86-SBE-128

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. **84A-616-SW**
STEPHEN T. AND ELEANOR WISE)

Appearances:

For Appellants: Robert **D'Angelo**
Attorney at Law

For Respondent: Grace Lawson
Counsel

O P I N I O N

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 Stephen T. and Eleanor Wise against a proposed assessment of additional personal income tax in the amount of **$23,232.19** 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 Stephen T. and Eleanor Wise

There are two issues presented in this appeal. The first issue is whether appellants have established that advances made to their wholly owned corporation were bona fide loans rather than contributions to capital. The second issue is whether appellants have established that they were entitled to a bad debt deduction of $67,490 for amounts they allegedly paid to creditors of their corporation pursuant to personal guarantee agreements.

Appellants were the owners of Stephen Edwards Company (Edwards), a furniture company which was incorporated on January 27, 1964. Appellants' initial capital investment totalled $40,000; however, between 1974 and 1978, their advances to the corporation totalled $328,333. Appellant Stephen Wise was the president and sole shareholder of Edwards. The corporation went bankrupt July 13, 1978.

For the year 1978, appellants filed a return claiming a business bad debt deduction of $328,333. At the end of taxable year 1978, appellants showed a negative taxable income with both business and nonbusiness bad-debt deductions. In 1979, appellants had substantial capital gains. Appellants subsequentiy filed an amended 1978 tax return in which they reclassified the $328,333 loss as a nonbusiness bad debt. If accepted, this would have generated a short-term capital loss deduction which could be carried over to 1979 to offset, dollar for dollar, appellants' large capital gains during that year.

Appellants@ 1979 return was reviewed by one of respondent's field auditors, who disallowed their claimed loss carryover of $328,333. He concluded that the amount was a business bad debt without carryover potential. When appellants received notice of respondent's finding, they protested the assessment. A protest auditor determined that the advances were contributions to equity with respect to stock held longer than five years, and allowed a 50-percent long-term capital loss carryover to 1979.

Edwards had also entered into a loan agreement with Wickes Furniture (Wickes) and'incurred a debt of $100,000. Appellant Stephen Wise personally guaranteed the loan. When Edwards went bankrupt, it still owed $79,990 to Wickes. Appellant Stephen Wise then entered into a compromise agreement with Wickes in the amount of $12,500, thereby discharging his obligation as personal guarantor. The difference between the $79,990 outstanding balance and the $12,500 settlement was $67,490.

Appellants have claimed a $67,490 bad debt deduction for 1979.

Respondent asserts that appellants told its field and protest auditors that the $67,490 deduction was based on the Wickes' settlement transaction. Appellants, however, contend that this deduction had nothing to do with Wickes; rather, the deduction was based on assorted loans to the corporation which were either made directly by appellants or which were personally guaranteed by appellants.

The question of whether appellants' advances to a corporation of which they owned 100 percent of the stock constituted a loan or a capital contribution is essentially one of fact on which the taxpayers bear the burden of proof. (See White v. United States, 305 U.S. 281 [83 L.Ed. 172] (1938).) 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 payable in any event. In other words, to qualify as 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).

We note that in this case the characterization. of the advances has a substantial impact on appellants' tax liability. If the advances constitute nonbusiness loans, then a loss based on these worthless debts is considered to be a loss from the sale or exchange of a capital asset held for not more than one year. (Rev. & Tax. Code, § 17207, subd. (d)(1)(B).) Pursuant to section 18162.5, subdivision (a)(1), the allowable carryover is 100 percent of the debt. If, however, the advances are contributions to capital, which increase the worth of the corporation and the basis of outstanding stock (Rev. & Tax. Code, § 18052, subd. (a)), when the stock becomes worthless it is treated as a sale of a capital asset and is subject to the carryover limitations of section 18162.5. As this stock was held for over five years, only 50 percent of the loss may be carried over to the subsequent year. (Rev. & Tax. Code, § 18162.5, subd. (a)(3).)

