BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DONALD E. AND JUDITH E. LIEDERMAN)

Appearances:

For Appellants Peter R. Stoll
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 Donald E and Judith E. Liederman against a proposed assessment of additional personal income tax in the amount of $12,434.23 for the year 1974.

The issue for determination is whether appellants are entitled to a business bad debt deduction in the amount of $198,826.71 for the year 1974. As Judith E. Liederman is involved in this appeal solely because she filed a joint return with her husband, Donald E. Liederman, hereinafter the latter will be referred to as "appellant."

Appellant earns his livelihood making loans and investments. During 1971 and 1972, he owned 54 percent of the stock of Recreation Industries, Inc. (Recreation), which owned over 50 percent of the stock of Delco Productions, Inc. (Delco).

On December 15, 1971, appellant and Delco entered into a contract which they superseded on July 31, 1972, and amended on December 5, 1972. According to the agreement in its final form, appellant promised to loan Delco $198,826.71 to produce a movie and promised to guarantee the company's $50,000 note to a bank. In return, Delco agreed to repay the loan at 8 percent interest on the earlier of Delco's public stock offering or June 30, 1973, and to give appellant 9 percent of the movie's net profits. Appellant had, in fact, made the $198,826.71 advance by July 5, 1972.

Delco was incorporated in 1969; its main purpose was the production of motion pictures. From March 6, 1970, until at least September 30, 1972, Delco's paid-in capital amounted to $21,133. In December 1971, the company bought the motion picture rights to its first film, "The Deja Vu," for $6,180. Delco then formed a wholly-owned subsidiary, Ridgedale Productions, Limited (Ridgedale), to produce this film. Delco sold Ridgedale the rights to the film for $6,180. Delco apparently advanced the money it received from appellant to Ridgedale, to produce "The Deja Vu." The film's principal photography was completed in April 1972, and its distribution, set to commence in 1973, was expected to generate Delco's and/or Ridgedale's first revenues.

The final agreement between appellant and Delco indicated that Delco would raise more capital through a public offering of stock in the corporation. On December 29, 1972, Delco submitted to the Securities and Exchange Commission (SEC) the registration statement which the SEC had to approve before Delco could make the public offering. The statement reported that, pursuant to an agreement for the distribution of "The Deja Vu," Delco was to receive 30 percent of the gross film rentals until the distributor's expenses were recouped, and 50 to 75

percent of the gross rentals thereafter. The statement also noted that as of December 1, 1972, appellant had assigned to Recreation his right to $140,000 of the $198,827 advance. The SEC returned the statement on February 8, 1973, for several modifications. Delco failed to make the modifications, and in November 1973 the SEC ordered the registration statement abandoned.

On June 18, 1973, Ridgedale sold the picture, which had apparently been renamed "A Time for Love." The film was sold to American Film Brokers, a different distributor from the one cited in the registration statement, and the film was booked for distribution in 1973 and 1974. According to appellant, Ridgedale was to receive $15,000 in cash and 9 percent of the first $4,560,000 in net proceeds distributed to American Film Brokers after all of the expenses incurred for the film had been recovered. Respondent's view is that the picture was sold for $15,000 in cash and between 3.15 and 4.5 percent of the first $12,200,000 in gross receipts and 17.5 percent thereafter. Neither party has presented evidence to support its view of this transaction,

The film was apparently unsuccessful, because appellant deducted his $198,827 advance as a business bad debt loss for the year 1974. Respondent initially disputed only the year of worthlessness, but ultimately disallowed the deduction for the following four stated reasons: (1) the advance was a capital contribution rather than a debt; (2) if the advance was a debt, it was a nonbusiness debt; (3) the bad debt loss, if there was one, occurred in 1973, when Delco's registration statement was withdrawn, and not in 1974; and (4) if a bad debt loss is allowed, the amount should be limited to $58,827, since appellant had assigned the balance of the advance to Recreation.

