BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
ROBERT W. AND )
MARGARET H. RECTOR )

For Appellants: Robert W. Rector, in pro. per.

For Respondent: Bruce W. Walker
Chief Counsel

Kendall Kinyon
Counsel

## OPINION

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 Robert W. and Margaret H. Rector against a proposed assessment of additional personal income tax in the amount of $97 1.09 for the year 1968.

The primary issue for determination is whether a loss claimed by appellants was deductible as an ordinary loss on "small business corporation stock" pursuant to sections 18206 through 18210 of the Revenue and Taxation Code.

Appellants were the principal incorporators of MHR Productions, Inc. (MHR). MHR was incorporated in California during 1966. Its principal business activity consisted of producing stage plays. The first board of directors' meeting was held on January 26, 1966, where it was resolved:

> That this corporation does hereby accept a loan from Margaret H. Rector, in the sum of $10,000.00, to be used as operating capital in the course and conduct of this corporation's business activities; that the said $10,000.00 shall be represented by two Promissory Notes, each in the sum of $5,000.00, with interest at the rate of 5% per annum, payable on demand;...

A further resolution passed at the meeting provided:

> That the President and Secretary of this corporation be, and they are hereby directed to prepare, and file, or cause to be prepared and filed on behalf of this corporation, an Amendment [sic], including amendments and/or supplements thereto, to the California Commissioner of Corporations, for a Permit authorizing the corporation to issue and sell to Margaret H. Rector, 50 shares of this corporation's no par capital stock, on the basis of $100.00 per share, in consideration of the discharge of this corporation's indebtedness to Margaret H. Rector, in the total sum of $5,000.00;...

The California Division of Corporations issued a permit authorizing the issuance of the fifty shares to Margaret H. Rector. The permit was effective April 6, 1966, and expired on July 1, 1966, unless renewed. After receipt of the permit the stock was issued,, partially extinguishing the corporation's debt to Mrs. Rector.

On January 27, 1966, a special meeting of the board of directors was held where it was resolved:

> that this corporation elect [sic] to be taxed as a Sub-Chapter "S" Small Business Corporation under Section 1372A.. ..

Appellants have expressed their belief that by incorporating MHR under subchapter S of the Internal Revenue Code of 1954 the corporation would qualify as a "small business corporation" in California.

For the year 1966, the corporation incurred a net loss of approximately $71,000. Since the corporation was unable to pay its operating expenses,. Mrs. Rector advanced a total of $69,000 to the Corporation during 1966. This amount included one-half of the original $10,000 loan for which stock was not issued. In return for the advances, Mrs. Rector received unsecured interest-bearing demand notes. No principal or interest payments were ever made on these notes.

During 1968, the corporation ceased operations and was dissolved. At the time of dissolution the corporation did not have sufficient assets' for Mrs. Rector to recover any portion of her advances or capital contributions.

On their joint personal income tax return for 1968, appellants claimed a $50,000 ordinary loss deduction resulting from the worthless stock and the advances to MHR. The basis for the deduction was that the loss resulted from worthless "small business corporation stock" and was entitled to ordinary loss treatment pursuant to sections 18206 through 18210 of the Revenue and Taxation Code. Initially, respondent determined that none of the loss qualified as an ordinary loss on "small business corporation stock, " and disallowed the deduction to the extent it exceeded the $1,000 maximum allowable capital loss. Appellants protested that action, and respondent allowed the initial $5,000 loss on the stock as an ordinary loss on "small business corporation stock, " but disallowed the remainder of the claimed ordinary loss. Respondent also allowed the maximum capital loss of $1,000. From that action appellants appeal.

Generally speaking, losses incurred when capital stock becomes worthless, or from a nonbusiness bad debt involving loans to a corporation, are capital losses, the deductibility of which is limited to capital gains plus $1,000 of ordinary income. (Rev. & Tax. Code, §§ 17206, 17207, 18152. ) As an exception to this general rule, if the stock qualifies as "small business corporation stock" and becomes worthless, the loss may be deductible as an ordinary loss up to a statutory maximum, The maximum deductible loss for any taxable year is $25,000, unless the taxpayer is a husband or wife filing a joint return, in which case the maximum deduction is increased to $50,000. (See generally, Rev. & Tax. Code, §§ 18206-18210; Cal. Admin. Code, tit. 18, regs. 18206-18210(a)-(h). )

Sections 18206 through 18210 of the Revenue and Taxation Code are substantially identical to section 1244 of the Internal Revenue Code of 1954. Section 1244 was enacted in 1958 to encourage the financing of "small business corporations" by providing for beneficial income tax treatment in case of a loss on stock investments in qualified corporations. (See generally, Anderson v. United States, 436 F. 2d 356. ) "Small business corporation stock" may be defined as common stock issued for money or other property by a domestic "small business corporation" under a plan adopted to offer such stock for a period specified in the plan, ending not later than two years after the date the plan was adopted. In general, a domestic corporation qualifies as a "small business corporation" if, at the time the plan is adopted, the aggregate amount of qualifying stock which may be offered under the plan does not exceed $500, 000; and, the sum of the aggregate amount which may be offered under the plan, plus the equity capital of the corporation does not exceed $1, 000, 000. Additionally, during the five most recent taxable years ending before the loss is sustained, no more than fifty percent of the corporation's gross receipts may be derived from certain passive investment income.

