BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
KIM LIGHTING& MANUFACTURING CO., INC.)

For Appellants William M. Hurst
Vice President and General Manager

For Respondent: Crawford H. Thomas
Chief Counsel

Gary Paul Kane
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Kim Lighting & Manufacturing Co., Inc., against a proposed assessment of'additional franchise tax in the amount of $1,076.18 for the income year ended August 31, 1962.

During the year in question appellant Kim Lighting & Manufacturing Co., Inc., did business only within California. On September 1, 1961, appellant created a wholly owned subsidiary, Eric Enterprises, Inc., hereafter referred to as Eric, for the purpose of developing manufacturing, and selling fiberglass fountains. Appellant provided Eric with capital of $5 000, and the subsidiary acquired an additional $10,000 through a bank loan. The two chief executives of appellant served in identical capacities for Eric, and the parent also loaned one full-time employee to the subsidiary. These three executives composed the board of directors of Eric.

During the year In question appellant advanced $26,693 to the subsidiary. Approximately one-half of this amount was furnished as cash, while the balance

took the form of payments for payroll, inventory, equipment, rent, tax, insurance, and miscellaneous expenses. These advances were recorded as loans on the general ledgers of both corporations; however notes or collateral were not given, interest was not charged, and repayment dates were not specified. During the same period the subsidiary transferred fountain products, worth $4,240, to the parent. In May of 1962 appellant began to doubt whether Eric would be successful, and in early August appellant decided to liquidate the subsidiary after its first year. At the end of August, Eric paid all of its debts and transferred its remaining assets, valued at $7,880, to the parent. While in existence the subsidiary did business only within California.

In reference to its operation of the subsidiary appellant claimed a bad debt deduction of $14,572, under section 24348 of the Revenue and Taxation Code, and a worthless stock deduction of $5,000, under section 24347 of the Revenue and Taxation Code, in its return for the year in question. Eric's return indicated a net loss of $18,888. The Franchise Tax Board determined that the advances to the subsidiary represented contributions to capital rather than loans, and consequently disallowed appellant* s claimed deductions. Whether this determination was correct is the primary issue of this case. Alternatively appellant now contends that Eric and appellant were engaged in a single unitary business during the year at issue and therefore their franchise tax should be computed accordingly. Whether this contention is correct is the second issue of this appeal.

The nature of shareholder advances to a corporation is a question of fact. (Diamond Bros, Co. v. Commissioner, 322 F.2d 725.) The basic inquiry is often formulated in terms of whether the funds were placed at the risk of the corporate venture, or whether there was reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, ,248 F.2d 399, on remand, T.C. Memo., Jan 23, 1959, aff d, 262 F.2d 512, cert. denied, 359 U.S.1002 [3 L. Ed. 2d 1030]; Appeal of George E. Newton, Cal, St. Bd. of Equal., May 12, 1964.) The. burden is on the taxpayer to establish that the advances were loans. (Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695.)

In the instant situation we do not think that appellant has adequately carried this burden. Eric was only in existence for one year. Yet Its initial capital plus. a bank loan of-twice that amount were not sufficient

for the subsidiary to meet its operating expenses. Eric evidently used almost all of the advances for this purpose. Thus it is apparent that the subsidiary was significantly undercapitalized. (Dodd v. Commissioner, 298 F.2d 570; Erard A. Matthiessen, 16 T.C. 781, aff'd, 194 F.2d 659; Appeal of George E. Newton, supra,) The advances were made without any of the usual formal indicia of indebtedness. No notes or collateral were given, no interest was charged and no fixed dates for repayment were set. (Arlington Park Jockey Club v. Sauber, 262 F.2d 902; Erard A. Matthiessen, supra; Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal., Nov. 6, 1967.) Also, appellant subordinated its claims to those of outside creditors. (Old Dominion Plywood Corp., T.C. Memo., June 20; 1966.) In view of the small amount of initial capital and Eric's eventual lack of success, it is doubtful that a prudent creditor would have advanced funds under similar circumstances. (Dodd v. Commissioner, supra.)

We must conclude that the funds advanced by appellant to Eric were placed at the risk of the subsidiary's, business success, and therefore represented contributions to capital. Consequently appellant is not entitled to a bad debt deduction with respect to these funds. Nor is appellant entitled to a worthless stock deduction in the instant situation. Section 24502 of the Revenue and Taxation Code applies here and provides that no gain or loss shall be recognized upon this type of complete liquidation of a subsidiary.

Appellant alternatively contends that Eric and it were engaged in a unitary business during the year at issue, and therefore the two corporations were required to submit a combined report which consolidates their respective net incomes or losses. However appellant and its subsidiary did business only within California during the year in question. In the recent Appeals of Pacific Coast Properties, Inc., et al., Cal. St. Bd. of Equal., decided November 20, 1968, we thoroughly considered and ruled against a similar contention. That holding controls the instant situation and therefore appellant's position must be rejected.

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 protest of Kim Lighting & Manufacturing Co., Inc., against a proposed assessment of additional franchise tax in the amount of $1,076.18 for the income year ended August 31, 1962, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of June, 1969, by the State Board of Equalization..

John W. Lynch, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary