BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
ROBERT E. AND M. E. HINK)
LESTER W., JR. AND BERTHA M. HINK)

For Appellants: William H. Coburn, Jr.
Attorney at Law

For Respondent: John A. Stilwell, Jr.
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 Robert E. and M. E. Hink and of Lester W., Jr., and Bertha M. Rink against proposed assessments of additional personal income tax In the amounts of $3,173.65 and $607.74, respectively, for the year 1977,

The sole question for decision in these appeals is whether loans to their closely-held corporation by appellants (hereinafter, "appellants" will refer only to Robert E. Hink and Lester W. Hink, Jr.), who were both employees and shareholders. of the corporation in. the year at issue, constitute business or nonbusiness debts. Because of the identity of facts, issue, and legal principles involved i.n each case, the two appeals are consolidated for purposes of this opinion.

J. F. Hink and Son (hereinafter "the corporation") is a closely-held California corporation formed in 1907 by L. W. Hink, Sr., appellants' father. The corporation's sole business is the operation of one retail department store located in Berkeley, California. Its assets consist solely of trade fixtures, stock-in-trade and cash. Appellants' father, L. W. Hink, Sr., 'controlled the corporation as president and manager until 1975. In 1975, in order to reverse certain financial setbacks, the corporation's bank demanded that appellants' father, then in his nineties, resign as president and manager of the corporation. Accordingly, after a lifetime of holding various positions for the corporation, appellant Robert Hink was appointed president. and appellant Lester W. Hink, Jr., was placed in charge of shipping and receiving merchandise. In spite of the change in management, the corporation's financial troubles continued. In 1977, the corporation's bank demanded that all obligations owed to it be repaid as *soon as* possible. The bank also informed appellants that it would not make any new loans to the corporation. The corporation desperately tried *to secure* new financing. However, appellants believed *'that the critical funds would be forthcoming only from someone who 'had a special and intense incentive or by selling the business. to some interest which had the desire to acquire it." Appellants concluded that they were the only ones with such a "special and intense incentive." Therefore, in March and April 1977, appellant Robert Wink loaned $91,900 to the corporation while appellant Lester Hink, Jr., loaned $31,716.02. In spite of these last minute efforts, on November 8, 1977, Chapter XI bankruptcy proceedings were filed on behalf of the corporation. On November 10, 1977, the corporation was purchased from the appellants and the other shareholders by C. H. Dunlap Company. Appellants each received $332.90 or 50 cents a share for their 665.79 shares. The Order Confirming Plan in the bankruptcy proceeding filed January 20, 1978, provided, among other things, that the appellants would be repaid only 40 percent of their loans to the corporation.

Because of the fact that 60 percent of the loans to the corporation were unpaid and became worthless in the 1977 bankruptcy proceeding, appellants Robert Hink and Lester Hink reported business bad debts of $56,875 and $20,051, respectively, deductible a:; ordinary losses in their 1977 returns. Appellants contend that they made *the* subject loans in order to preserve and' to continue their employment

with the corporation. However, on audit,. respondent concluded that appellants' dominant motive for making the loans was not related to their trade or business and, accordingly, respondent disallowed such business bad debt deductions and, instead, allowed nonbusiness bad debt deductions to each, deductible as short-term capital losses. That action gave rise to these timely appeals.

It is well settled that respondent's determination to dfsallow a deduction is presumed correct and the burden of proof is upon the taxpayer to establish his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.) Business bad debt losses are fully deductible against taxable income in the year sustained, whereas nonbusiness bad debt losses are regarded as short-term capital losses which are deductible only to the extent of capital gains, plus taxable income or one thousand dollars, whichever is less (Rev. & Tax. Code, §§ 17207 and 18152.).

For purposes of the bad debt deduction, Revenue and Taxation Code section 17207, subdivision (d)(2), defines a "nonbusiness debt" as a debt other than one created, or incurred in connection with the taxpayer's trade or business. Thus, in order to deduct the advances in question as "business bad debts," appellants must establish that such loans were created or incurred in connection with their trade or business. It is now well settled that being an employee may be a trade or business for the purposes of the bad debts section. (Trent v. Commissioner, 291 F.2d 669 (2nd Cir. 1961).) Accordingly, if the appellants' loans to the corporation were 'made in order to protect their jobs or were otherwise related thereto, the resulting debts are "business debts" deductible against taxable income. (Isidor Jaffee, ¶ 67,215 P-H Memo. T.C. (1967).) On the other: hand, where the motivation for the loans is that of an investor and gain is sought in the form of an increase in the value of the investment or in dividends, those loans are "nonbusiness debts." (Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963); Appeals of Walter E. and Pearl Robertson, et al., Cal. St. Bd. of Equal., June 2, 1969.)

The difficulty in determining the proper classification of the instant debts is a result of the fact that each of the appellants had a dual status with respect to the corporation in the year at issue. Each was both a shareholder and an employee. In such situations, the requisite relationship between the taxpayer's trade or business as an employee and the loss is established only if the taxpayer's dominant motivation in entering into the loan was the protection of the employee interest. (United States v. Generes, 405 U.S. 93 [31 L.Ed.2d 62] (1972); Appeal of James C. and Antoinette Glaser, Cal. St. Bd. of Equal., Sept. 28, 1977.) "Dominant," for these purposes, is defined as "the most important reason" or "primary reason." Significant motivation is not enough. (United States v. Generes, supra.)