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.

In other words, a bona fide debt arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. (Treas. Reg., § 1.166-l(c),) No deduction may be taken for a loan made with no intention of enforcing payment or where there was no reasonable expectation of repayment when the loan was made. (Appeal of Harry and Peggy Groman, Cal. St. Bd. of Equal., Dec. 7, 1982.)

Applying the above considerations 'to the present case, we must conclude that the advances appellants made to the corporation were contributions to capital and'not loans. By 1971, the corporation was beginning to experience losses. These losses continued and, by 1977, the corporation was in such financial difficulties that it could not pay its rent. Yet between 1974 and 1978, appellants advanced 'the corporation $328,333. This amount far exceeds appellants' initial investment of $40,000.

Furthermore, there is no evidence that appellants obtained any collateral or security for their advances even though the corporation appears to have continually been in need of cash durins the time the **advances** were made. (See Appeal of Southwestern Development Company, Cal. St. Bd. of Equal., Sept. 10, 1985.)

The independent-creditor test also provides a useful analytical framework for ascertaining the economic reality of a purported debt. As was stated above, at the time the advances were made, no security was taken. There is also limited evidence that the advances were even in the form of loans. Appellant has testified that notes were made, but now contends that these notes were seized by the court when the corporation went into bankruptcy and were subsequently destroyed. Appellants have, also failed to show that the corporation paid them any interest on any of the advances. Although amounts were repaid to appellants, these amounts were small compared to **the** amounts appellants continued to advance. (See Appeal of **Hinshaw's** Department Stores, Inc., Cal. St. Bd. of Equal., June 27, 1984.) In considering all the corporation's financial difficulties, we cannot reasonably conclude that an objective creditor would have made an unsecured loan to the corporation.

The identity of interest between appellants and the corporation is also of consequence. Stephen Wise was the sole shareholder of the corporation and had complete control over how the corporate funds were spent. While in itself this evidence is not conclusive, it does further indicate that equity investments, rather than loans, were being made.

The second issue presented in this appeal is whether appellants have established that they were entitled to a bad debt deduction for amounts they allegedly paid to creditors of their corporation as personal guarantees. Appellants contend that their initial statement that $67,490 was paid as a result of their personal guarantees of third-party loans to the corporation, was incorrect and that the correct amount is **$79,997.47.**

Loans and guarantees are treated identically for purposes of a bad debt deduction (Putnam **v.** Commissioner, 352 U.S. 82 **[1 L.Ed.2d 144] (1956)),** and loans by a controlling shareholder to his closely held corporation give **rise to** nonbusiness debts. (Kelly v. Patterson, 331 **F.2d** 753,755 (5th Cir. **1964).)** Appellants have the burden of proving that they are entitled to the deduction

claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).)

In support of their position, appellants have submitted photocopies of checks written on their personal account. These copies do not clarify appellants' position that the amounts paid-are unrelated to the Wickes debt and settlement. One of the checks for $12,500 does, in fact, carry a notation of "Wickes Furniture." If the claimed deduction for $79,997.47 did arise out of the Wickes loan, appellants were relieved of that obligation through a $12,500 settlement. The remaining $67,497.47 is not, therefore, a deductible bad debt.

If the entire amount is not related to the Wickes Furniture debt,. appellants must document the debt and the payment of such debt in order to be entitled to a deduction. This they have not done. Unsubstantiated assertions by the taxpayer are not sufficient to satisfy the burden of proof. (Appeal of Linn L. and Harriett E. Collins, Cal. St. Bd. of Equal., Nov. 18, 1980.)

For the above reasons, respondent's action in this matter will be sustained.

Appeal of Stephen T. and Eleanor Wise

ORDER

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 Stephen T. and Eleanor Wise against a proposed assessment of additional personal income tax in the amount of **$23,232.19** for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of June , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9