BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of CHARLES H. AND MARGARET N. KERSHAW AND JOHN R. AND LOIS E. KERSHAW	)	Nos. 84A-600 and 84A-601-KP

For Appellants: J. Wiley Jones
Attorney at Law

For Respondent: Bill S. Heir
Counsel

OPINION

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protest of Charles H. and Margaret N. Kershaw and against proposed assessments of additional personal income tax in the amounts of $21,371.20, $326.92, and $5,556.91 for the years 1975, 1976, and 1978, respectively, and on the protest of for John R. and Lois E. Kershaw against proposed assessments of additional personal income tax in the amounts of $21,839.48, $1,555.62, $195.57, and $5,097.33 for the years 1975, 1976, 1977, and 1978, respectively.

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

Appeals of Charles H. and Margaret N. Kershaw and John R. and Lois E. Kershaw

The issue presented by these appeals is whether payments appellants made pursuant to a series of bank loan guarantees are deductible as business bad debts during the years in question.

Although there are two separate appeals presented, the facts and issue on appeal are identical. Therefore, the appeals have been consolidated for purposes of decision. Appellants Charles Kershaw and John Kershaw are brothers. As Margaret Kershaw and Lois Kershaw are appellants solely because they filed joint tax returns with their respective husbands during the years at issue, hereinafter Charles and John Kershaw will be referred to as "appellants."

During the appeal years, appellants were the sole shareholders of a California commercial cattle feed lot operation called Kershaw & Sons, Inc. Each brother paid $50,000 for his one-half of the corporation's stock. Appellant John Kershaw was the president of the corporation, Charles Kershaw was the vice-president, and both were on the board of directors. Both men spent a majority of their time devoted to the corporation's business. Additionally, each brother owned one-half of the shares of a New Mexico cattle feed lot corporation called Kershaw's K Bar, Inc. Appellants were directors and officers of this corporation as well.

To feed and manage their own cattle, appellants formed, and were equal partners in, a general partnership called the Rockwood Cattle Company (Rockwood). Beginning in the early 1970's, the brothers organized a series of limited partnerships to purchase and feed-out cattle on the above-mentioned feed lots, thereby increasing the profits from those two corporations. Although there were a number of different limited partnerships, they were organized into two groups with each group having the same general partner.

To act as the general partner in one series of limited partnerships, appellants formed the Superior Cattle Company, a California corporation. The brothers were two of the four shareholders of the Superior Cattle Company, with each shareholder owning 25 percent of the outstanding shares of stock. This group of limited partnerships shall be referred to as "Superior." Kershaw & Sons acted as the general partner for the other group of limited partnerships called the K Bar Cattle Feeding Fund limited partnerships (K Bar).

All financing for the above-described businesses was obtained through the Bank of America. All loans made to the various businesses were personally guaranteed by appellants. Additionally, all loans to the Superior limited partnerships were guaranteed by Rockwood and all loans to the K Bar limited partnerships were guaranteed by Kershaw & Sons.

During the years in question, each brother's salary from Kershaw & Sons varied between $56,000 and $156,000 yearly and each brother collected a yearly "commission" from Kershaw's K Bar, Inc., of $12,000. There is no evidence that appellants received any compensation from the limited partnerships or Rockwood during that period. Prior to the appeal years, Kershaw's K Bar, Inc., Rockwood, and each of the limited partnerships all sustained heavy financial losses.

In December 1975, the brothers decided to pay their guarantee obligations and cure all delinquent loans of the above-described businesses by a consolidated loan of $2.2 million. As the consolidated loan was insufficient to satisfy all of the outstanding delinquent loans, the balance of the outstanding indebtedness was to be paid by the brothers from dividends declared by Kershaw & Sons.

The dividends and the consolidated loan were placed in a trust account from which the outstanding notes were paid off over a 10-day period beginning in late December 1975 and ending in January 1976. Appellants each deducted one-half of the amount paid in December on their 1975 personal income tax returns as a business bad debt loss. In 1976, the brothers began to make principal and interest payments on the consolidation loan. Appellants deducted their yearly totals of their respective halves of the loan payments as business bad debt losses on their respective 1976, 1977, and 1978 tax returns.

