

123.82
133.80
119.66
128.61
135.75
141.59
123.70
117.58
146.25
130.43
125.04

4/30/56
3/31/56
6/30/56 140.59
5/31/56 133.01
6/30/56 140.40
6/30/56 143.50

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<u>APPELLANT</u>	<u>TAXABLE YEAR</u>	<u>AMOUNT</u>
Lark Construction Co.	5/31/56	132.07
Malinda Construction Co.	6/30/56	138.75
Maxey Construction Co.	4/30/56	127.91
Maynew Construction Co.	6/30/56	135.43
Montepar Construction Co.	6/30/56	138.05
Micro Construction Co.	5/31/56	132.29
Nedra Construction Co.	5/31/56	133.58
Oriol Construction Co.	4/30/56	127.74
Palamino Construction Co.	6/30/56	137.77
Rockport Construction Co,	6/30/56	143.76
Target Construction Co.	6/30/56	142.25
Taurus Construction Co.	5/31/56	134.64
Walt Construction Co.	5/31/56	131.99
Wildbre Construction Co.	6/30/56	139.09

The forty corporations involved in these appeals were formed by two individuals, Mark Boyar and G. Harry Rothberg, for the purpose of constructing and selling residential units on three adjoining tracts of land, comprising approximately 1,000 lots. Each corporation was financed and conducted its operations in the same manner. Due to the factual similarities, only the specific facts regarding Argo Construction Co. were set forth by the parties. Our decision in each appeal is made on the basis of those facts.

Argo was incorporated on September 14, 1954. Mark Boyar and G. Harry Rothberg each paid Argo \$375 and each received 50% of Argo's capital stock in return.

On November 23, 1954, Argo received \$6,000 from a lending institution and gave its promissory note payable in one year with 3% interest. In a separate agreement, Argo also assigned to the lending agency the first \$2,000 of net profits from its operations.

One week later, Argo purchased certain land from Boyar for \$51,300, which was approximately the cost of the land to Boyar. Argo paid \$5,485 down, and gave a note for the balance payable on or before June 30, 1956, with 5% interest. Argo agreed to pay Boyar \$1,800 out of the sale proceeds of each house, before conveying title to the purchasers, until the balance owing was paid in full.

On December 16, 1954, the Irving Trust Company recorded a deed of trust as security for a construction loan to Argo in the amount of \$248,037.

At the request of the lender, Boyar and Rothberg, on December 27, 1954, paid off the \$6,000 note, with the understanding that the same amount would again be loaned immediately after the close of the year. On January 3, 1955, Argo gave the lender

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a new note with the same terms as the original note, and Boyar and Rothberg received \$6,000 in cash from the lender.

On January 4, 1955, Argo borrowed \$2,500 from the Union Bank and Trust Company on a six-month promissory note bearing 5% interest.

Argo completed the construction and sale of its houses, paid all of the above obligations on or before their maturity dates and then dissolved on November 10, 1955,

In its final franchise tax return, Argo arrived at its net income figure by taking, among others, a deduction of \$2,017 as interest on the \$6,000 note and \$1,041.41 as interest on the debt to Boyar.

The Franchise Tax Board disallowed the deduction of these items on the ground that they arose from contributions to capital rather than debts and were in the nature of dividends. Thus, we must decide whether each of the two transactions gave rise to a valid debt.

The parties' formal designations of the transactions are not conclusive but must yield to facts which even indirectly give rise to inferences contradicting them. (Sam Schnitzer, 13 T.C. 43, aff'd, 183 F. 2d 70.) Whenever a corporation is "thinly capitalized" or has a high "debt-equity" ratio, that is, when it is financed with a nominal investment in its stock and a large amount of ostensible loans, the inference arises that part of the "loans" by the stockholders are in fact investments in capital. (Gilbert v. Commissioner, 248 F. 2d 399; Isidor Dobkin, 15 T. C. 31, aff'd, 192 F. 2d 392; R. M. Gunn, 25 T.C. 424, aff'd sub nom. Perrault v. Commissioner, 244 F. 2d 408, cert. denied 355 U.S. 830.)

