BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 83A-49
DAILEY ENTERPRISES )

For Appellant: John T. Dailey
President

For Respondent: George Bond
Counsel

## O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Dailey Enterprises against proposed assessments of additional franchise tax in the amounts of $2,700, $3,363, and $6,144 for the income years 1979, 1980, and 1981, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appeal of Dailey Enterprises

The sole issue in this appeal is whether respondent abused its discretion in disallowing the claimed additions to appellant's bad debt reserve for the years in question.

Appellant, Dailey Enterprises, was incorporated under the laws of California on September 29, 1977. It is an accrual basis taxpayer whose principal business activities are rental management, finance, construction, and real estate. Appellant employs the reserve method of accounting for its bad debts.

During the years at issue, John Dailey was the president and 50-percent shareholder of appellant, Dailey Enterprises. Mr. Dailey's wife was the only other officer of appellant and owned the other 50 percent of appellant's common stock. Mr. Dailey was chairman of appellant's board of directors and his wife was the only other board member. During the years at issue Mr. Dailey was also president of Dailey International Air Service (DIAS), an air freight company incorporated in Florida in May 1979. In addition, Mr. Dailey held a one-third partnership interest in the Flying Good Guys (FGG).

For the income years 1979, 1980, and 1981, appellant added $30,000, $35,700, and $64,000, respectively, to its bad debt reserve. Respondent disallowed all the additions. According to appellant, the disallowed additions reflect loans made to DIAS and FGG as follows:

| Year | Debtor | Amount |
|---|---|---|
| 1979 | DIAS | $30,000 |
| 1980 | DIAS | 38,700 |
| 1981 | FGG | 83,365 2/ |

It is appellant's position that the advances in issue were valid loans which became worthless in whole or in part thereby creating valid bad debt deductions. Respondent disallowed the total amount of these additions to appellant's bad debt reserve on the basis that appellant has failed to establish that the advances made to DIAS and FGG constituted bona fide debts rather than contributions to capital.

2/ It is appellant's contention that the alleged loan to FGG was only 75% worthless in 1981.

This appeal results from the denial of appellant's protest.

Whether advances to a closely held corporation by a stockholder are loans or contributions to capital is a question of fact. The taxpayer-stockholder has the burden of establishing that a bona fide debt existed and that he is, therefore, entitled to a deduction upon its becoming worthless. (Matthiessen v. Commissioner, 16 T.C. 781 (1951), affd., 194 F.2d 659 (2d Cir. 1952); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.) Although the courts have stressed a number of factors which are to be considered in determining the nature of a stockholder's advance to the corporation, the basic inquiry appears to be whether the funds have been put at the risk of the corporate venture or whether there is a genuine expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); on remand, ¶ 58,008 T.C.M. (P-H) (1958), affd., 262 F.2d 512 (2d Cir. 1959), cert. den., 359 U.S. 1002 [3 L.Ed.2d 1030] (1959).) The entire factual background must be examined in order to answer this question.

We turn to the promissory notes provided by appellant as evidence of a bona fide debtor-creditor relationship between itself and DIAS. The notes are signed by John Dailey in his capacity as president of DIAS and owner of 33 percent of DIAS stock. At the same time, Mr. Dailey was also president and a 50-percent owner of appellant; thus, as respondent points out, he had complete discretion as to whether and when the notes would be repaid. While the form of the advances to DIAS may indicate the existence of a valid debtor-creditor relationship, we must conclude that the facts and circumstances surrounding the advances strongly indicate the contrary. In the Appeal of Dudley A. and Sherrill M. Smith, decided by this board on December 15, 1976, we stated that advances made under such a state of facts were contributions to capital as opposed to valid loans and concluded that bad debt deductions based upon such advances should be disallowed. Additionally, participation of a creditor in the management of the debtor, such as exists in the instant case, has been held to be an indication that advances made by such creditor to such debtor are contributions to capital. (Matter of Uneco, Inc., 532 F.2d 1204, 1208 (8th Cir. 1976).)

Perhaps most significantly, appellant continued to make advances to DIAS at times when it was obvious

that DIAS did not have the resources to repay them. In such cases where the advanced funds have been put at the risk of the corporate venture, that is, when their repayment is contingent upon the success of the business, it is an indication that the advance is investment capital and not a loan for which a bad debt deduction may be taken. (Midland Distributors, Inc. v. United States, 481 F.2d 730, 733 (5th Cir. 1973); Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.) As such, we must conclude that the advances made to DIAS by appellant were not bona fide debts and, therefore, were not deductible as worthless bad debts.

With regard to the advance made in 1981 to FGG, a partnership in which appellant had a one-third interest, appellant has again failed to establish the existence of a bona fide debt for which a bad debt deduction may be taken.

Appellant has not provided any instrument evidencing FGG's alleged indebtedness. Additionally, as with the adances made to DIAS, the alleged advances made to FGG are subject to close scrutiny due to appellant's one-third interest in FGG.

Appellant's unsecured advancement of funds to FGG even though the company was in extreme financial difficulty indicates that the advance was investment capital. This is particularly so if we view the circumstances existing at the time the advance was made. Appellant notes that the poor U.S. economy was "causing many air freight carriers [the potential customers of FGG] to file bankruptcy and otherwise go out of business." (Resp. Br., Ex. A at 3.) FGG owned only one aircraft which it had been unsuccessful in leasing throughout the entire fourth quarter of 1980. By 1981, FGG did not have any income at all and yet had many expenses. Payments on the aircraft purchase loan had to be made each month and continuing maintenance on the aircraft was required even though it was not flying. Additionally, parking costs and insurance premiums for the idle aircraft continued each month.

While a prudent lender would have considered these facts as reasons not to make a loan, appellant asserts that it is because of these circumstances that it did advance money to FGG. Further, appellant states that the advance was made, in part, to enable FGG to repay a bank loan. Certainly a true creditor would not make an unsecured loan to such a financially troubled business so

that that business could repay loans to other creditors. We must conclude that the advance made to FGG was also obviously a contribution to capital, and therefore not deductible as a bad debt.

For the reasons stated above, we must conclude that appellant has failed to establish that the advances it made to DIAS and FGG were bona fide debts. Accordingly, respondent's action must be sustained.

## 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Dailey Enterprises against proposed assessments of additional franchise tax in the amounts of $2,700, $3,363, and $6,144 for the income years 1979, 1980, and 1981, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day of October, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9