

Appeal of Dave Gardner Cross Associates

Dave Gardner Cross Associates (hereinafter referred to as "appellant"), an architectural services corporation, is wholly owned by its president, Dave Gardner Cross. Mr. Cross was, during the year in issue, and is presently, also president of American Home Industries (hereinafter referred to as "AHI"). AHI, a corporation engaged in the modular home manufacturing industry, was incorporated in November 1969 and became publicly held in 1970. Prior to the transaction in issue, appellant and its president and sole shareholder, Mr. Cross, owned 550,000 shares of AHI's stock. After the subject advance, Mr. Cross continued to own, directly or indirectly through appellant, 440,000 shares (approximately 16%) of the stock in AHI.

In January 1972, AHI experienced serious cash flow **problems resulting** in a shortage of working capital to meet factory operating requirements. To alleviate this problem, Mr. Cross caused appellant to sell 110,000 shares of its stock in AHI to private investors and to lend the proceeds to AHI. The stock was sold for three dollars a share. A promissory note evidencing the loan was given to appellant on February 7, 1972. The sale of stock resulted in a \$342,959 taxable gain for appellant. Shortly thereafter, AHI experienced serious financial difficulties which culminated in its filing for reorganization under Chapter XI of the Bankruptcy Act on June 7, 1972. On its tax return for the income year ended May 31, 1972, appellant deducted, as a bad debt, the entire \$330,000 it advanced AHI on February 7, 1972.

The sole issue presented for determination is whether appellant is entitled to a bad debt deduction in the amount of \$330,000 for the income year ended May 31, 1972. Although the assessment includes a delinquent filing penalty, appellant has not disputed the **penalty** on appeal.

Respondent's primary contention is that appellant's advances to AHI **were** in reality contributions to AHI's capital rather than loans. That being so, respondent argues, the resulting losses cannot properly be characterized as bad debt losses. In the alternative, respondent contends that if the advance was in fact a loan, it did not become worthless during **the income year** in issue.

To support its contention that the **amount** advanced to AHI is deductible as a bad debt, appellant apparently relies upon section 24348 of the Revenue and

Appeal of Dave Gardner Cross Associates

Taxation Code. That section provides for the deduction of "debts which become worthless within the income year." Only a bona fide debt qualifies for purposes of that section; a contribution to capital does not constitute a debt. (Cal. Admin. Code, tit. 18, reg. 24348(d), subd. (3).) Consequently, the initial question presented for our determination is whether appellant's advance to AH1 constituted a bona fide loan, or whether it was actually a contribution to capital. The secondary issue of whether the advance became worthless during the year in issue arises only if it is determined that appellant's advance was a loan.

The determination of whether advances to a corporation represent loans or capital investment depends upon the particular facts of each case. (See Gilbert v. Commissioner, ¶ 56,137 P-H Memo. T.C. (1956), 248 F.2d 399 (2d Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958), affd., 262 F.2d 512, (2d Cir. 1959) cert. den., 359 U.S. 1002 [3 L.Ed.2d 10301 (1959).) Although the courts have stressed a number of factors which are to be considered in determining the nature of such advances, 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. (See Gilbert v. Commissioner, supra; Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.) Whether an advance to a corporation by a principal stockholder is a capital contribution or a loan deductible as a bad debt is a question of fact upon which the taxpayer has the burden of establishing the right to a deduction.. (White v. United States, 305 U.S. 281 [83 L.Ed. 172] (1938); Diamond Bros. Company v. Commissioner, 322 F.2d 725 (3d Cir. 1963).)

Debt, as distinguished from-capital investment, may be defined for tax purposes as "an unqualified obligation to pay a sum certain at a **reasonably close** fixed maturity date, along with a fixed percentage in interest payable, regardless of the debtor's income or lack thereof." (Gilbert v. Commissioner, supra, 248 F.2d 399, 402.) While indicia of a debtor-creditor relationship is a major factor in determining whether such a relationship has actually been established, the courts have stressed that the "substance" rather than the "form" of purported loan transactions is **determinative**. (U.S. v. Henderson, 375 F.2d 36 (5th Cir. 1967); American-LaFrance-Foamite Corp. v. Commissioner, 284 F.2d 723 (2d Cir. 1960).) Accordingly, the

Appeal of Dave Gardner Cross Associates

existence of a promissory note is not **conclusive** in determining whether an advance of the type in issue here is in fact a loan or a **contribution** of capital. (Erard A. Matthiessen, 16 **T.C.** 781 (1951), **affd.**, Matthiessen v. Commissioner, 194 **F.2d** 659 (2d Cir. 1952).)

With respect to the instant appeal, the record - reveals that the advance in issue, while evidenced by an instrument of indebtedness, was unsecured, despite **AHI's** very tenuous financial condition. While the promissory note from AHI to appellant fixed a maturity date for repayment of the "loan" and indicated that interest was to be charged on the purported indebtedness, it appears that full repayment of the supposed indebtedness was expected only upon the ultimate success of the "debtor" corporation. In this regard, we note that **Mr. Cross**, as president and sole shareholder of appellant and president of **AHI**, had complete discretion as to whether and when appellant would press for repayment of the advance. In this position, he could insure that AHI would not repay the advance if it would jeopardize his investment in that corporation. Additionally, it is significant that appellant advanced money to AHI even after it became evident that **AHI**, as it then existed, was not a profitable enterprise. Advances made under such circumstances constitute evidence of an intent to invest capital. (Appeal of George E., Jr. and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.) In light of **AHI's** proven unprofitability, it is unlikely that an objective creditor would have made an unsecured loan to AHI with the expectation of repayment. (Dodd v. Commissioner, 298 **F.2d** 570 (4th Cir. 1962).)

Additional factors supporting respondent's determination that the subject advance to AHI was a contribution to capital and not a loan are: (i) the fact that the advance was used by AHI for current operating expenses; (ii) evidence that **Mr. Cross** caused appellant to make the advance so as to protect his initial investment in **AHI**; and (iii) the subordination of the advance to the claims of others. In previous cases these factors have been found to constitute evidence of an intent to invest capital. (See, e.g., Diamond Bros. Company v. Commissioner, supra; Appeal of Dudley A. and Sherrill M. Smith, Cal. St. Bd. of Equal., Dec. 15, 1976.)

Under the circumstances described above, and absent persuasive evidence to the contrary; it is our opinion that the advance in issue constituted working..

Appeal of Dave Gardner Cross Associates

capital which Mr. Cross, through appellant, caused to be contributed to AH1 in order to protect his investment in that corporation. Consequently, appellant is not entitled to a bad debt loss deduction with respect to the funds it advanced to **AH1**. (See Fin Hay Realty Co. v. United States, 398 **F.2d** 694 (3rd Cir. 1968); Dodd v. Commissioner, supra; Motel Corp., 54 T.C. 1433, 1436-1439 (1970); Lewis L. Culley, 29 T.C. 1076, 1087-1089 (1958); Appeal of Armored Transport, Inc., Cal. St. Bd. of Equal., Feb. 2, 1976.) This conclusion makes it unnecessary to consider the subsidiary question of whether the advance became worthless during the income year in issue.

