BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HAROLD F. AND MARY L. CARPENTER)

Appearances:

For 'Appellants: Arthur E. Gore
Attorney at Law

For Respondent: 'James P. Corn
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Harold F. and Mary L. Carpenter against proposed assessments of additional personal income tax in the amounts of $702.25, $890.60, $917.09, and $1,276.93 for the years 1964, 1965, 1966, and 1967, respectively.

The primary issue is whether certain rental receipts of Carpenter Investment Company, appellants" wholly owned corporation, which were collected and

deposited by appellants in their own bank account were dividends.

Appellants are California residents. In 1962, they created two wholly owned corporations, Carpenter's Garage, Inc. (hereinafter called Garage) and Carpenter Investment Company (hereinafter called Investment). On July 1, 1963, Garage succeeded to appellants9 'garage and salvage business and Investment began holding and managing their real estate interests. Neither corporationdeclared any formal dividends during the years on appeal. While appellant Harold F. Carpenter received substantial annual salaries from Garage, Investment paid no salary or wages to anyone.

For its income years ended June 30, 1964, through June 30, 1967, Investment's records show rental receipts in the amounts of $24,915.00, $26,972.55, $29,217.45, and $28,860.00, respectively. Although appellants were advised to open a corporate bank account for Investment when it began operations? they failed to do so until March 29, 1968. During each of the years in question Garage was charged $14,400.00 rent by Investment, which was shown as a note. receivable from Garage in Investment's books and records. Adjustments were made in this account for each fiscal year to reflect the fact that Garage paid most of Investment's operating expenses.

Rental income to Investment paid by third parties was collected by appellants and deposited in their own bank account. When sufficent funds were accumulated, time deposit certificates were purchased in appellants' name. Investment recorded this rental income by charging appellant Harold F. Carpenter's note receivable account, These rental receipts from third parties amounted to $10,525.00, $12,572.55, $14,817.45, and $14,460.00 for the respective income years. Of the $10,525.00 in Investment's rental receipts for the year ended June 30, 1964, $5,190.00 thereof was collected and deposited in appellants: account in the last half of 1963. Appeliants paid $482.78 of Investment's expenses for the year ended June 30, 1964, none the following year, $4,217.00 of Investment's property taxes the third income year, and $2,368.30 of such taxes in the last of those years.,

Interest earned on the deposited funds was reported by appellants on their own personal income tax returns.

On June 30, 1964, appellant Harold F. Carpenter executed a $10,032.22 negotiable promissory note payable to Investment, representing the rental collections (less the aforementioned $482.78). The note was payable one year from date and was to bear interest at the rate of six percent per annum. No payment. of principal or interest was made during that year. On June 30, 1965, appellant executed a note for $23,206.40. The terms were the same as the first one, but the face amount represented the principal of the first note, plus interest, plus the rental amounts collected during the year ended June 30, 1965. Again no payment thereon was made. On June 30, 1966, appellant repeated the same procedure (after allowing for the property tax payment) by executing a new interest-bearing note in the amount of $34,597.60. The identical practice was followed on June 30, 1967, with the principal of the note being $47,371.88. At all times appellant had sufficient cash to pay the notes, but no payment thereon was made. Appellants deducted no interest payments on their income tax returns.

With respect to the years on appeal, Investment's records indicate the following:

Investment's Income Year	Appellants' Cumulative Retained Deposits	Investment's Cumulative Retained Earnings
June 30, 1964	$10,032.22	$10,430.84
June 30, 1965	$22,604.77	$23,954.61
June 30, 1966	$33,205.22	$38,117.26
June 30, 1967	$45,296.92	$50,700.41

During that corporation's fiscal year ended June 30, 1968, appellants paid $31,216.63 for certain property and improvements in behalf of Investment and collected rental receipts

of $5,126.65, still retaining $19,206.94 of all rental receipts deposited in this and previous years. It was in September of 1967 that respondent began its audit of appellants. The amount of Investment's rental receipts retained was further reduced to $12,514.66 in the fiscal year ended June 30, 1969, by paying $6,692.28 for a corporate building improvement for Investment .No rental receipts were deposited in appellants' account that year . There was no deposit or expenditure the. following fiscal. year.

Notes continued to be issued after June 30, 1967. The note dated June 30, 1970, showed principal of $18,113.99, all but $12,514.66 thereof representing past accumulated interest. On or prior to April 29, 1971, $11,100.00 of appellants' own personal rental receipts were said to have been "inadvertently deposited in the corporate bank account and upon discovery applied against appellants ' notes. " This was 'the last adjustment. Consequently, appellants have retained $1,414.66 of the Investment rental receipts collected and commingled with their personal bank account and no interest- has ever been paid.

Respondent determined that the difference between appellants' deposits of rental receipts in their personal bank account and their payments in behalf of Investment in each of that corporation's income years ended within the period July i, 1963, through June 30, 1967, constituted informal dividends. That determination gave rise to the major part of the proposed assessments here in question.

Appellants contend that they collected and held the rental receipts as agents for Investment, using their personal bank account as a mere place of deposit. Accordingly, they -claim, there were no stockholder withdrawals . They say that their belated opening of a corporate account was due simply to neglect and that the receipts were. treated as loans for accounting purposes.

We conclude that the amounts in cuestion were actually withdrawn from the corporation by its sole stockholders, the appellants. They commingled the collections

with their own funds, deriving interest income which they have retained and reported as their own on income tax returns. They still retain some of the principal. Furthermore, during the earlier years it was money owed by Garage which was principally spent on Investment's behalf. The cases cited by appellants are factually distinguishable. In Home News Publishing Co., T.C. Memo, Aug. 13, 1969, there was no commingling in the bank account and in Arthur Rosencrans, T.C. Memo, Feb. 26, 1954, the stockholders merely 'placed corporate funds in their safe deposit box and later expended them all for corporate purposes.

