal. Admin. Code, tit. 18, reg. 17252, subd. (b). (Repealer filed April 16, **1981**, Register 81, No. **16**.)

We are convinced, therefore, that deduction of the guest house expenses should not be limited by the provisions of Revenue and Taxation Code section 17233. We are equally convinced, however, that appellant's percentage allocation of the total expenses for both houses is unjustified. Given the relative sizes of the two houses, we believe that appellant's deductions should be limited to 25 percent of the nonsegregated expenses.

The second question for decision is whether appellant's cash withdrawals from his **corporation** during the years 1973 through 1976 were loans or taxable dividends.

Appellant was the president and sole shareholder of West Transportation, Inc. ("West"). In 1973, he constructed a building, at a cost of **\$332,608.00**, which he leased to West. Contemporaneously with the execution of the lease, appellant, for himself and as West's president, signed an agreement under which West agreed to advance him funds during the construction period. He agreed to refinance the building "as soon as practical **upon** completion of the premises" in order to repay the funds advanced. In consideration of West making the advances, he agreed to reduce West's monthly rental for the building from **\$7,015.00** to **\$6,100.00**.

From **1973** through **1976**, appellant made net withdrawals from West of **\$105,467.07**, ranging in amount from \$29.50 to **\$17,400.00**. He states that most of the withdrawn amounts were used in connection with the construction and initial years' operation of the building. The withdrawals were carried on West's books as accounts receivable. Small payments on the account were made in 1973 and 1974 and payments totaling about **\$19,000.00**

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were credited in **1975**. Appellant states that "West received the reduced rental credit of **\$10,980** per annum throughout the life of the agreement." Although appellant does not indicate how this amount was treated on the corporate books, it did not reduce the amounts shown as receivables from appellant.

In **1976**, appellant's marriage with Elaine Pardini was dissolved. Pursuant to the property settlement, Elaine received, among other things, one-half of West's stock. West redeemed these shares in **1976** for \$199,000. Appellant states that his withdrawals from West were considered by the parties to the dissolution as a liability which was taken into account in determining the net assets available for partition.

During 1976, appellant approached a bank about securing a loan. A letter from the bank manager, dated **June 13, 1980**, states his recollection that appellant had told him the loan proceeds would be used to repay amounts owing to West. Loans of **\$100,000.00** each were approved in February and **March** 1977, and the proceeds were deposited in West's bank account.

Respondent initiated an audit of West in July **1976**. Sometime thereafter an audit of appellant's returns was begun. Respondent determined that the withdrawals were not loans, but dividend distributions to appellant and issued a proposed assessment of additional personal income tax.

A dividend is any distribution to shareholders out of earnings and profits accumulated after February **28, 1913**, out of the current year's earnings and profits. (Rev. & Tax. Code, § 17381.) Withdrawals from a corporation by a stockholder are presumed to be dividend distributions unless the stockholder can affirmatively establish that they were loans. (W. T. Wilson, **10 T.C. 251, 256**, affd., **170 F.2d 423** (9th Cir. 1948).)

Whether a withdrawal is a dividend or a loan depends upon the intent of the stockholder at the time of the withdrawal. (Weise v. Commissioner, **93 F.2d 921, 923** (8th Cir. 1938), affg. **35 B.T.A. 701** (1937), cert. den., **304 U.S. 562** [82 L.Ed. 15291 (1938).]) Intent is a question of fact to be determined from all the facts and circumstances surrounding the transactions between the stockholder and the corporation. (Chism's Estate v. Commissioner, **322 F.2d 956, 960** (9th Cir. 1963); Elliot J. Roschuni, **29 T.C. 1193, 1201** (1958).) When

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the withdrawer is in control of the corporation, such control invites special scrutiny of the situation. (Elliot J. Roschuni, supra; W. T. Wilson, supra.)

Appellant contends that the withdrawals clearly were loans because he executed a written agreement to repay, interest was paid in the form of reduced rental, the advances were carried on West's books as loans to appellant, the withdrawals were considered loans for purposes of the property division in appellant's marital dissolution, efforts to secure a bank loan with which to repay West were begun before respondent's audit, and the advances were in fact repaid. Respondent argues that appellant was in a position to control conditions and enforcement of the agreement with West, the agreement did not provide for security or repayment date, no dividends had ever been paid by the corporation, the funds were used to construct a building owned by appellant rather than the corporation, and loans to other officers of West were evidenced by promissory notes providing for due dates, repayment schedules, interest, and default procedures.

While appellant lists a number of factors which could tend to show that he had the intent to repay the withdrawals, the weight which we accord to them, after a consideration of all the circumstances, is much less than that accorded them by appellant. On the whole we find the evidence insufficient to support a conclusion that appellant intended to repay at the time he made the withdrawals.

