

Appeal of Lambert-California Corporation

The sole issue presented for determination is whether appellant is entitled to a bad debt deduction, in the amount of \$55,000 for the income year ended September 30, 1974.

The transaction which constitutes the subject of this appeal arose out of the same series of events and circumstances which gave rise to appellant's appeal of additional assessments proposed for the income years ended September 30, 1972 and 1973. (See Appeal of Lambert-California Corporation, Cal. St. Bd. of Equal., Dec. 9, 1980.) The rendition of those events and circumstances is herein incorporated by reference. Additional data relating to the instant appeal is set forth below.

In 1974, appellant advanced \$55,000 to its subsidiary, Lambert Towing Equipment, Inc. (hereinafter referred to as "Towing"). The purpose of the advance was to maintain the subsidiary as a going concern in an effort to limit the amount of actual losses that appellant would sustain because of certain outstanding continuing guarantees it had executed in favor of Towing's creditors. Through this action, appellant apparently reduced its potential losses from the \$574,351 in outstanding guarantees existing as of September 30, 1973, to \$279,414 by the end of the income year in issue.

Appellant argues that the subject \$55,000 advance was uncollectible in its 1974 income year and should be allowed as a bad debt deduction. Respondent's primary contention is that appellant's advance to Towing was in reality a contribution to the latter's capital rather than a loan. That being so, respondent argues, the resulting loss cannot properly be characterized as a bad debt loss. 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 Towing is deductible as a bad debt, appellant relies upon section 24348 of the Revenue and 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

Appeal of Lambert-California Corporation

appellant's \$55,000 advance to Towing 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.

Whether an advance to a corporation by a principal stockholder ^{1/} 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).) 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 of ten 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, ¶ 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 1030] (1959); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.)

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 a purported loan transaction is determinative. (United States v. Henderson, 375 F.2d 36 (5th Cir. 1967); American-LaFrance-Foamite Corp. v. Commissioner, 284 F.2d 723 (2d Cir. 1960).)

With respect to the instant appeal, the record indicates that the advance in issue, in addition to evidently not being evidenced by an instrument of

1/ The record of this appeal reveals that appellant held approximately 88 percent of Towing's stock at the time of the subject advance.

Appeal of Lambert-California Corporation

indebtedness, was unsecured, despite Towing's very tenuous financial condition. Appellant's president has acknowledged that repayment of the supposed indebtedness was not expected and that the "sole purpose" for the \$55,000 advance "was to keep [Towing] in business so as to minimize the losses that [appellant] would incur if [Towing] was forced out of business or into bankruptcy." By appellant's own admission, the \$55,000 was advanced to its subsidiary even after it was evident that Towing, 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 its proven unprofitability, it is unlikely that an objective creditor would have made an unsecured loan to Towing with the expectation of repayment. (Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962).) The fact that the advance was apparently used by Towing for current operating expenses further supports respondent's determination that the subject advance was a contribution to capital and not a loan. (Appeal of Dave Gardner Cross Associates, Cal. St. Bd. of Equal., June 23, 1981.)

Under the circumstances described above, we can only conclude that the advance in issue constituted working capital which appellant contributed to its subsidiary in order to reduce the losses it would incur if Towing were forced out of business or into bankruptcy. Consequently, appellant is not entitled to a bad debt loss deduction with respect to the subject advance. (See Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d 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.

Appeal of Lambert-California Corporation

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 Lambert-California Corporation against a proposed assessment of additional franchise tax in the amount of \$1,436.63 for the income year ended September 30, 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

..... William M. Bennett , Chairman
..... Ernest J. Dronenburg, JR. , Member
..... Richard Nevins , Member
..... , Member
..... , Member