Appellants! next contention is that if the amounts in question constituted withdrawals by stockholders, they were nevertheless loans rather than dividends. Whether a stockholder% withdrawals from a corporation are loans rather than taxable distributions of earnings is a question of fact to be determined from ail the circumstances present in a particular case, and the controlling factor is whether at the time of each withdrawal the parties intended that it should be repaid. (Harry E. Wiese, 35 B.T.A. 701, aff'd, 93 F.2d 921, cert. denied, 304 U.S. 562[82 L. Ed. 1529]; Elliott J. Roschuni, 29 T.C. 1193, aff'd, 271 F.2d 267, cert. denied, 362 U.S. 988 [4 L. Ed. 2d 1021-j; Clark v. Commissioner, 266 F.2d 698; Chism's Estate v. Commissioner, 322 F.2d 956; Berthold v. Commissioner, 404 F.2d 119.) Withdrawals are deemed to be dividend distributions, as determined by respondent, unless the taxpayer can affirmatively establish that they were loans, and when the corporation is wholly owned by the person making the withdrawals, his control invites special 'scrutiny. (Ben R. Meyer, 45 B.T.A., 228; W. T. Wilson, 10 T.C. 251, aff'd, 170 F.2d 423; Appeal of Robert B. and Joanna C. Radnitz, Cal. St. Rd. of Equal., May 6, 1971.)

After considering all the facts in this case, we are not persuaded that appellants have proved an intention to repay the net amount of the withdrawals. Appellants stress that in many cases where notes were prepared the courts have found the existence of loans. In the matter under present consideration, however, at no time during the appeal years, despite ability to pay, was there any payment of principal or interest on

the yearly due date of the notes. Particularly damaging to appellants ' second contention is again the Pact that interest has never been paid. This suggests appellants never intended to be bound by any loan agreement, Moreover, where the stockholder making the withdrawals is in control of the corporation, the existence of a technical legal obligation to repay means nothing if the stockholder does not intend to have the corporation enforce the obligation. (Cf. Chism's Estate v. Commissioner, supra.)

Appellants emphasize the fact of an ultimate declining balance. Its significance is considerably lessened by the fact that in each of Investment's fiscal years ended within the period on appeal the net withdrawals increased substantially. Furthermore., it was Garage then which was making most of the expenditures for Investment. With respect to the declining balance in later years, it is not clear that the decline began before respondent questioned the withdrawals. Moreover, some of t'ne decline was due to an inadvertent transfer of funds to the corporate account. Appellants cite several cases for the aforementioned view that the substantial repayments were evidence of true original loans. In those cases, however, we find complete payment; a history of amounts owed to, as well as by, the taxpayer in earlier years; demand notes issued prior to withdrawals and substantial partial payments during the 'appeal years ; or at least a partial payment on the due date in addition to renewal of the obligation.

Appellants stress that the payments to appellants were treated as loans "on the balance sheet submitted for all purposes" and that this was an important evidentiary matter. If the corporation showed them as loans on balance sheets submitted to third parties for credit purposes this fact would have some. evidentiary value. (See Herman M. Rhodes, 34 B.T.A. 212, 216; rev'd on other grounds, 100 F.2d 966.) In the cases cited by appellants, however, including Rhodes, the conclusion that the withdrawals were loans was based on other considerations as well.

Appellants place considerable emphasis upon the decision in Fred T. Wood, 27 B.T.A. 162, in claiming that the net annual withdrawals were loans. In that case, however, it was held that the taxpayer failed to meet his burden of proof where he was trying to establish that the net collections by him were dividends.- Moreover, during a considerable part of the corporation's operating period the taxpayer was not the sole stockholder.

Appellants maintain that, in any event, rental receipts of $5,190.00 collected and deposited in their own account in the last six months of 1963 were erroneously included in their-1964 income. We agree. Journal entry number (1) shown on Investment's first of the four working trial balance sheets clearly establishes collections of that amount by appellants in 1963. Consequently, constructive dividends in the amount of $5,190.00 should not have been included in respondent's calculation of appellants' 1964 income.

The only other issue presented is whether appellants were entitled to certain business expense deductions for claimed business lunches and entertainment in the amounts of $900.00 and $1,500.00 for the years 1966 and 1967, respectively. Appellant contends he spent these sums entertaining insurance men, auto repairmen, and others in furthering his towing service, which was conducted as an individual proprietorship.

Section 17202 of the Revenue and Taxation Code allows as a deduction ordinary and necessary expenses paid or incurred in carrying on a trade or business. Section 17296 of that code provides, however, that no deduction shall be allowed for any entertainment expenses unless substantiated by adequate records or by sufficient evidence which corroborates the taxpayer's own statement. Furthermore, income tax deductions are a matter of legislative grace and the burden of clearly showing the right to the claimed deductions is imposed upon the taxpayer. (New Colonial Ice Co, v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]; Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416].) Appellants have offered no evidence to substantiate the claimed expenditures.

Accordingly, we must sustain respondent's action disallowing these deductions.

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 Harold F. and Mary L. Carpenter against proposed assessments of additional personal income tax in the amounts of $702.25, $890.60, $917.09, and $1,276.93 for the years 1964, 1965, 1966, and 1967, respectively, be modified by eliminating from 1964 income the $5,190.00 received in 1963. In all other respects the action of the Franchise Tax Board is sustained-.

Done at Sacramento, California, this 6th day of June, 1973, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary