BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DUDLEY A. AND SHERRILL M. SMITH)

Appearances:

For Appellants: Arnold H. Fink
Attorney at Law

For Respondent: David M. Hinman
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 Dudley A. and Sherrill M. Smith against proposed assessments of additional personal income tax in the amounts of $10,874.71 and $421.92 for the years 1964 and 1965, respectively.

Appeal of Dudley A. and Sherrill M. Smith

Appellants, husband and wife, filed joint federal and California personal income tax returns for the years 1964 and 1965 wherein they claimed the following deductions:

	Year	Amount
Partnership Losses	1964	$129,098
	1965	6,021
Interest Expense	1964	$ 13,430
Bad Debt	1965	$ 15,470

The items listed above represent loss or expense allegedly incurred by Dudley A. Smith (hereinafter referred to as appellant) in connection with his business activities as a real estate developer. Respondent disallowed the deductions on the basis of corresponding action taken by the Internal Revenue Service.

Deficiency assessments issued by respondent on the basis of corresponding 'federal action are presumed to be correct, and the burden is upon the taxpayer to prove they are erroneous. (Appeal of William G., Jr., and Mary D. Wilt, Cal. St. Bd. of Equal., March 8, 1976; Appeal of Paritem and Janie Poonian, Cal. St. Bd. of Equal., Jan. 4, 1972.) In the instant appeal, the record consists solely of the written briefs submitted on behalf of the respective parties. Respondent's assessments were issued without the benefit of an independent field investigation conducted by its auditors. Appellants, on the other hand, have expressly rejected respondent's' continuing offer to conduct such an audit. Furthermore, appellants have failed to present any tangible evidence in support of the claimed deductions. After a careful review of the record on appeal, and for the specific reasons set forth below, it is our opinion that appellants have failed to carry their burden of establishing impropriety or error in respondent's action.

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Partnershin Losses

For several years preceding 1965, appellant and George Bjorklund were equal partners in the partnership Bjorklund and Smith. On its respective 1964 and 1965 federal returns, the partnership reported certain bad debt deductions for unreimbursed advances which it had made to or on behalf of the following entities:

	Year of Deduction	Amount
Panama Land Company	1964	$100,669
	1965	2,588
Main Land Company	1964	$ 11,540
	1965	9,455
Lassellette Homes, Inc.	19.64	$ 29,700
Village Estates	1964	$ 22,570
Village Sales	1964	$ 13,818
H. A. Albright	1964	$ 1,000
Rolf Properties Corporation	1964	$ 78,900

The first four of the above listed entities (hereinafter referred to individually as Panama, Main, Lassellette, and Village Estates, respectively, and collectively as the Smith-Bjorklund corporations) were organized by appellant and Bjorklund prior to 1960 for the purpose of developing and constructing residential housing projects. Initial capital investment in the Smith-Bjorklund corporations ranged from $1,000 to $5,000 and, with the exception of Panama, each of the corporations issued its stock to appellant and Bjorklund in approximately equal shares; Panama issued all of its stock to Bjorklund.

In the latter part of 1961, the Smith-Bjorklund corporations commenced development of a housing project at Lompoc, California. Main and Panama, the developer corporations, acquired land and arranged financing for the project, while Lassellette and Village Estates, the general contractor corporations, supervised home construction. The Smith-Bjorklund corporations also hired Village Sales, a corporation owned by H. A. Albright, to handle the home sales and loan processing aspects of the Lompoc housing project.

At various times during the period from 1961 to 1964, appellant and Bjorklund had funds transferred from their partnership to the Smith-Bjorklund corporations. The advances were made to enable the corporations to pay certain operating expenses incurred during the development and construction of the Lompoc housing project. The partnership also advanced funds directly to Village Sales and H. A. Albright, apparently as payment for services which Village Sales performed while employed by the Smith-Bjorklund corporations.

A decline in the Lompoc housing market in 1963 left the Smith-Bjorklund corporations with many unsold lots and houses. Early in 1964, the corporations were forced to forfeit their respective interests in the unsold lots and houses in satisfaction of loan obligations which the corporations had incurred in connection with the initial financing of the housing project. As previously indicated, the Bjorklund and Smith partnership reported the unrepaid portions of its advances to or .on behalf of the Smith-Bjorklund corporations as bad debts on its 1964 and 1965 federal returns.,

For several years prior to 1.964, Rolf Properties Corporation (hereinafter referred to as Rolf) owned and operated a motel in Lompoc. During those years appellant and Bjorklund, each of whom owned 25 percent of the outstanding stock of Rolf, transferred funds from their partnership to Rolf. The advances were made to enable Rolf to pay various expenses incurred in connection with the motel operation, Thereafter, Rolf ceased operation of the motel, and the partnership reported the advances to Rolf as bad debts on its 1964 federal return.

