BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ESTATE OF ARTHUR C. CROFT, DECEASED,)
AND CHRISTINE M. CROFT, DECEASED)

For Appellant: Richard W. Craigo
Attorney at Law

For Respondent: Charlotte Meisel
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 Estate of Arthur C. Croft, Deceased, and Christine M. Croft, Deceased, against proposed assessments of additional personal income tax in the amounts of $808.54, $1,621.12, and $1,346.00 for the years 1975, 1976, and 1977, respectively.

Appeal of Estate of Arthur C. Croft, Deceased, and Christine M. Croft, Deceased

The sole issue for determination is whether periodic withdrawals by Mr. and Mrs. Croft (hereafter "appellants") from their closely held corporation were loans rather than taxable constructive dividends.

Appellants, husband and wife, now both deceased, had been the majority shareholders of A. C. Croft, Inc., an Illinois corporation engaged in the publication of periodicals. As of January 1, 1975, appellants owned 94 percent of the corporation's stock, while their adult grandchildren owned the remaining six percent. Appellant-husband died on September 6, 1975. At about the same time, August 28, 1975, Elizabeth Hartzell, appellant-wife's niece, purchased 43.2 percent of the corporatio-n's stock. Thereafter, and throughout the period under appeal, appellant-wife and Elizabeth Hatzell each owned 43.2 percent of corporate shares and held an additional 7.6 percent of the shares in joint tenancy. Appellants' grandchildren continued to own the remaining shares.

Before his death, appellant-husband served as chief executive officer and chairman of the board of the corporation, while appellant-wife served as vice president and director. After his death, appellant-wife added chairman of the board to her other duties. The corporate franchise tax returns indicate that appellant-wife devoted 50 percent of her time to corporate activities throughout the period at issue.

From at least 1965, the corporation maintained open accounts for appellants denoted as loans on the corporate books. As of January 1, 1975, those accounts indicated a balance due from appellants to the corporation of $64,042.56. During the years at issue, that account showed the following transactions:

	1975	1976	1977
Account balance as of January 1	$ 64,042.56	$101,062.11	$113,340.59
Money advanced to appellants	36,757.46	17,872.24	7,800.00
Note advanced to appellants	3,331.04		
Corporate liabilities paid by appellants	(1,518.95)		

	1975	1976	1977
Contributions of stock by appellants to corporation	(1,550.00)	(5,000.00)	
Reversal of 1974 error		(593.76)	
Net advances	37,019.55	12,278.48	7,800.00
	$101,062.11	$113,340.59	$121,140.59

Upon audit, it was learned that no note or other formal indication of indebtedness had been executed at the time of the withdrawals. Moreover, at the time of such withdrawals, no interest had been charged, no collateral had been given, no ceiling had been placed on the amounts which could be withdrawn, nor had a repayment schedule been established. The audit further indicated no dividends had been declared during the years at issue and that corporate earnings and profits for each year exceeded the amounts advanced to appellants.

On the basis of this information, respondent determined that the withdrawals in question constituted taxable dividends. Respondent issued notices of proposed assessment increasing appellants' income accordingly. Appellants protested, taking the position that the subject withdrawals represented loans. Respondent's denial of that protest resulted in this appeal.

The question of whether appellants' shareholder withdrawals are to be characterized as dividends or loans depends on all the facts and circumstances surrounding the transactions between them and the corporation. (Harry E. Wiese, 35 B.T.A. 701, affd., 93 F.2d 921 (8th Cir. 1938), cert. den., 304 U.S. 562 [82 L.Ed. 1529] (1938); Elliot J. Roschuni, 29 T.C. 1193 (1958), affd., 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 10211 (1960); Carl L. White, 17 T.C. 1562 (1952); C. F. Williams, ¶ 78,306 P-H Memo. T.C. ('1978); Appeal of Albert R. and Belle Bercovich, Cal. St. Bd. of Equal., March 25, 1968.) Specifically, the question is whether at the time of each withdrawal there-existed an intent by the shareholder to repay the loan and by the corporation to enforce the obligation. (Commissioner v. Makransky, 321 F.2d 598 (3d Cir. 1963); Clark v. Commissioner, 266 F.2d 698 (9th Cir. 1959); Jack Haber, 52 T.C. 255 (1969),

affd., 422 F.2d 198 (5th Cir. 1970).) Furthermore, special scrutiny of the situation is invited where the withdrawer is in substantial control of the corporation (Jack Haber, supra; William C. Baird, 25 T.C. 387 ('1955); W. T. Wilson, 10 T.C. 251 (1948), affd. sub nom., Wilson Bros. & Co. v. Commissioner, 170 F.2d 423 (9th Cir. 1948); Ben R. Mayer, 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.)