At the time Argo received the \$6,000 in exchange for its note, operations had not commenced and total corporate assets did not exceed the \$750 received from Boyar and Rothberg as full payment for all of its shares of stock. It requires no expertness in financial matters to recognize that loans by a commercial lending institution to Argo and 39 other corporations similarly situated, solely on their own credit, in an aggregate amount of some \$240,000 would have constituted a departure from sound financial practices. The temporary elimination of these loans from the lender's books at year end and the payment of the balance owing at that time by Boyar and Rothberg, however, demonstrate that the lender did not rely on the credit of the corporations. Since the facts indicate an understanding that the lender would look primarily to Boyar and Rothberg for repayment the transactions, in substance, amounted to loans to the shareholders, who in turn

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advanced the funds to the corporations. (Putnam v. Commissioner, 352 U. S. 82, 93; Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 830, 835.) Since these advances were essential to the commencement of operations, the inference that they were contributions to capital is very compelling. (J. Terry Huffstutler, T.C. Memo., Dkt. No. 26046, Dec. 18, 1953.)

Considering all of the circumstances, it is our opinion that Argo discharged the obligation of its stockholders by paying the principal and interest on the loan and that the payment of the interest and a share of the profits constituted a non-deductible dividend to the stockholders.

Turning now to the transaction with Boyar, the point of "thin capitalization" or high "debt-equity" ratio loses some of its significance in view of our finding that the \$6,000 obtained from Beneficial was a contribution to capital. Of even greater import is the fact that the debt created by Boyar's transfer of his land was far out of proportion to the percentage of the stock which he held. This factor strongly suggests that the debt was what it purported to be. (Leach Corp., 30 T.C. 563.)

The chief case upon which the Franchise Tax Board relies, The Colony, Inc., 26 T.C. 30, aff'd on other grounds, 244 F. 2d 75, rev'd on other grounds, 357 U.S. 28, held that advances by stockholders were not loans even though the advances were not in proportion to the stockholdings. In that case, however, there was other evidence that the parties did not regard their advances as loans. The "notes" were, with a single exception, never paid, no attempt was made to enforce payment and the "notes" and stock were treated as parts of a single package.

Unlike the facts in the Colony case, Boyar's note was fully paid by the due date together with interest. There is no indication that because of the transfer of his land, Boyar was given increased control of Argo or a greater share of the profits, whether as salary or otherwise than as payment of his note with interest at a reasonable rate. Nor is there any indication that Rothberg was merely a straw man or conduit for Boyar. Having advanced far more than Rothberg, it is reasonable to assume that Boyar expected repayment as would any other creditor, with priority over Rothberg as a shareholder. So far as the record shows, the note to Boyar represented an actual indebtedness and the interest is therefore deductible.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of the following Appellants to proposed assessments of additional franchise tax in the amounts and for the taxable years indicated be modified by allowing as deductions the amounts paid to Mark Boyar as interest on the notes with respect to lands acquired from him. In all other respects the action of the Franchise Tax Board is sustained.

<u>APPELLANT</u>	<u>TAXABLE YEAR</u>	<u>AMOUNT</u>
Agate Construction Co.	5/31/56	\$ 129.92
Amestoy Construction Co.	6/30/56	145.29
Aragon Construction Co.	5/31/56	133.96
Argo Construction Co.	3/31/56	122.33
Argus Construction Co.	4/30/56	123.82
Aristo Construction Co.	5/31/56	133.80
Aztec Construction Co.	3/31/56	119.66
Barkley Construction Co.	4/30/56	128.61
Bergdor Construction Co.	6/30/56	135.75
Bosco Construction Co.	6/30/56	141.59
Bowen Construction Co.	4/30/56	123.70
Buster Construction Co.	3/31/56	117.58
Calistoga Construction Co.	6/30/56	146.25
Carmona Construction Co.	5/31/56	130.43
Clyde Construction Co.	4/30/56	125.04
Elco Construction Co.	4/30/56	122.98
Fanray Construction Co.	6/30/56	141.91
Frontnac Construction Co.	6/30/56	143.79
Garda Construction Co.	5/31/56	132.25
Garnet Construction Co,	5/31/56	132.09
Harglen Construction Co.	4/30/56	125.81
Harville Construction Co,	3/31/56	122.28
Havenhurst Construction Co.	6/30/56	140.59
Jaco Construction Co.	5/31/56	133.01
Junon Construction Co.	6/30/56	140.40
Lakeville Construction Co.	6/30/56	143.50
Lark Construction Co.	5/31/56	132.07
Malinda Construction Co.	6/30/56	138.75
Maxey Construction Co,	4/30/56	127.91
Maynew Construction Co.	6/30/56	135.43
Montepar Construction Co.	6/30/56	138.05
Micro Construction Co.	5/31/56	132.29
Nedra Construction Co.	5/31/56	133.58
Oriol Construction Co.	4/30/56	127.74