Appellant relies heavily on the agreement dated September 14, 1973. He contends that this clearly reveals his intent to repay. The agreement stated that appellant would refinance the building "as soon as practical" after completion. This effectively left the decision as to when or if it would be practical to refinance the building and repay the advances entirely within appellant's discretion. In the context of the language and effect of this agreement, its probative value as to appellant's intent is severely diminished. Appellant's contention that interest was paid through reduced rental credits does not bolster the persuasiveness of the agreement since appellant had complete control over the amount of rental to be charged the corporation. (Cf. Estate of Taschler v. United States, 440 F.2d 72 (3d Cir. 1971).)

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Appellant also contends that the withdrawals should be considered loans because the above agreement would have been enforceable against him if he had sold his stock to another. He admits that the agreement was, in practical effect, not enforceable during the years on appeal because appellant, as sole shareholder, could control whether or not the corporation would demand enforcement. Whether a court might find a legal obligation to repay under these circumstances does not mean that appellant intended to repay the advancements when they were made. (Atlanta Biltmore Hotel Corp., ¶ 63,255 P-H Memo. T.C. (1963).) Similarly, appellant's assertions that a loan was acknowledged for purposes of his marital dissolution property settlement or his loan application to the bank are not indicative of his intent at the time the funds were withdrawn.

Appellant contends that the arrangements for refinancing and repayment began long before respondent's audit of his tax returns and, therefore, the repayment in 1977 should be considered determinative of his intent. Repayment is often a factor in **characterizing** withdrawals as loans rather than dividends (cf. Irving T. Bush, 45 B.T.A. 609 (1941); Edwards Motor Transit Co., ¶ 64,317 P-H Memo. T.C. (1964)), although repayment after an audit has begun is **generally unpersuasive**, at least where there is no other strong evidence of an intention to repay. (George R. Tollefsen, 52 T.C. 671 (1969), affd., 431 F.2d 511(2d Cir. 1970); Elliot J. Roschuni, 29 T.C. 1193 (1958), affd. per curiam, 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 10211 (1960).) In the present appeal, the audit of appellant's solely-owned corporation was begun in 1976 and the **withdrawals** revealed in this audit were apparently what led to the audit of appellant's returns. The time at which questions were raised about the withdrawals is not clear from the record. Regardless of the timing, however, we do not find the repayment convincing evidence of appellant's intent at the time of the withdrawals. We note that West was apparently experiencing financial difficulties and had redeemed Elaine Pardini's shares in 1976 for \$199,000.00. Then, early in 1977, appellant obtained two loans from the bank totaling \$200,000.00. It appears that at that time appellant may have decided that he had to replace the funds withdrawn, but given these circumstances, the repayment does not strengthen his assertion of such an intent in earlier years.

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In examining all the facts and circumstances of the transactions between appellant and his corporation, we also note the following: the agreement did not limit the withdrawals in amount and there was no effective time limit for repayment; although the funds were advanced purportedly to construct a building, there was no mortgage or other security given; the withdrawals continued long beyond the time provided in the agreement; and no dividends were ever paid by the corporation, although it apparently had substantial retained earnings as well as current earnings for some of the years on appeal. Appellant would have us discount these circumstances which are unfavorable to him because informalities are not unusual in dealings between corporations and their sole shareholders. (Harry Hoffman, ¶ 67,158 P-H Memo. T.C. (1967); Edwards Motor Transit co., supra.) While it is undoubtedly true that such lack of business formality will not cause withdrawals to be considered dividends where evidence of an intent to repay is strong, it does nothing to bolster an argument that withdrawals are loans where, as here, the evidence of intent to repay is not strong. We also find appellant's withdrawals from West to be in significant contrast to loans made to other corporate officers. In those cases, notes were required which provided for interest, security, and due dates. (See Elliott J. Roschun, supra.)

Considering all the facts and circumstances of this appeal, we must conclude that appellant's withdrawals from West constituted distributions equivalent to the payment of dividends. We, therefore, sustain respondent's determination on this issue.

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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 protests of Joseph L. and Elaine M. Pardini against proposed assessments of additional personal income tax in the amounts of \$4,455.84, \$5,159.59, and \$1,186.01 for the years 1973, 1974, and 1975, respectively, and of Joseph L. and Sharon K. Pardini against a proposed assessment of additional personal income tax in the amount of \$1,902.27 for the year 1976, be and the same is hereby modified in accordance with the foregoing opinion to reflect the allowance of part of appellants' expenses for their rental property. In all other respects, the action of the Franchise Tax Board is sustained.

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 II. Bennett , Member

Richard Nevins , Member

Kenneth Cory , Member