In support of their contention that such withdrawals were, in fact, bona fide loans, appellants make the following arguments: (1) After the sale of 43.2 percent of the shares to Elizabeth Hartzell on August 28, 1975, and appellant-husband's death on September. 6, 1975, appellants did not control the corporation. Mrs. Hartzell acted as president of the corporation, and appellant-wife took a less active role in managing the corporation. Accordingly, appellants argue, the transactions were arms-length, bona fide loans. (2) While no note was executed at the time of the withdrawals, appellant-wife did execute a promissory note on June 1, 1977, in the sum of $120,000. That note provided for the payment of interest and for the repayment of principal and interest upon appellant-wife's death in ten equal annual payments. At the same time, the corporation set a limit of $120,000 on the amount of the loan. In addition, as indicated above, the corporate books had reflected these withdrawals as loans. These formalities, appellants contend, indicate an original intent to treat the withdrawals as loans. (3) Appellant-wife had a net worth in excess of $120,000 and, accordingly, had the ability to repay the advances. Indeed, during 1975 and 1976, appellant-wife repaid the corporation $7,568.95.

For the reasons discussed below, we believe that appellants attach more weight to these factors than is warranted.

First, the record indicates that $32,002.52 of the net $37,019.55 advanced to appellants in 1975 was advanced prior to the sale of stock to Mrs. Hartzell and prior to Mr. Croft's death. This sum (i.e., $32,002.52) not only represents the bulk of the amount at issue in 1975 (i.e., 85 percent), but also the major portion of the amount at issue during the entire appeal period (i.e., 56 percent). Clearly, appellants were the majority shareholders (94 percent) and were in actual control of the corporation during that period. Moreover, while

the corporation during that period. Moreover, while subsequent to August 28, 1975, appellants owned but 43.2 percent of the shares in their own names, appellant-wife also owned 7.6 percent of the- corporation's shares in joint tenancy, and her grandchildren continued to own an additional six percent. In addition, Mrs. Hartzell, the owner of the remaining shares, was appellant-wife's niece. After her husband's death, appellant-wife became chairman of the board of the corporation and continued to devote substantial time to corporate activities. In such a situation, we cannot conclude that appellants were "under the disadvantages that sometimes confront holders of minority interests." (Estate of Felton, 176 Cal. 663, 668 [169 P. 392] (1917).) Accordingly, we must find that during the period after August 28, 1975, appellant-wife was in substantial control of the corporation and that the advances, both before and after the sale to Mrs. Hartzell, were not made at arms-length. (See Jack Haber, supra; William C. Baird, supra.)

Secondly, we can attribute little significance in the resolution of this matter to the formalities noted by appellants. While it is true that the execution of a note is a common indicator that a real loan existed, the subject note was not executed until the end of the period under review (i.e., June 1, 1977). Under these circumstances, the execution of the note and the terms therein included appear to have little weight with respect to ascertaining appellants' original intent. (Appeal of William R. and Mary R. Horn, Cal. St. Bd. of Equal., May 19, 1981.) Moreover, such factors as treating the withdrawals as loans on the corporate books and financial statements are entitled to limited weight when the corporation is wholly owned or controlled by the taxpayer. (Regensburg v. Commissioner, 144 F.2d 41 (2d Cir. 1944); Daniel Hunt, Jr., 6 B.T.A. 558 (1927).) Since appellants substantially controlled the corporation during the entire period at issue, we cannot conclude that an intention to create bona fide loans or to repay the withdrawals is manifested by the formalities cited above.

Limited weight attaches as well to the third factor cited by appellants. The amount allegedly repaid, approximately $7,500, was relatively minor compared to the amounts withdrawn. Moreover, none of this amount was paid in cash but was either paid by transferring other closely held stock or by the assumption of corporate notes. Accordingly, we cannot conclude that these infrequent and unsubstantial transactions manifested an intent to repay the subject withdrawals. (Cf. Harry Hoffman, ¶ 67,158 P-H Memo. T.C. (1967).)

For the foregoing reasons, we must find that the withdrawals at issue were taxable corporate distributions rather than bona fide loans. Accordingly, respondent's action will be sustained.

Appeal of Estate of Arthur C. Croft, Deceased, and Christine M. Croft, Deceased

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 Estate of Arthur C. Croft, Deceased, and Christine M. Croft, Deceased, against proposed assessments of additional personal income tax in the amounts of $808.54, $1,621.12, and $1,346.00 for the years 1975, 1976, and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

_____, Member