Appellant Lester W. Hink, Jr., stated that his "dominant motive in making the loans was- to continue [his] employment and, thus, have an income. ..." He explained:

> In 1977 I was 59 years of age and with very limited personal assets. I was too young to collect Social Security, had no skills, which lead [sic] me to believe that at my age I could not obtain employment. with any other person or organization. I believed and still! believe, that if I did not make a loan to J. F. Hink & Son that I would very soon be unemployed and unemployable. . . .

Appellant Robert Hink echoed his brother's sentiments:

> [In 1977] I was. 57 years old and with limited personal assets. Considering my age and limited business experience, it was extremely doubtful that I could obtain employment of any kind with any other person or organization in the event the business terminated for whatever reason. I was too young for Social Security.
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> I believed then, and I still believe, that if the loans were not made to J. F. Hink & Son, I would have soon been unemployed and unemployable. My dominant motive in making the loans was to continue my employment, and thus, have an income on which to live.

Yet, Robert Hink's salary history indicates that he had been paid only a modest salary, both before and after he was appointed president of the corporation. He earned $20,025 in 1973, $21,069 in 1974, $21,563 in 1975, $23,581 in 1976, $21,034 in 1977, and $18,173 in 1978. Moreover, while a detailed salary history of appellant Lester W. Hink, Jr., is not available, the record does indicate that he accepted a salary reduction from $19,000 to $15,000 for 1977. Robert Rink explained that the reason "he had always worked at an extremely low salary .. . [was due to] the expectation that the Hink's stock gifted to him was enhancing in value and would yield handsomely'at the time of future sale." In addition, the reason for Lester Hink's salary reduction was to preclude any "suggestion of self-indulgence on the part of the Hink family .. . [which might deter] persons willing to put $1,000,000 into our company to save it." It would thus appear that appellants were quite concerned about their investment in the corporation. Indeed, as indicated above, as of October 15, 1.975, each appellant owned 665.79 shares of the corporation's total outstanding shares of 4,676.20 with a basis to each of $71,555.52. Moreover, after the sale of the corporation to C. H. Dunlap Company, both appellants continued their employment with the corporation.

For the reasons that follow, we believe that appellants have not established that their dominant motive in making the loans was to protect their jobs. Therefore, we believe respondent's action must be sustained. Where the salary at issue is small compared to the investment at stake, it is difficult to prove that a loan was necessary to keep a job. For example, in United States v. Generes, supra, the comparison of a $7,000 salary to a $38,900 investment was a factor in determining that protecting the taxpayer's job was not the dominant motivation. In the instant case, while a precise measure may be difficult, it is clear that appellants' investments in the corporation were substantial and certainly significant to them. As noted above, the basis to each of the appellants in his stock was $71,555.52. As indicated above, appellant Robert Hink had an expectation that, the stock gifted to him "was enhancing in value." The expectation of a handsome yield at a future sale was the reason that Robert Hink was willing to work at "an extremely low salary." Between 1973 and 1978, Robert's average annual salary was between $20,000 and $21,000 while Lester's appears to have been below $19,000. Accordingly, as in United States v. Generes, supra, comparison of the appellants' admittedly "extremely low" salaries to their investments makes it difficult to show that the subject loans were made in order to keep their jobs.

Appellants Robert Hink and Lester Hink, Jr., however, argue that because of their limited business experience and because of their ages in 1977, 57 and 59, respectively, it would have been extremely difficult for them to replace their jobs. We cannot agree. First, nothing in the record indicates that the skills possessed by appellants were unique. It would appear that the skills obtained in working for a large retail enterprise would be readily marketable elsewhere. Indeed, unlike the taxpayer in Charles J. Haslam, ¶ 74,097 P-H Memo. T.C. (1974), who had to obtain employment in a field unrelated to his previous job as an explosives expert at a salary less than he had been earning, appellants found immediate employment. Moreover, since the appellants admittedly worked at "extremely low salaries," a salary reduction may have been unnecessary. Indeed, the record does not indicate that the appellants suffered any salary reduction. Second, unlike the taxpayer in Isidor Jaffee, supra, who was 72 years old at the date at issue and who never worked again, appellants were relatively young and, in fact, did find other employment. Lastly, the letter confirming Lester Hink's acceptance of a salary reduction from $19,000 to $15,000 sheds some light on the motivation of the appellants. Appellants were most interested in finding "persons willing to put $1,000,000 into our company to save it." In comparison, their salaries and their jobs were much less important.

Again, appellants have not established that the "dominant motive" or the "most important reason" for making the subject loans was the preservation of their jobs and, accordingly, the respondent's determination must be sustained.

Appeals of Robert E. ahd M. E. Hink
and Lester W., Jr. and Bertha M. Hink

ORDER

Pursuant to the views expressed in the opinion of the board on file in these proceedings, 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 Robert E. and M. E. Hink and of Lester W., Jr., and Bertha M. Hink against proposed assessments of additional personal income tax in the amounts of $3,173.65 and $607.74, respectively, for the year 1977 be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of April, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code Section 7.9