BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
SAMUEL S. AND JANET R. VICK) No. 79A-131-VN, 81A-832

Appearances:

For Appellants: Samuel S. Vick in pro. per.

For Respondent: Karen D. Smith 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 Samuel S. and Janet R. Vick against proposed assessments of additional personal income tax in the amounts of $5,172.65 and $933.08 for the years 1976 and 1977, 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.

Appeal of Samuel S. and Janet R. Vick

The question presented for our decision is whether Samuel S. and Janet R. Vick, husband and wife, are entitled to bad debt deductions in the years claimed for advances made to their boat manufacturing company. Since Mrs. Vick is a party to this appeal only because she filed joint income tax returns with her husband, "appellant" shall refer to Samuel S. Vick for purposes of this opinion.

During the appeal years, appellant was president and the owner of 89 percent of the stock in Westsail Corporation (Westsail), a sailboat manufacturing company with facilities in Costa Mesa and Wrightsville, North Carolina. Appellant owned the industrial properties on which Westsail's production facilities were located and leased the parcels to the company. His annual salary from Westsail was $30,000, not including bonuses. Appellant's wife, moreover, was the sole shareholder of an advertising firm that derived 80 percent of its revenues marketing Westsail's products.

Westsail was started by appellant in 1971 with the idea of building high quality, cruising sailboats. Five years later, Westsail employed a work force of 300 persons and its sales had grown to $9 million per year. Yet, the company was, using appellant's words, always in an "uncomfortable financial position due to its method of financing production. Since its inception, Westsail had relied principally on customer purchase payments to pay for production expenses and the purchase of parts and materials. In addition, the company used trade creditor financing to purchase supplies rather than make immediate payments to suppliers to receive customary trade discounts. By September 1976, Westsail had serious financial problems. It had fallen behind in payments to trade creditors who in turn refused to deliver further parts and materials to the company until it had paid past due obligations. Consequently, production was disrupted and the company faced $3 million in back orders as well as a cash flow shortage. In order to keep receiving necessary materials and maintain production, Westsail entered into agreements with suppliers to repay its debts at progressively higher monthly installments. At the same time, realizing that the company required additional capital if it were to ever pay its debts and operate profitably, appellant began negotiations with Berry Oil Company, a Fresno oil producer, for the sale of $500,000 to $1 million in Westsail stock.

In November 1976, suppliers remained unpaid and would not deliver parts and materials unless **Westsail** paid for the shipments on delivery. Appellant thereupon advanced $75,000 to the company to permit production to continue until completion of the negotiations with Berry Oil Company. The advances were evidenced by unsecured promissory notes bearing interest at an annual rate of seven percent. Of these advances, $56,000 was due and payable on December 31, 1976, and $19,000 was due and payable on December 31, 1977.

In December 1976, Westsail's new controller allegedly conducted an inventory of new materials and work in progress. On preparation of the company's financial statements, the controller calculated that the value of supplies and incomplete boats had been previously overstated due to the underestimation of production costs. After making book adjustments to accurately reflect the cost of production, the controller determined that **Westsail** suffered a $1 million loss in 1976. When advised about the poor financial prospects for Westsail, Berry Oil Company thereupon terminated the discussions **for** the purchase of an interest in the sailboat company.

In January 1977, **Westsail** filed a federal chapter 11 bankruptcy petition seeking protection from creditors while it continued operations. Subsesquently, appellant was replaced as Westsail's president when new investors purchased a controlling interest in the company. In March 1978, the bankruptcy court authorized the sale of **Westsail** to a new company formed by a former **Westsail** employee. Under the terms of the sale, repayment of appellant's advances was contingent on the success of the new company and repayment by it of all other **Westsail** liabilities. In 1980, the successor company was liquidated and appellant never recovered his $75,000 in advances.

On his and his wife's joint returns for 1976 and 1977, appellant claimed bad debt deductions of $56,000 and $19,000, respectively, for the advances made to **Westsail** in 1976. On review, the Franchise Tax Board disallowed the deductions based on its determination that these claimed bad debts were not shown to have been worthless in the years in which deductions were taken by appellant. In this appeal, respondent now contends that the advances made to **Westsail were** more properly treated as contributions to capital and not losses.

Section 17207 allows as a deduction any debt which becomes worthless within the taxable year. This section is substantially similar to section 166 of the Internal Revenue Code. Federal precedent is, therefore, persuasive in the proper interpretation and application of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

In order for a debt to be deductible under section 17207, it must be a bona fide debt; that is, one that "arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Treas. Reg. § 1.166-1(c).) A deduction may not be taken for an advance which was made with no intention of enforcing payment (Hayes . Commissioner, 17 B.T.A. 86 (1929)) or where there was no reasonable expectation of repayment when it was made (Arrigoni v. Commissioner, 73 T.C. 792, 799 (1980).) In addition, the debt must have become worthless in the taxable year for which the deduction is claimed. (Messer Co. v. Commissioner, 5'7 T.C. 848, 861 (1972).)