Upon review of appellants' returns for the appeal years, respondent disallowed any loss deduction for the payments relating to the Rockwood loans. On the other hand, respondent did allow deductions for the guarantee payments for the K Bar, Superior, and Kershaw's K Bar, Inc., loans but only as nonbusiness bad debts. Assessments were issued and this appeal followed.

On appeal, appellants take the position that all of the guarantees in question were based upon valid

loans to their business interests which created bad debt losses related to their trade or business. Respondent accepts appellants' argument that the guarantee payments for the loans to Kershaw's K Bar, Inc., and the Superior and K Bar limited partnerships were in satisfaction of legitimdte loans to the various business interests from which appellants could not reasonably expect repayment. The sole issue in these three instances then becomes whether the bad debts were related to appellants' trade or business.

Section 17207, subdivision (a)(1), stated that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." Business bad debt losses are fully deductible in the year sustained whereas nonbusiness bad debt losses are regarded as short-term capital losses which are allowed only to the extent of capital gains plus either taxable income or one thousand dollars ($1,000), whichever is less. (Rev. & Tax. Code, §§ 17207 and 18152.)

To determine the'character of a bad debt, we first consider section 17207, subdivision (d)(2), which defined a nonbusiness debt as a debt other than:

> (A) A debt created or acquired ... in connection with a trade or business of the taxpayer: or
>
> (B) A debt the loss-from the worthlessness of which is incurred in the taxpayer's trade or business.

The definition of trade or business in this context includes all means of gaining a livelihood by work. (Trent v. Commissioner, 291 F.2d 669 (2nd Cir. 1961).) In contrast, a taxpayer's status as a shareholder of a corporation is capital in nature because a shareholder's rewards are expectative and flow, not from personal effort, but from investment earnings and appreciation. (United States v. Generes, 405 U.S. 93, 103 [31 L.Ed.2d 62] (1972).) Therefore, while a shareholder who loans money to his corporation may not deduct any such loans which become worthless as a business bad debt, an employee who makes loans to his employer in order to secure his job can deduct the amount paid as a business bad debt when those loans become worthless. (Trent v. Commissioner, supra.) The determination of whether losses are business bad debts is a question of fact. (Smith v. Commissioner, 457 F.2d 797 (5th Cir. 1972);

Jaffee v. Commissioner, ¶ 67,215 T.C.M. (P-H) (1967).) "[I]n determining whether a bad debt has a 'proximate' relation to the taxpayer's trade or business ... and thus qualifies as a business bad debt, [the] proper measure is that of dominant motivation, ..." (United States v. Generes, supra, 405 U.S. at 103.) An employee-shareholder makrng a loan to his corporation usually acts with two motivations, the one to protect his investment and the other to protect his employment. The question is which of the taxpayer's motivations was the dominant, and not merely significant, reason for the loan. (United States v. Generes, supra.) "By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and however insignificant, from controlling the tax result at the taxpayer's convenience." (United States v. Generes, supra, 405 U.S. at 104.)

Appellants contend that the dominant motive for their personal guarantee and ultimate satisfaction of all of the loans was to protect their employment as executives of "the corporation."

We start by considering the loans to Kershaw's K Bar, Inc., which res'pondent treated as nonbusiness bad debts. In applying the *above* discussion to the guarantees of the loans we note that although appellants were officers of the corporation, it appears their only compensation was the $12,000 yearly "commission" each received. While we are unaware of either appellant's initial investment in Rershaw's K Bar, Inc., it is unlikely that a person would guarantee loans to a corporation of over $200,000, which represents after-tax income, to ensure such a small yearly, pre-tax "commission." Consequently, by weighing the objective facts presented, we must conclude that appellants' dominant motivation in guaranteeing the loans was not to protect their employment. Therefore, respondent's determination that the payments on the loans to Kershaw's K Bar, Inc., were nonbusiness bad debt losses will be upheld.

We differ with respondent in its analysis of the guarantees appellants provided for the K Bar limited partnerships which respondent treated as nonbusiness bad debts. Respondent argues that appellants have failed to prove that they received any salary from the limited partnerships and that appellants' employee roles in the limited partnerships, if any, were minimal. Therefore, respondent concludes, the dabts created by these loans are properly classified as nonbusiness bad debts.