The partnership losses claimed by appellants on their 1964 and 1965 personal returns represent appellant's distributive share of the losses allegedly incurred by the Bjorklund and Smith partnership as a result of the above described bad debts. It is appellants' position that the partnership's advances to Rolf and to or on behalf of the Smith-Bjorklund corporations represent loans made pursuant to a valid debtor-creditor relationship. Respondent, on the other hand, contends that the advances represent capital investment, not bona fide indebtedness, and that the corresponding partnership losses must therefore be disallowed.

The determination of whether advances to a corporation represent loans or capital investment depends upon the particular facts of each case. [Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959), cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030] (1959); Foresun, Inc., 41 T.C. 706, 714-716 (1964).] There is no comprehensive rule by which the question may be decided in all cases, and it would serve little purpose to compare the myriad details that distinguish the cases cited by appellants and respondent in support of their respective positions. (See generally, Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal (1971) 26 Tax L. Rev. 369.)

Debt, as distinguished from capital investment, may be defined for tax purposes as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage of interest payable regardless of the debtor's income or lack thereof." {Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957).) With respect to the instant appeal, the record indicates that the advances in question were not evidenced by instruments of indebtedness, the advances were unsecured, fixed maturity dates for repayment of the purported loans were not established, and no interest was charged on the alleged indebtedness. Furthermore, the partnership did not establish a definite schedule for repayment of the advances, and it appears that full repayment of the alleged indebtedness was reasonably expected by the partnership only upon the ultimate success of the particular business ventures which the "debtor"

corporations had undertaken.. In- this regard, we note that appellant and Bjorklund, as principal or coatrolling shareholders of each of the "debtor" corporations, apparently had complete discretion as to whether and when the advances would be repaid. Finally, the advances were used primarily for the payment of operating expenses incurred by the "debtor" corporations during the normal course of their respective businesses. Under the circumstances, and absent persuasive evidence to the contrary, it is our opinion that the advances in question constituted working capital which appellant and Bjorklund contributed to Rolf and the Smith-Bjorklund corporations in order to protect their initial investments in those corporations: the advances were capital investments, not loans. (See Fin Hay Realty Co. v. United 'States, 398 F.2d 694 (3d Cir. 1968); Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 19621; Motel Corp., 54 T.C. 1433,1436-1439 (1970); Burr Oaks Corp., 43 T.C. 635, 647-648 (1965), aff'd, 365 F.2d 24 (7th Cir. 19661, cert. denied, 385 U.S. 1007 [17 L. Ed. 2d 545] (1967); Lewis L. Culley, 29 T.C. 1076, 1087-1089 (1958); Appeal of Armored Transport, Inc., Cal. St. Bd. of Equal., Feb. 2, 1976.1

In light of our determination regarding the nature of the partnership advances, we must sustain respondent's action in disallowing the partnership losses claimed by appellants on their 1964 and 1965 returns.

Interest Expense

The interest expense deduction claimed by appellants on their 1964 federal and state returns apparently represents interest allegedly owed and paid by appellant to George Bjorklund. Respondent disallowed the deduction on the basis of information contained in a federal audit report which indicated that appellant did not pay the interest in the year claimed.

Appellants have offered no evidence to show either the nature and amount of the indebtedness allegedly owed to Bjorklund in 1964 or that interest on such indebtedness was in fact paid in the year claimed. Consequently, we have no alternative but to sustain respondent's action in disallowing the interest expense deduction.

Bad Debt

On their 1965 federal and state returns, appellants claimed a bad debt deduction for certain unrepaid advances made by appellant to or on behalf of the Smith-Bjorklund corporations. Appellants allege that the advances represent loans made pursuant to a valid debtor-creditor relationship.

The record on appeal does not indicate the amount or date of each of the advances in question. However, the record does indicate that the advances were used for the payment of expenses incurred by the Smith-Bjorklund corporations in connection with the Lompoc housing project. Furthermore, as was the case with the previously described partnership advances, appellant's advances to or on behalf of the Smith-Bjorklund corporations were not evidenced by any formal indicia of indebtedness. Thus, on the basis of our conclusion regarding the nature of the partnership advances, it is our opinion that appellant's personal advances also constituted capital investment. Accordingly, since appellant did not establish that the advances constituted bona fide indebtedness, we must sustain respondent's action in disallowing the bad debt deduction.

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,

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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 Dudley A. and Sherrill M. Smith against proposed, assessments of additional personal income tax in the amounts of $10,874.71 and $421.92 for the years 1964 and 1965, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of December, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Executive Secretary