A contribution to capital is not considered a debt for purposes of the bad debt deduction. (Treas. Reg. § 1.166-l(c).) When distinguishing debt from equity, the courts have relied on the presence of a number of criteria, including: (1)The formal indicia of debt, such as the presence of promissory notes or other documents showing indebtedness, the existence of a fixed maturity date, and the bookkeeping treatment of the transactions: (2) the efforts to enforce payment of principal and interest: (3) participation in management as a result of the advances: (4) the intent of the parties: (5) adequacy of capitalization in relation to debt: (6) identity of interest between creditor and stockholder: (7) the ability of the corporation to obtain loans from outside lending institutions; and (8) the risk of nonrepayment. (See Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3rd Cir. 1968).) However, no single criterion nor any series of criteria can provide a conclusive answer to whether advances are ioans. (See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 [90 L.Ed. 278] (1946).) These various factors are mereiy aids in answering the significant inquiry, whether the- funds were advanced with reasonable expectations of repayment regardless of the success of the business, or were invested.as risk capital subject to the fortunes of the corporate venture. (Gilbert v. Commissioner, ¶ 56,137 T.C.M. (P-E) (1956), 248 F.2d 399

(2nd Cir. 1957), on remand, ¶ 58,008 T.C.M. (P-H) (1958), affd., 262 F.2d 512 (2d Cir. 1959), cert. den., 359 U.S. 1002 [3 L.Ed.2d 1030] (1959); Fin Hay Realty Co. v. United States, supra, 398 F.2d at 697.) Whether advances to a corporation represent capital contributions or loans is thus a question of fact to be determined from all of the facts and circumstances with the taxpayer bearing the burden of proof. (Matthiessen v. Commissioner, 194 F.2d 659 (2nd Cir. 1952); Dunmire v. Commissioner, ¶ 81,372 T.C.M. (P-H) (1981).)

In support of his position that the payments were loans, appellant has contended that he made the advances as an employee of Westsail, not as a stockholder, in order to save his job. He further argues that, at the time of the payments, Westsail was believed to be a profitable business. Appellant states then that repayment, thus, did not depend on the success of the company since he expected to be repaid for the profits or from the funding provided by Berry Oil Company. It is his position that he did not realize that Westsail was unprofitable until the December 1976 inventory. We are not convinced by appellant's arguments.

First, appellant was the majority 89 percent shareholder as well as president of Westsail. His wife, moreover, operated an advertising agency which derived most of its revenues from business with Westsail. Under these circumstances, it is difficult to differentiate between appellant's interests as an employee and as a shareholder since he obviously had a vested interest in the continued survival and possible success of the company. Appellant adds that he had but an insignificant investment in the company whose common stock is revealed to have been valued at $15,000. However, this argument merely serves to undercut appellant's position that the advances were loans since it is well settled that inadequate or thin capitalization indicates that advances may well be further capitalization instead of losses. (Jewell Ridge Coal Corporation v. Commissioner, 318 F.2d 695, 699 (4th Cir. (1963).)

Second, the record does not support appellant's stated belief that Westsail was a profitable enterprise at the time of the advances. In September 1976, prior to the time the advances were made, suppliers were refusing to deliver parts and materials to Westsail due to nonpayment of accounts, resulting in the disruption of production. The company had $3 million in back orders for its boats that it could not meet due to the lack of funds and supplies and was required to enter into special payment plans with the suppliers. In addition, Westsail did not have sufficient funds in its bank accounts to cover its drafts. This is hardly a portrait of a solvent corporation. Indeed, appellant has admitted that Westsail had "stretched [its capital] to its limits" relying on trade suppliers to finance production and "needed a big infusion of capital to pay existing liabilities and make its operation profitable. Appellant was aware of the poor financial condition of Westsail when he made the advances and should not have been surprised by the results of the analysis performed by his controller at the end of the year. Advances to a corporation which is not profitable and needs the advances to meet operating expenses indicate an intent to contribute to capital. (Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd of Equal., Feb. 18, 1970.)

Third, appellant has failed to prove that he reasonably believed repayment of his advances was possible without regard to the future success of Westsail. While appellant has suggested that the company had an established history of profitability, the record shows that this was not the case at all. Moreover, the so-called funding from Berry Oil Company was contingent on that corporation agreeing to buy stock in Westsail. Any expectation of repayment from that source was unreasonable since the parties at the time of the advances had yet to complete the sale of stock. As it turned out, the negotiations were terminated and Westsail never received the capital that it needed. Since repayment of the advances in this appeal should have been reasonably expected only through the future success and earnings of the company, the advances have the earmarks of contributions of capital rather than bona fide loans. (See Diamond Bros. Co. v. Commissioner, 322 F.2d 725 (3rd Cir. 1963).)

. Based on the foregoing, we conclude that the existence of any formal indicia of indebtedness in this appeal is not sufficient to overcome the many characteristics of equity surrounding the advances. Because we find the advances to be capital contributions, it is not necessary to discuss the question of whether the advances become worthless during the years in question. Respondent's action will be sustained.

Appeal of Samuel S. and Janet R. Vick

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 Samuel S. and Janet R. Vick against proposed assessments of additional personal income tax in the amounts of $5,172.65 and $933.08 for the years 1976 and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of August , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett and Mr. Carpenter present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

________________, Member

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA'

In the Matter of the Appeal of)
) No. 79A-131 and 81A-812-VN
SAMUEL S. and JANET R. VICK)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed September 14, 1987, by Samuel S. and Janet R. Vick for rehearing of their appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby denied and that our order of August 18, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 3th day of December, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter, and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

Anne Baker*, Member

__________, Member

*For Gray Davis, per Government Code section 7.9