



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the **Matter** of the Appeals of) Nos. **82A-445** and **82A-444-KP**
BRUCE A. AND SUSAN E. CARVER,)
AND RANDALL B. AND)
SUZETTE CARVER)

For Appellants: David R. **Hickey**
Certified Public Accountant

For Respondent: Michael R. Kelly
Counsel

O P I N I O N

18593^{1/} These appeals are made pursuant to section of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protest of Bruce A. and Susan E. Carver against a proposed assessment of additional personal income tax in the amount of **\$3,400.00** for the year 1979, and on the protest of Randall B. and Suzette Carver against a proposed assessment of additional personal income tax in the amount of \$417.79 for the year 1979.

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

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The issue presented by these appeals is whether cash disbursements made during the year at issue to appellants by their family-owned corporation were distributions of corporate earnings or bona fide loans.

Appellants Bruce A. Carver and Randall B. Carver are brothers. As their appeals involve similar facts involving the same issue, their appeals have been consolidated. As Susan E. Carver and Suzette Carver have been included in these appeals solely because they filed joint tax returns with their respective husbands, the two brothers will be referred to as "appellants."

Appellants are officers and shareholders of the Carver Corporation. Each **brother** owns one-third of the outstanding shares of their closely held corporation. The other one-third of the shares is held by their father.

In early 1979, appellants and their father' began to take cash advances from their corporation in a form they referred to as "unsecured loans." By June 30, 1979, Bruce Carver had been advanced \$51,000, Randall Carver received \$7,500, and their father, Arthur Carver, received \$35,000. The brothers also benefited from "**work done**" by the corporation in the following amounts: Bruce **Carver**, \$596; and Randall Carver, \$3,797.

On June 30, 1979, \$58,500 of these advances were forgiven by the corporation in the form of "bonuses" in the following amounts: Bruce Carver, \$16,000; Randall Carver, \$7,500; and Arthur Carver, \$35,000. On July 1, 1979, notes were signed by appellants for the balance of the amount appellants owed to the corporation. The notes were payable on demand without any fixed repayment schedule and specified an interest rate at "the minimum legal rate," which the parties interpreted to mean 0 percent interest. The balance of the amounts owed by the brothers as shareholders was entered in the corporate books as "notes Receivable - Officer's Account."

Respondent audited the above transactions and determined that the advances were actually constructive dividends. Appropriate assessments were issued and appellants protested. Within a week after the protest hearing, the loan balances were repaid. Despite the repayments to the corporation, respondent affirmed its assessments. These appeals followed.

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Whether withdrawals from a corporation by a stockholder represent loans or taxable dividends depends upon all of the facts and circumstances surrounding the transactions between the shareholder and the corporation. (Wiese v. Commissioner, 35 B.T.A. 701 (1937), affd., 93 F.2d 921 (8th Cir. 1938), cert. den., 304 U.S. 562 [82 L.Ed. 1529], reh'g. den., 304 U.S. 589 [82 L.Ed. 1549] (1938); Roschuni v. Commissioner, 29 T.C. 1193 (1958), affd., 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 1021] (1960).) A determination that a withdrawal constitutes a loan depends upon the existence of an intent at the time the withdrawal was made that it should be paid back. (Atlanta Biltmore Hotel Corp. v. Commissioner, ¶ 63,255 T.C.M. (P-H) (1963), affd., 349 F.2d 677 (5th Cir. 1965); Clark v. Commissioner, 266 F.2d 698 (9th Cir. 1959).) The crucial concept in finding a constructive dividend is whether the corporation conferred an economic benefit on the stockholder without expectation of repayment. (Appeal of Milton K. and Irene T. Harwood, Cal. St. Bd. of Equal., June 30, 1980.)

Because of the special relationship enjoyed by related parties, family control of a corporation invites careful examination of transactions between shareholders and the corporation. (Baird v. Commissioner, 25 T.C. 387 (1955); Meyer v. Commissioner, 45 B.T.A. 228 (1941).) Accordingly, the burden of proving that the withdrawal of funds from their wholly owned corporation was, in fact, a series of loans, and not taxable dividends, rests upon appellants. (Appeal of Richard M. and Beverly Bertolucci, Cal. St. Bd. of Equal., May 4, 1976; Appeal of Gordon A. and Zelda Rogers, Cal. St. Bd. of Equal., May 7, 1968.)

In support of their contention that the advances made to them constituted loans, appellants stress several factors. As outlined below, we do not find these factors persuasive.

The first factor upon which appellants rely is the treatment of the transactions on the books of the corporation as loans and accounts receivable. Appellants argue that this treatment, coupled with the executed notes, is sufficient documentation that the disbursements were originally intended as loans. Appellants are incorrect in this conclusion. In the Appeal of Albert R. and Belle Bercovich, decided by this board on March 25, 1968, which also involved a family-owned corporation, we stated that the treatment of withdrawals as loans on the corporate books is not conclusive evidence of their ultimate

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character, but "merely one factor to be considered within the total factual picture." Further, the mere execution of a note signifying indebtedness is even less significant when the note, as here, is a demand instrument with no fixed schedule for repayment and effectively does not impose interest. (See Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971); Appeal of William R. and May R. Horn, Cal. St. Bd. of Equal., May 19, 1981.) We also note that none of the note papers were signed until the full amounts of the 1979 "loans" were in the hands of the appellants and the bonuses had been declared, not at the time the original advances were obtained.