Appellant contends that he incurred the claimed loss in his "business of financing and arranging financing for corporate business," in which he has been involved for over 25 years, and that his intention in this instance was to make a business loan. He has submitted various documents, such as SEC registration statements, continuing loan guarantees, corporate resolutions, and others, to indicate that he was and is in the trade or business of financing and that he has not been merely an investor. He points out that he was a shareholder of neither Delco nor Ridgedale. He also contends that after the registration statement was abandoned, Delco informed appellant that it could obtain substantial payments under the

contract with American Film Brokers, it would continue to raise funds from other sources, and it would ultimately repay appellant. He says it was not until 1974 that it became reasonably apparent, from the 1974 quarterly reports on the sale of the film, that the film would not earn enough to permit Delco to receive the balance of the purchase price and repay his loan.

Revenue and Taxation Code section 17207, subdivision (a)(1), permits a taxpayer to deduct "any debt which becomes worthless within the taxable year;" subdivision (d)(1) limits this deduction to business debts and requires nonbusiness debts (defined in subdivision (d)(2)) to be treated the same as a loss from the sale or exchange of a short-term capital asset. As with any deduction from gross income, the taxpayer has the burden of proving entitlement to a deduction under this section. (Appeal of Estate of Robert P. McCulloch, Deceased, and Barbara B. McCulloch, Cal. St. Bd. of Equal., Sept. 30, 1980; Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal., Nov. 6, 1967.) Only a bona fide debt qualifies for purposes of this section. (Former Cal. Admin. Code, tit. 18, reg. 17207(a), subd. (3), repealer filed April 18, 1981, Register 81, No. 16.) Consequently, the first question for determination is whether appellant's advance constituted a bona fide loan or a contribution to capital. (Appeal of Richard M. Lerner, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.) If it is determined that the advance was a contribution to capital, it is no longer necessary to determine whether the advance may be characterized as a business or a nonbusiness debt. (Raymond v. United States, 511 F.2d 185 (6th Cir. 1975); Appeal of George E., Jr., and Alice J. Atkinson, supra.)

Whether an advance to a closely held corporation represents a loan or a capital investment is a question of fact on which the taxpayer bears the burden of proof. (White v. United States, 305 U.S. 281, 292 [83 L.Ed. 172, 179] (1938); Appeal of Richard M. Lerner, supra,) "A bona fide debt is a debt which arises 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, Register 81, No, 16; see-also Appeal of Joyce D. Kohlman, Cal. St. Bd. of Equal., June 29, 1982; Appeal of Hubert J. and Leone E. Taylor, Cal. St. Bd. of Equal., Aug. 18, 1980.) Here, the agreement between appellant and Delco appears to

create a debtor-creditor relationship. However, it is well settled that "not every advance cast in the form of a loan gives rise to an 'indebtedness' which will justify a tax deduction" (Gilbert v. Commissioner, 248 F.2d 399, 404 (2d Cir. 1957)), and that the substance rather than the form of the transaction is determinative for purposes of establishing the incidence of taxation. (Commissioner v. Court Holding Company, 324 U.S. 331 [89 L.Ed. 981] (1945); Matthiessen v. Commissioner, 194 F.2d 659 (2d Cir. 1952).)

Among the factors that courts have stressed in characterizing an advance to a corporation are the proportion of advances to equity, the adequacy of the corporate capital previously invested, whether the donor had some control over the corporation, whether the advance was subordinated to the rights of other creditors, the use to which the funds were put, and whether outside investors would make such an advance. (See United States v. Henderson, 375 F.2d 36, 40 (5th Cir.), cert. den., 389 U.S. 953 (19 L.Ed.2d 362] (1967); Gilbert v. Commissioner, supra, 248 F.2d at 406.) Courts analyze these factors with a view toward whether they indicate-either that the funds were placed at the risk of the corporate venture or that there was a reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, supra; Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.)

Applying the above considerations to the present case, we are convinced that the advance to Delco was an equity investment.