Respondent does not argue that MHR was not qualified as a "small business corporation" insofar as its size; capitalization, and the nature of its business activity was concerned. What respondent does maintain is that .the advances to MHR, whether characterized as loans or additional contributions to capital, did not constitute "small business corporation stock" ("section 18208 stock"), and do not qualify for ordinary loss treatment. For the reasons set out below, we agree with respondent's contention.

In order for stock to qualify for ordinary loss treatment it must first be "small business corporation stock, " and, secondly, it must be issued in accordance with a written plan. (Rev. & Tax. Code, 9 18208; Cal. Admin. Code, tit. 18, reg. 18206-18210(c). )

In allowing the $5,000 ordinary loss deduction, respondent apparently determined that the corporate minutes, resolutions, application for a permit to issue shares, and the permit itself, constituted a written plan for the issuance of the $5,000 in stock to Mrs. Rector. It is true that corporate writings such as these may constitute a satisfactory plan if they embody all of the elements required by the statutes and regulations. (See, e. g. , Eger v. Commissioner, 393 F. 2d 243. ) Although the issue is not directly before us, we do not believe that the corporate documents referred to above constituted a written plan within the scope of the statutes and regulation::. The so-called plan was deficient in, at least, two respects. First, there was no evidence that the plan was adopted with either sections 18206 through 18210 of the Revenue and Taxation Code or section 1244 of the Internal Revenue Code of 1954 in view. (See generally, Anderson v. United States, supra; Godart v. Commissioner, 425 F. 2d 633; Childs v. Commissioner, 408 F. 2d 531; Comms v. issioner, 407 F. 2d 530; John H. Rickey, 54 T. C. 580, aff d, 502 F. 2d 748. ) Secondly, an offering period for the stock "ending not later than two years after the date such plan was adopted" was not specified in the plan. (See generally, Rev. & Tax. Code, § 18208, subd. (a)(1); Warner v. Commissioner, 401 F. 2d 162; Eugene Coloman, T. C. Memo., March 28, 1974. )

Even if we were to assume that a satisfactory plan existed, appellants could not prevail. Whether the advances to MHR constituted loans or additional capital contributions, in neither case could they qualify for ordinary loss treatment as "section 18208 stock". Section 18208 specifically provides that only common stock may qualify as small business corporation stock. Thus, if the advances by Mrs. Rector are characterized as loans to the corporation, the resulting loss thereon cannot qualify for ordinary loss treatment as "section 18208 stock". (See Ray Franconi, T. C. Memo., April 7, 1965. ) On the other hand, if we characterize the advances as contributions to corporate capital, appellants are in no better position. For purposes of section 18208,. an increase in the basis of outstanding stock as a result of a

contribution to capital is not an issuance of stock. Any such contribution to capital shall be treated as an increase to the basis of stock other than "section 18208 stock". (Rev. & Tax. Code, § 18208, subd. (a); Cal. Admin. Code, tit. 18, reg. 18206-18210(c), subd. (2); see also H. R.. Rep. No. 2198, 85th Cong., 1st Sess. [ 1959-2 Cum. Bull. ,709, at 714]. )

Appellants maintain that in incorporating MHR under subchapter S of the Internal Revenue Code of 1954 they did have a plan and they did, in spirit, qualify the corporation as a California "small business corporation". This argument has been specifically rejected by the United States Tax Court. (Eugene Coloman, supra. ) In Coloman the court held that an attempt to obtain subchapter S benefits does not evidence an intent to achieve. benefits under the federal counterpart to sections 18206 through 18210 of the Revenue and Taxation Code.

Appellants also request that the interest be waived. W e have held, on numerous occasions, that the assessment of interest under section 18688 of the Revenue and Taxation Code is mandatory. and cannot be waived. (See, e. g. , Appeal of Thomas P. E. and Barbara Rothchild, Cal. St. Bd. of Equal., March 27, 1973; Appeal of Albert A. Ellis, Jr. , Cal. St. Bd. of Equal. , Nov. 14, 1972. )

**In accordance with the views set out above, it is our conclusion that respondent's action in this matter must be sustained.**

## ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Robert W. and Margaret H. Rector

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 Robert W. and Margaret H. Rector against a proposed assessment of additional personal income tax in the amount of $971.09 for the year 1968, be and the same is hereby sustained.,

Done at Sacramento, California, this 3rd day of June, 1975, by the State Board of Equalization.

John W. Lynch, Chairman

William M. Bennett, Member

George R. Reilly, Member

Robert E. Collier, Member

_____, Member

ATTEST: W. W. Dunlop Secretary