Limited weight attaches as well to the payments appellants made to the corporation supposedly in repayment of the "loans." First, the only repayments made prior to respondent's action were in the form of bonuses, simple forgivenesses of debt rather than an actual payment. Forgiveness of loans by means of a bonus has been criticized by several decisions and is accorded little weight. (See, e.g., Cruser v. Commissioner, ¶ 61,060 T.C.M. (P-H) (1961); Appeal of William R. and May R. Horn, supra.) Second, the majority of the actual repayment efforts were made only after respondent had notified appellants of its determination and appellants had filed their protests. Payments made after the start of an inquiry by respondent go far to weaken the "repayments" as persuasive evidence of a pre-existing intention to repay the amounts withdrawn. (Atlantic Biltmore Hotel Corp. v. Commissioner, 349 F.2d 677 (5th Cir. 1965); Appeal of William R. and May R. Horn, supra.)

The Bercovich decision, discussed above, also addresses another factor upon which appellants have placed reliance; namely, the fact that the disbursements were not in proportion to stock ownership. Appellants contend that this factor should weigh heavily in their favor as an indication that the disbursements were loans. Our response to this argument was clearly enunciated in Bercovich, supra, wherein we stated, "[n]either is it decisive of the existence of loans that the withdrawals by appellant and his two brothers from the corporation were not in proportion to their stockholdings, or that the brothers agreed to the larger withdrawals made by appellant." (See also Appeals of George K. and Ann H. Nagano, et al., Cal. St. Bd. of Equal., Dec. 10, 1981.)

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In explanation of the lack of payments and lack of collateral for the "loans" to Randall Carver, appellants state that the corporation knew Mr. Carver's salary and that the amounts borrowed were not significantly large in comparison with that salary. Therefore, this evidences the fact that the withdrawals were loans.

We do not find this argument persuasive because no matter how small the advances may have been, the fact remains that neither Randall Carver nor his brother made any attempt to secure their loans for the benefit of the corporation or effect repayment during the year at issue. (See Tollefsen v. Commissioner, 52 T.C. 671 (1969); Appeal of William R. and May R. Horn, supra.)

In an attempt to justify the larger advances to Bruce Carver, appellants argue that because they had an independent business purpose for Bruce Carver, the improvement of his personal real estate, the advances were necessarily loans. We, however, are not concerned with the business significance of the advances to Bruce Carver. We are concerned with the business purpose of the "loans" to the corporation. (See Goldstein, et al. v. Commissioner, ¶ 84,062 T.C.M. (P-H) (1984).) Without any interest accruing for the corporation or any other corporate benefit evident, appellants have failed to provide us with any independent business reason why the corporation would advance the money to either brother.

Finally, appellants argue that there were not enough retained earnings' at the end of the corporation's fiscal year 1979 to support the constructive dividends claimed by respondent. In support of their position, appellants point out that the copy of fiscal 1979's tax return shows that as of June 30, 1979, the corporation's retained earnings were \$21,296. If this latter figure were accurate, and assuming there were no profits in fiscal 1979, appellants would be correct in saying that all advances from January 1, 1979, to June 30, 1979, could not be dividends because there would not have been enough retained earnings to declare dividends.

Respondent notes, however, that the corporation's fiscal 1980 tax return states that the retained earnings of the corporation as of July 1, 1979, were \$696,862. This figure is almost \$676,000 higher than was stated on the fiscal 1979 tax return. Both figures regarding the retained earnings of fiscal 1979 should be identical. If the latter figure is correct, there were

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ample retained earnings from which to declare dividends. We note that a taxpayer has the burden of proving the insufficiency of earnings and profits to support the dividend claimed by respondent. (Appeal of Jack A. and Norma E. Dole, Cal. St. Bd. of Equal., Nov. 6, 1970.) Appellants have not attempted to explain the discrepancy in the retained earnings figures or to prove that the profits for fiscal 1979 were insufficient to declare the subject dividends. Accordingly, we must conclude that appellants have failed to prove that there was **an** insufficiency of earnings and profits of the Carver Corporation to support the dividends claimed by respondent.

After careful assessment of the record, we are of the opinion that appellants have not met their burden of proving that the **subject** advances were bona fide loans. Accordingly, respondent's action in this matter must be sustained.

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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 actions of the Franchise Tax Board on the protest of Bruce A. and Susan E. Carver against a proposed assessment of additional personal income tax in the amount of **\$3,400.00** for the year 1979, and on the protest of Randall B. and Suzette Carver against a proposed assessment of additional personal income tax in the amount of \$417.79 for the 1979, be and the same is, hereby sustained.

Done at Sacramento, California, this **4th** day of February , **1986**, by the State **Board** of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9