BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1776-SW
JONATHAN T. TAPLIN)

For Appellant: Lawrence J. Milov
Tax Manager

For Respondent: Jon Jensen
Counsel.

OPINION

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 Jonathan T. Taplin against a proposed assessment of additional personal income tax in the amount of $6,270.73 for the year 1979.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

Appeal of Jonathan T. Taplin

The issue presented in this appeal is whether appellant's advances made to a corporation, of which he is a 25-percent shareholder, are contributions to capital or loans.

Appellant is a film producer and was a shareholder and chairman of the board of American Film League, Inc., a New York-based corporation which had distributed specialized films in the art film market. The corporation was capitalized in the amount of $1,071 and appellant held a 25.53-percent interest. As set forth in the Film League Shareholder's Agreement of December 5, 1977, the shareholders were to vote their shares to provide for the employment by the corporation of appellant for a period of three years at a salary of $750 per week. The agreement further provided that appellant was to remain in the exclusive employ of the corporation for the three years specified unless the corporation became unable to meet its payroll obligations.

Shortly after its creation, the Film League purchased the rights to and began distributing a film entitled "Short Eyes,", an undertaking requiring a substantially greater amount of money than its capitalization. One shareholder, Mrs. Harvey Bennett, advanced $140,000 to the corporation and appellant himself claims advances of $72,500. Appellant also guaranteed an advance to the corporation of $50,000 made by Frederick Herrick. The transaction guaranteeing the loan by Mr. Herrick is documented in formal loan papers; however, the terms and intended character of the other advances have not been documented and promissory notes were never executed. The Film League's balance sheet at the end of its 1977-1978 fiscal year does not show the advances either as loans from stockholders or as contributions to capital. None of these advances were ever repaid by the corporation, no interest was ever charged on the advances, and no definite terms of repayment were ever arranged.

The Film League operated at a large deficit in each of its two years of operation, resulting in its ultimate dissolution on July 31, 1979.

In preparing his 1979 tax return, appellant deducted the $13,228 he paid to Frederick Herrick as a result of his personal guarantee of Herrick's loan to the corporation. He also deducted the sum of $72,500 as a business bad debt. Respondent concluded that these advances were contributions to capital and should be treated as a capital loss.

Appellant contends that even though the corporation was never able to meet its obligation to pay a salary to him and he was never actually employed by the corporation, his involvement with the Film League was viewed by him as a step in establishing a production-distribution structure for his films. In other words, appellant contends that the advances to his corporation are loans so that when they become worthless, appellant will have a deduction against ordinary income in the form of a business bad debt. Respondent contends that the advances are contributions to capital and as such they become part of appellant's investment. When the stock in the corporation becomes worthless, appellant is only allowed a capital loss.

The question of whether appellant's advances to a corporation of which appellant is a 25-percent shareholder are loans or contributions to capital is essentially one of fact on which the taxpayer bears the burden of proof. (Diamond Bros. Co. v. Commissioner, 322 F.2d 725 (3d Cir. 1963).) A capital contribution is intended as an investment placed at the risk of the business,, while a loan is intended to create a definite obligation which is payable in any event.. In other words, to qualify for a bad debt deduction, the advance must be made with a reasonable expectation of repayment. '(Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964; Gilbert v. Commissioner, 248 F.2d 399 (2d 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).)

Section 17207, which governs the deductibility. of bad debts, is substantially similar to section 166 of. the Internal Revenue Code. It is well settled in California that when state statutes are patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653, 658 [80 Cal.Rptr. 403] (1969); Appeal of Horace C. and Mary M. Jenkins, Cal. St. Bd. of Equal., Apr. 5, 1983.) The courts, in attempting to deal with the problem of distinguishing a loan from a capital contribution, have isolated certain factors. While no single criterion or series of criteria can provide a conclusive answer

(see Newman v. Quinn, 558 F.Supp. 1035, 1039 (D.V.I. 1983)), the following have been considered:

(1) the proportion of advances to equity;

(2) the adequacy of the corporate capital previously invested;

(3) the control the donor has over the, corporation;

(4) whether the advance was subordinated to the rights of other creditors:

(5) the use to which the funds were put; and

(6) whether outside investors would make such an advance.

(See United States v. Henderson, 375 F.2d 36, 40 (5th Cir.), cert. den., 389 U.S. 953 [19 L.Ed.2d 362] (1967).)

Applying the above to the present case, we must conclude that appellant's advances to the Film League. were. equity investments. The evidence available indicates that the corporation was capitalized in the amount of $1,071. Shortly after its creation, the corporation received advances from shareholder Bennett totaling $140,000 and from appellant allegedly totaling $72,500. In addition to these amounts, an additional $50,000 was advanced by Frederick Herrick. Although an examination of this financial data does not conclusively establish that the corporation was inadquately capitalized, the evidence does indicate that from its creation the corporation was in need of cash to handle the distribution costs of the film "Short Eyes." The corporation did operate at a large deficit for each of the two years of operation, which is also evidence that appellant could not have reasonably expected repayment. (See Thaler, et al. v. Commissioner, ¶ 78,024 T.C.M. (P-E) (1978).)

The independent-creditor test also provides a useful analytical framework for ascertaining the economic reality of a purported debt. In this case, the advance was made by appellant without a formal note, a secured interest, or any type of collateral. Another individual, not a shareholder, also advanced funds to the corporation but not without appellant personally guaranteeing the advance. We must conclude that the advances made by appellant were not made under the conditions comparable

to those required by an outside lender. (See Appeal of Hinshaw's Department Stores, Inc., Cal. St. Bd. of Equal., June 27, 1984.)

We finally note that the Film League's 1977-1978 fiscal year balance sheet does not describe appellant's advances as loans and no repayment was made. Given the identity of interest between the Film League and appellant as well as the other factors discussed above, we must conclude that the funds advanced to the corporation by appellant were placed at the risk of the business' success, and therefore represent contributions to capital. When there is no reasonable expectation of repayment, appellant cannot be entitled to a bad debt deduction.

A portion of the amount in dispute represents payments appellant made to Frederick Herrick as a result of his personal guarantee of Herrick's loan to the Film League. No evidence has been presented which would lead us to conclude that this amount should be treated any differently.

Appellant has cited several cases which he contends support his position. These cases, however, do not address the issue of whether an advance is a "loan" or a "contribution to capital." Rather, the cases relate to whether a debt is a business or a nonbusiness debt. Only the case of Funk v. Commissioner, 35 T.C. 42 (1960), addresses the issue of reasonable expectation of repayment, and that case favors respondent's position and holds that the advances made under declining financial conditions are not made with reasonable expectation of repayment.

In sum, we conclude that because the advances were placed at the risk of the business' success and were made without reasonable expectation of repayment, the advances represent contributions to capital. Respondent's position must be sustained.

Appeal of Jonathan T. 'Taplin

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 Jonathan T. Taplin against a proposed assessment of additional personal income tax in the amount of $6,270.73 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of March , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9