

BEFORE THE STATE **BOARD OF** EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ROBERT E. AND BETH B. HADADY) No. **84A-422-GO**

Appearances:

For Appellants: Robert E. Hadady,
in pro. per.

For Respondent: Grace Lawson
Counsel

O P I N I O N

This appeal is made pursuant to section **18593^{1/}** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert E. and Beth B. Hadady against proposed assessments of additional Personal income tax in the amounts of \$204.91, **\$1,482.80,** 'and **\$2,101.00** for the years 1978, 1979, and 1980.

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

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Robert E. Hadady is the sole shareholder and president of Hadady Publications, Inc. (hereinafter "corporation"), a firm which offers commodity investment advice through publications and seminars. In 1978, the corporation became interested in the use of a computer and concluded that a purchase, as opposed to a time sharing arrangement, was most appropriate for its needs. Appellants allege that since the corporation was not a good credit risk, they were required to personally guarantee any loans **involving the** purchase of such computer. Since they would be liable anyway, appellants decided to purchase the computer equipment themselves and rent such equipment back to the corporation. (Resp. Ex. B at f(2).)

Schedule C of appellants' personal income tax returns for the years at issue **included** depreciation, programming **and outside** expenses related to the computer equipment allegedly rented to the corporation. However, those same schedules apparently did not reflect regular rent paid to appellants by the corporation for the use of the computer equipment. Upon audit, respondent concluded that appellants failed to substantiate a lease arrangement with the corporation and that the subject arrangement was not for profit. (Resp. Ex. F.) Denial of appellants' protest led to this appeal.

It is well settled that respondent's determinations are presumed to be correct and that it is the taxpayer's burden to prove any error. (Appeal of Alan and Ellen Salke, Cal. St. Bd. of Equal., June 27, 1984; Appeal of Ambrose L. and Alice M. Gordos, Cal. St. Bd. of Equal., Mar. 31, 1982.) Initially, respondent determined that appellants had failed to provide any evidence indicating that they had leased the computer equipment to the corporation. (Resp. Ex. F; Resp. Oct. 23, 1985, letter.) However,, attached to a letter dated October 30, 1985, appellants submitted a lease agreement and supplement signed November 14, 1979, which indicates that commencing on January 1, 1980, and running for a period of seven consecutive years, the corporation was to rent the subject equipment paying Beth Hadady monthly payments **of \$1,110** and Robert Hadady monthly payments of \$1,480. **On the** option of the corporation, the payments to Robert Hadady could be deferred, but simple interest was to accrue at the rate of 10 percent. Documentation submitted indicates that three payments to Beth Hadady were not made in 1980 while all payments to Robert Hadady in 1980 were deferred by the corporation. By letter dated December 12, 1985, respondent argues that the above documents are

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"highly suspect" since they surfaced so late in the review process.

Notwithstanding this controversy with respect to the authenticity of the subject documents, we find them of limited value in this matter. First, the terms of the documents submitted indicate that the rental period covered was not to begin until January of 1980, while the period covered by this appeal includes 1978 and 1979 in addition to 1980. Accordingly, even assuming the authenticity of the subject lease, no evidence has been submitted with respect to the expenses associated with 1978 and 1979. Moreover, again assuming the authenticity of the documents submitted, for tax purposes a transaction between closely related parties demands special scrutiny to determine whether it has substance. (Appeal of Riltmore Homes, Inc., Cal. St. Bd. of Equal., Feb. 26, 1962.) If a transaction is not what it appears to be in form, it may be disregarded for tax purposes. (Appeal of Buyer Investment Co., Cal. St. Bd. of Equal., Dec. 29, 1958.) Thus, in 58th Street Plaza Theatre, Inc. v. Commissioner, 16 T.C. 469 (1951), the tax court refused to recognize a sublease by a family corporation to the wife of the principal stockholder and, accordingly, denied the family corporation any deduction for "rental payments" purportedly made to the wife. The tax court stated that it is unreasonable to believe that the taxpayer "would have entered into a sublease of this kind with any stranger or in an arm's length transaction. ... The sublease was obviously bad business for [the taxpayer] ." (58th Street Plaza Theatre, Inc. v. Commissioner, supra, 16 T.C. at 476.) Likewise, we find that the lease agreements submitted by appellants are clearly bad business for them and that they would not have entered into such a lease with a stranger in an arm's length transaction. The documents submitted indicate that the computers were purchased and, presumably, put into service by the corporation in May of 1979 (Resp. Ex. C), yet no formal written agreement was executed until November of 1979. **More-**over, those agreements themselves did not appear to be at arm's length. Rental payments were not to begin until January of 1980 and the payments to Robert Hadady were deferred indefinitely, clearly a preferential treatment of the corporation by appellants. In spite of these lenient terms, the corporation **was delinquent** in three monthly payments to Beth Hadady in 1980 and nine more payments in 1981 for a total delinquency of \$13,320. In addition, the lease provided that at its expiration, the corporation could buy the equipment for \$1,000, a nominal price which might indicate the agreement was, in fact, a

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disguised sale by appellants to the corporation and not a bona fide lease. Based upon this conclusion and the record outlined above, we find that appellants' purported rental arrangement with the corporation should not be recognized as a bona fide lease for tax purposes. Accordingly, respondent's action **must** be sustained. 2/

2/ Respondent's brief addresses the application of section 17233, which provides that if an individual's activity is "not engaged in for profit," only those deductions allowable regardless of a profit motive are allowed. While this opinion tracks the same ground and relies upon the same factors regarding the bona fide **nature of** the arrangement, due to this conclusion, discussion **of** section 17233's application here is not required.

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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 action of the Franchise Tax Board on the protest of Robert E. and Beth B. Hadady against proposed assessments of additional personal income tax in the amounts of \$204.91, **\$1,482.80**, and **\$2,101.00** for the years **1978**, 1979, and **1980, respectively**, and the same is hereby sustained.

Done at Sacramento, California, this 10th day of June , 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