BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAM AND **DINA HASHMAN**)

Appearances:

For Appellants: Chris H. **Carlson**
Certified Public Accountant

Perry Lerner
Attorney at Law

For Respondent: Carl G. Knopke
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 Sam and **Dina Hashman** against a proposed assessment of additional personal income tax in the amount of **$51,450.00** for the year 1976.

Appeal of Sam and Dina Hashman

The issues are whether appellants are entitled to bad debt deductions for advances made to Transinforms International, Ltd., and to Mr. Barry Lercher.

Transinforms International, Ltd. ("Transinforms") was incorporated in Canada in March 1973, It s principal business activity is the development and marketing of computer programs. Mr. Hashman (hereinafter referred to as 'appellant") has owned approximately 21 percent of the outstanding shares of Transinforms since its incorporation. Transinforms was capitalized by the issuance of 29,067 shares of no-par stock for $292 and "loans" from the shareholders in the amount of $452,710. Appellant made a contribution to capital of $58 and a "loan" of $102,566. At sometime prior to February 1976, Transinforms needed additional cash in order to operate. Therefore, the three major shareholders made additional advances to the corporation, which were also in the form of loans. The amount of appellant's "loan" at this time was $100,000.

In 'a meeting held on August 16, 1976, the board of directors of Transinforms resolved that because of the company's poor financial condition, its business operations would be wound down. At a shareholder's meeting held on September 2, 1976, the directors explained that only three of the company's marke'ting leads had any potential to produce revenue and that additional capital of $60,000-$80,000 would be needed to make the leads revenue producing. The directors further explained that, because of the unfavoaahle debt-equity ratio of the company, the additional funds could not be borrowed. The board then asked th.e shareholders to relinquish the company's notes held by them which were dated prior to February 28, 1976. The shareholders agreed to this and surrendered all such notes. Subsequent to the September shareholders' meeting, appellant advanced an additional $10,000 to Transinforms.

In March 1977, liquidation of Transinforms was commenced. To date the liquidation has not been completed because Transinforms has a lawsuit pending against ccrtain'former employees.

Appellant's position is that all three of the advances he made to Transinforms were debts which became worthless in 1976. He claimed the sum of these advances as a bad debt deduction in 1976,

The second bad debt deduction involved in this appeal concerns an advance of $13,861 appellant made to Mr. Barry Lercher in 1971. According to appellant, Mr. Lercher executed a demand note, appellant demanded payment in 1976, and Mr. Lercher refused to pay the loan. Appellant contends that Mr. Lercher was in poor financial condition in 1976, and there was no chance of him repaying the amount advanced. Thus, appellant concluded that the debt was worthless in 1976, and deducted it as a bad debt.

Upon audit, respondent determined that appellant had not proven that he was entitled to a bad debt deduction for either the Transinforms or the Lercher advance; therefore, it disallowed both deductions. Respondent made another adjustment to appellant's 1976 taxable income which apparently is not disputed. Subsequent to appellant's protest against the disallowance of the two bad debt deductions, respondent affirmed its proposed assessment and this timely appeal was filed.

Revenue and Taxation Code section 17207 allows a deduction for "any debt which becomes worthless within the taxable year." In order to be deductible, the debt must be bona fide, that is, it must arise "from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Former Cal. Admin. Code, tit. 18, reg. § 17207 (a), subd. (3) (Repealer filed April 18, 1981, Reg. 81, No. 16).) In addition, to be deductible, the debt must have become worthless during the year in which the deduction is claimed. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976.) The burden of proving that the debt was bona fide and that it became worthless during the taxable year rests on the taxpayer. (Appeal of Alfred J. and Margaret J. Ersted, Cal. St. Bd. of Equal., Dec. 19, 1962; Appeal of Isadore Teacher, Cal. St. Bd. of Equal., April 4, 1961.)