The proper focus should not be upon appellants' employee roles in the limited partnerships but upon their employee roles in the general partner of the limited partnerships. While the K-Bar limited partnerships may not have been. producing any income for appellants, Kershaw & Sons paid appellants well. Appellants, through their corporate positions, received salaries during each of the appeal years that was at least equal to their initial investments in the corporation. Once the financial situation worsened, appellants needed to cure the delinquent loans to allow the business and their salaries to continue. Therefore, under the Generes rationale, we find that the dominant motive for appellants' guarantees of loans to these limited partnerships was to protect their employment in Kershaw & Sons. Accordingly, respondent's determination in regard to the loans to the K Bar limited partnerships must be reversed.

We next consider the loans to Superior which respondent treated as nonbusiness bad debts. We begin by noting that appellants give us nothing more than their assertions that they guaranteed more than $600,000 worth of loans for the purpose of protecting their employment in the Superior Cattle Company, the general partner of. Superior. .The.taxpayer bears the burden of proving that respondent's determination is erroneous and that he is entitled to the claimed deduction. (Appeal of James C. and Monablanche A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975.) Appellants' own unsupported assertion that they are entitled to a deduction is not sufficient to satisfy their burden of proof. (See Appeal of James C. and Monablanche A. Walshe, supra.) No facts are presented which show what positions they held, if any, or what salary or benefits they received for their services to the corporation. Therefore, there is no support for their argument that their guarantees were dependent upon, or even related to, their positions as employees of Superior Cattle Co. Accordingly, respondent's action allowing a nonbusiness bad debt deduction for appellants' satisfaction of the loans to the Superior Cattle Feeding limited partnerhips must be upheld.

Finally, respondent contends that appellants' satisfaction of the guarantees of loans to Rockwood did not create a bad debt in their hands. Rather, the payments of the partnership loans were contributions. to the partnership's capital under section 17915.

Whether an advancement of monies to a partnership is a contribution to the capital of-the partnership

or creates a valid debtor/creditor relationship is a question of fact. (Hambuechen v. Commissioner, 43 T.C. 90 (1964).) As respondent points out, if a true debt/guarantee situation-had been involved, the payment of the guarantees by appellants would have relieved the partnership of its debt, thereby, increasing the gross income to the partnership during the year of repayment. (Rev. & Tax. Code, § 17071, subd. (a)(12).) In other words, the discharge of indebtedness constituted income to the partnership which would have been properly allocable to the individual partners pursuant to section 17851.

In reality, Rockwood reported on its tax return that the guarantee payments were contributions to the partnership's capital which the partnership used to pay off its own debts. This treatment increased appellants' bases in Rockwood allowing the partnership to pass through to the brothers the losses generated by.the partnership's loan payments which they then deducted on their individual tax returns.

From the above, it is clear that appellants did not structure the loan payments as guarantee payments directly to the creditors from themselves as they now claim. Accordingly, we find that the monies used to pay the debts of Rockwood.were contributions to the partnership's capital. Respondent's action in so treating the transaction will be upheld.

For the above-stated reasons, respondent's action in this matter, as modified by this opinion, will. be sustained.

Appeals of Charles H. and Margaret N. Kershaw and John R. and Lois E. Kershaw

O R D E R

Pursuant to the views expressed in the opinion of the board on file in these proceedings, 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 Charles H. and Margaret N. Kershaw against proposed assessments of additional personal income tax in the amounts of **$21,371.20,** $326.92, and **$5,556.91** for the years 1975, 1976, and 1978, respectively, and on the protest of John R. and Lois E. Kershaw against proposed assessments of additional personal income tax in the amounts of **$21,839.48, $1,555.62,** $195.57, and **$5,097.33** ***for*** the years' 1975, 1976, 1977, and 1978, respectively, be and the same are hereby modified in accordance with this opinion. In all other respects, the actions of the Franchise Tax Board are 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.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For **Kenneth Cory, per Government Code section 7.9**