BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JAMES C. AND ANTOINETTE GLASER)

For Appellants: Richard A. Falge
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

James C. Stewart
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 James C. and Antoinette Glaser against a proposed assessment of additional personal income tax in the amount of $986.50 for the year 1972.

The issue is whether a shareholder's guarantee of a loan to his controlled corporation, and the subsequent discharge of his obligation as guarantor by partially repaying the loan, constituted a loss from a business or a nonbusiness bad debt.

Appellant James C. Glaser was employed by the Coca-Cola Bottling Company of Salinas (hereinafter referred to as Bottling) for some years prior to 1965. His father was the majority shareholder and operating manager of Bottling. Appellant worked as a route manager distributing soft drinks to retail outlets in the Salinas-Monterey area for an annual salary of $11,000 to $12,000.

In 1965 appellant decided to go into business for himself. He believed his experience distributing soft drinks would prove useful in a vending machine operation, and therefore made plans to set up food, snack and beverage dispensing units at various sites around Monterey and Salinas. Appellant began this business as a sole proprietor, but soon took in an associate and incorporated under the name Brew A Cup Coffee Service, Inc. (hereinafter referred to as Service or as the corporation.) While the record does not reveal the respective ownership interests of appellant and his associate, it appears that appellant was the controlling shareholder.

Appellant initially invested about $10,000 in Service, but this proved insufficient to cover all the start-up costs. He therefore negotiated bank loans of about $20,000 for the purchase of fifty coffee and hot chocolate machines. These loans were made directly to the corporation but were personally guaranteed by appellant.

Service was in business for approximately one year. Appellant worked for the corporation on a part-time basis, three to five nights a week and Saturdays, but did not receive any salary for this work. In order to support his rather large family, therefore, appellant had to keep his old job with Bottling. His salary from Bottling was apparently his only significant source of income during this period., After Service ceased operations in 1966, appellant stayed on at Bottling until 1969 when he found employment as a real estate salesman.

Service was bankrupt when it went out of business. Its vending machines were therefore seized and sold at a public auction, but the proceeds of the auction

were not sufficient to pay off the above mentioned bank loans. The bank accordingly filed suit to enforce appellant's guarantee. Ultimately, in December 1972, appellant paid the bank $10,751.56 plus interest in full satisfaction of his obligation as guarantor.

The parties to this appeal agree that the payment appellant made as guarantor was deductible in 1972 as a bad debt. Appellant contends that it was a business bad debt deductible in full from ordinary income. Respondent, on the other hand, contends that it was a nonbusiness bad debt deductible only as a short term capital loss.

Loans and guarantees are treated identically for purposes of the bad debt deduction. (Putnam v. Commissioner, 352 U.S. 82 [1 L. Ed. 2d 144] (1956).) They are nonbusiness debts unless they are created or acquired in connection with the taxpayer's trade or business; or unless they become worthless and result in a loss incurred in the taxpayer's trade or business. (Rev. & Tax. Code, § 17207, subd. (d)(2).) Respondent's regulations indicate that the relation between the loan or guarantee and the taxpayer's trade or business must be a "proximate" one. (Cal. Admin. Code, tit. 18, reg. 17207(e), subd. 2(B).)

Generally loans by a controlling shareholder to his closely held corporation give rise to nonbusiness debts. (Kelly . Patterson, 331 F.2d 753, 755 (5th Cir. 1964).) This is true even where the shareholder devotes his time and energy to the corporation's affairs, because "investing is not a trade or business and the return to the [shareholder], though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." (Whipple v. Commissioner, 373 U.S. 193, 202 [10 L. Ed. 2d 288] (1963).) An exception is recognized in cases where the shareholder is employed by the corporation under circumstances which indicate that the employment is itself a trade or business, if the loan was "proximately related" to that trade or business. (Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969).) Such a relationship exists when the shareholder's trade or business as employee, rather than his status as investor, is the "dominant motivation" for making the loan. (United States v. Generes, 405 U.S. 93 [31 L. Ed. 2d 621 (1972).)

Appellant contends that he was employed by Service and that this employment constituted a trade or business. Although he earned no wages from the

corporation, he claims that he expected to earn a salary of $14,000 per year once the business became established, and that he guaranteed Service's loans in order to protect his employment. For purposes of this appeal we will assume, without deciding, that the work appellant performed for Service was a trade or business. The question presented therefore resolves to the following: When appellant guaranteed Service's loans, was his dominant motivation to secure continued employment, or was it to protect and enhance his investment in the corporation? This is a question of fact on which appellant bears the burden of proof. (Putoma Corp., 66 T.C. 652 (1976).)

The evidence in this case indicates, for the most part, that the guarantee was motivated primarily by investment considerations. On brief, appellant admits that he negotiated the loans in "an effort to establish this business," and negotiation of loans to cover start-up costs is typically associated with the activities of an investor. (Cf. Ray Franconi, ¶ 65,087 P-H Memo. T.C. (1965).) Moreover, the fact that appellant received no salary from Service reduces the likelihood that continued employment was the dominant motivation behind the guarantee, even though he may have expected to receive a salary in the future, As the Tax Court said in Putoma Corp., supra:

> While [taxpayer] might have had the expectation of future salary payments, a Poan motivated by one's status as an employee seems more plausible where its objective is to protect a present salary, rather than promote a future one. Putting funds at risk under such circumstances 'is more characteristic of the investor. (66 T.C. at 674, footnote omitted.)

Appellant argues, however, that his entire investment in Service was employment related. He alleges that he set up the corporation solely as a means of creating future employment for himself because he was dissatisfied with his position at Bottling. It is true that similar arguments have been accepted by the Tax Court in cases where the taxpayer was unemployable because of age, ill health or personality problems. (See, e.g., Isidor Jaffee, ¶ 67,215 P-H Memo. T.C. (1967); Estate of Kent Avery, ¶ 69,064 P-H Memo. T.C. (1969).) No such circumstances are present here, however., Appellant was certainly not unemployable, since he continued to work for Bottling until 1969 and then found employment as a

real estate salesman. In short, appellant did not have to guarantee the loans to Service in order to save his only possible job. (See Alvis Kaczmarek, ¶ 75,358 P-H Memo. T.C. (1975).) The mere allesation that he was dissatisfied with his position at Bottling, without more, does not prove that independent employment rather than the financial incentive of equity ownership was the motivating force behind appellant's actions. (See Niblock v. Commissioner, supra.

Appellant has failed to prove that his guarantee of Service's loans was proximately related to his trade or business, and we therefore sustain respondent's action. The cases cited by appellant (William G. Young, ¶ 74,076 P-H Memo. T.C. (1974); Charles J. Haslam, ¶ 74,097 P-H Memo. T.C. (1974); Brown v. United States, 34 Am. Fed. Tax R. 2d 74-5619 (D. Vt. 1974)) contain nothing inconsistent with this decision.

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 James C. and Antoinette Glaser against a proposed assessment of additional personal income tax in the amount of $986.50 for the year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of September, 1977, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member