As of September 20, 1972, Delco had $222,385 in outstanding "liabilities" (largely from appellant), and possessed $21,133 in paid-in capital, resulting in a debt-equity ratio of over ten to one.1/ An excessive

1/ The debt-equity ratio is even larger--nearly sixteen to one--if we consider the liabilities and equities of Delco and Ridgedale combined. The liabilities of the two entities together amounted to $331,867 while their combined paid-in capital remained $21,133. It is appropriate to view both companies together because they possess an identity of interests and because Delco appears to have been active only to the extent that it funneled money to Ridgedale.

ratio of corporate debt to net corporate capital may provide a significant indication that the business is undercapitalized and that the advance in question represents additional capital investment rather than a loan. (Appeal of George E., Jr., and Alice J. Atkinson, supra; Appeal of George E. Newton, supra.)

Where an advance is necessary to launch a new, undercapitalized business, a strong inference arises that the money is a capital investment. (American-LaFrance-Foamite Corporation v. Commissioner, 284 F.2d 72.3 (2d Cir. 1960), cert. den., 365 U.S. 881 [6 L.Ed.2d 192] (1961); Appeal of George E., Jr., and Alice J Atkinson, supra.) Without the transfer of assets from appellant, the corporation would have been a mere shell, unable to fulfill its stated function of producing a film. The corporation relied upon his contribution to purchase the assets and meet the expenses necessary to commence and operate the venture. From this, the inference may be drawn that the advance constituted investment capital. (Sherwood Memorial Gardens, Inc. v. Commissioner, 42 T.C. 211 (1964), affd., 350 F.2d 225 (7th Cir. 1965); Appeal of Richard M. Lerner, supra.)

According to the terms of the amendment to Delco's agreement with appellant, dated December 5, 1972, he guaranteed a $50,000 bank note for which Delco was liable. By personally guaranteeing this loan to Delco, appellant in effect subordinated his own advance to the interest of the bank, since the bank had to be paid before he could be fully reimbursed. One of the attributes of creditor status is "the right to share with general creditors in the [corporate] assets in the event of dissolution or liquidation" (P. M. Finance Corporation v. Commissioner, 302 F.2d 786, 789-790 (3d Cir. 1962); concomitantly, an advance that is subordinated to the claims of others may indicate an equity interest rather than a debtor-creditor relationship. (Reef Corporation v. Commissioner, 368 F.2d 125, 132 (5th Cir. 1966), cert. den., 386 U.S. 1018 [18 L.Ed.2d 454] (1967).)

Additional evidence supporting a characterization of the advance as an equity investment is found in the fact that the advance was unsecured and that apparently no payments of interest or principle were ever made to appellant. (Bordo Products Co. v. United States, 476 F.2d 1312, 1325 (Ct. Cl. 1973); Appeal of Richard M. Lerner, supra.)

Appellant argues that the motion picture business is substantially financed through borrowed funds, and that high leveraging is traditional in this industry. He presents news articles and portions of annual reports of certain film companies to show the extensive use of outside financing by the film business. Industry custom or practice is a factor that may be considered in evaluating and interpreting the financial scheme at issue in this-case. (In-re Indian Lake Estates, Inc., 448 F.2d 574, 579 (5th Cir. 1971).) However, the companies he mentions are substantial ones whose names and reputations have been firmly established for many years. The agreement between appellant and Delco was formulated when the latter was a fledging and unproven enterprise: it had been in existence for-less than three years and had yet to create a product.

In the usual situation, a capital contribution is made by a stozkholder of the recipient corporation; in contrast, appellant is not a shareholder of Delco. However, appellant did own over half the stock of Recreation, which owned over half the stock of Delco. If the other circumstances surrounding a particular advance provide a sufficiently strong indication of its character, then the fact that a non-shareholder made the advance will not prevent treatment of the advance as a capital contribution. (In re Indian Lake Estates , Inc., supra; Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965); Sherwood Memorial Gardens, Inc. v. Commissioner, supra.)

Given the aggregate of circumstances noted above in reference to the contract at issue, it appears that very few creditors would have agreed to make an extremely large, unsecured loan to an undercapitalized and unproven company such as Delco. It is our considered opinion that appellant's advance represented a contribution to capital, placed at the risk of the success or failure of the corporate venture, and not a valid debt. Therefore, appellant is not entitled to the claimed business bad debt deduction for the year 1974.

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 Donald E. and Judith E. Liederman against a proposed assessment of additional personal income tax in the amount of $12,434.23 for the year 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of October 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

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9