With regard to the Transinforms advances, respondent first contends that the advances were contributions to capital. A contribution to capital is not a bona fide debt. (Former Cal. Admin. Code, tit. 18, § 17207(a), subd. (3).) The determination of whether an advance by a shareholder is a debt or a contribution to capital is a question of fact. (Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.) The basic question is whether the advance creates an unconditional obligation on the part of the corporation to repay a definite sum of money. (Appeal

of Estate of John M. Hiss, Sr., Deceased, and Ella N. Hiss, Cal.. St. Bd.. of Equal., Sept. 23, 1974.) Despite the form of the advance., if there is- no genuine expectation of repayment unless the business venture succeeds, the. advance is a contribution to capital. (Appeal of George E., Jr., and Alice J. Atkinson, supra.) - -

The. circumstances surrounding all three of the advances appellant made to Transinforms lead us to conclude- that these advances were contributions to capital. Even if advances are designated as loans, there is a strong. inference that they are contributions to capital if they were needed to launch the business. (Appeal of George E., Jr., and Alice J. Atkinson, supra.) The initial two advances made by the shareholders of Transinforms, were: clearly needed to launch the business. The amount des-ignated.as paid--in capital. was a mere $2.92; there can. be no argument-that this was enough to commence the development and marketing of computer programs.

At the time of the first two advances, the corporation was' thinly capitalized. This board has held that a 5 to 1 debt-equity ratio indicated that "loans" were really contributions. to capital. (Appeal of George E. Newton, Cal. St. Rd. of Equal..,. May 12, 1964.) Transinforms was incorporated with a 1562 to 1 debt-equity ratio. Such a high ratio strongly indicates that the shareholder "loans" were not bona fide debts. This is also indicated by the fact that the advances were made without any security. (Appeal of Cecil W. Harris, Cal. St. Bd. of Equal., Jan. 6, 1977.) In view of Transinforms' financial condition at the time of the. first two advances,, it is clear that repayment could be expected only if the business succeeded,, Even if these advances had been bona fide debts when made, it appears that appellant's voluntary relinquishment of the promissory notes would have constituted a contribution to capital.

Repeated advances to a corporation which is not showing a profit, and which needs the advances to meet operating expenses indicate an intent to contribute to capital. (Appeal of George E., Jr., and Alice J. Atkinson, supra.) Here, appellant's final advance was such an advance; in fact, it was made after appellant relinquished the notes representing the first two advances, and after the decision was made to wind down business operations. Under these circumstances, appel-

lant obviously could not expect repayment of that $10,000 unless the business started to succeed.

The only factor which supports appellant's position that the advances were loans is the fact that they were characterized as such and that notes were executed. In light of the numerous factors which indicate that the advances were contributions to capital, we find that they were contributions to capital and that no bona fide debt existed between appellant and Transinforms, Therefore, appellant is not entitled to a bad debt deduction under section 17207 for the advances to Transinforms.

The second question presented by this appeal concerns appellant's advance to Mr. Lercher. In respondent's view, appellant has proven neither the existence of a bona fide debt nor the occurrence of any event in 1976 which caused the "debt" to become worthless. The only evidence presented by appellant is a letter from Mr. Lercher dated February 8, 1979. In this letter, Mr. Lercher acknowledges that, during 1976, appellant demanded repayment of approximately $12,000 he had loaned to Mr. Lercher. The letter states further that, neither in 1976 nor as of the date of the letter, was Mr. Lercher in the position to repay the loan.

Assuming, without deciding, that this evidence establishes the existence of a bona fide debt, it does not prove that this "debt" became worthless during 197G. In order for a taxpayer to meet his burden of proving a debt worthless, he must prove that the debt had value at the beginning of the year in question and that some event occurred during that year which changed the debtor's financial condition and caused the debt to become worthless. (Appeal of Myron E. and Daisy I. Miller, Cal. St. Bd, of Equal., June 28, 1979.) The letter from Mr. Lercher merely indicates that he thought his financial condition precluded payment of the "debt" in 1976 and that his financial condition had not improved from that time to 1979. It does not prove either that Mr. Lercher could have paid the debt at the beginning of 1976 or that some event occurred during 1976 which caused him to be unable to pay the debt. Since appellant has not met his burden of proof, respondent correctly disallowed the bad debt deduction.

For the foregoing reasons,-the action of respondent is hereby sustained.

'Appeal of Sam and Dina Hashman

O R D E R

Pursuantto 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 Sam and Dina Hashman against a proposed assessment of additional personal income tax in the amount of $51,450.00 for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June , 1982, by the State Board of Equalization-, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman
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Ernest J. Dronenburg, Jr., Member
Richard Nevins, Member
, Member
, Member