BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter or' the Appeals of)
) Nos. 82A-1020 and
RICHARD P. AND MAUREEN MCCARTHY) 82A-1136-MA

For Appellants: George Manolakas
Attorney at Law

For Respondent: Lazaro L. Bobiles
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Richard P. and Maureen McCarthy against proposed assessments of additional personal income tax in the amounts of' $21,830.47 and $35,684.87 for the years 1976 and 1977, respectively.

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

The issues presented by these appeals are whether advances made by appellant[2/] to his corporation were deductible as nonbusiness bad debts or, alternatively, whether the advances constituted capital contributions for which appellant could claim a worthless stock deduction for the years 1976 or 1977.

Cal-Mac Farms ("Cal-Mac") was incorporated in California in 1974. Richard P. McCarthy, appellant, owned 90 percent of Cal-Mac's stock in the taxable year 1976. The other 10 percent was owned by his son. The corporation's purpose was to operate a commercial trucking business specializing in the transportation of agricultural produce. Although the record is not specific, apparently, appellant also owned several other related business entities during the same period.

Cal-Mac's operations were unprofitable from its inception. In both 1974 and 1975, Cal-Mac suffered large financial losses. Appellant advanced $170,000 to Cal-Mac as of March 31, 1975. The advance did not have a targeted date for repayment, was unsecured, and, at least on $20,000 of this amount, no interest was payable. On the remaining $153,000, interest was purportedly payable at the prime rate plus one point. However, there is no record that any interest was ever paid. Cal-Mac continued to have cash flow problems, resulting in another advance of money from appellant in the amount of $250,000 as of March 31, 1976. There was no note, no date of repayment, no security, and no interest assessed for this advance. Also, as of March 31, 1976, trailer rentals from corporations affiliated with Cal-Mac in the amount of $122,040 were advanced to Cal-Mac but attributed to appellant. As a result, as of March 31, 1976, appellant had advanced to Cal-Mac a total of $542,040.

In the spring and summer of 1976, appellant employed a team of auditors to analyze Cal-Mac's financial condition. Based on the auditor's findings, appellant concluded that Cal-Mac was "hopelessly insolvent" and had amassed a cumulative deficit of $861,188. As a result of the auditor's report, Cal-Mac's management purportedly decided during the summer of 1976 to

2/ This case actually involves two appellants, husband and wife. Appellant-wife, Mrs. Maureen McCarthy, is a party to this appeal only by virtue of having filed a joint return. Therefore, references to appellant in this opinion will be to appellant-husband, Mr. McCarthy.

terminate the corporation's business and to sell its assets. No minutes of the corporate meeting were prepared. An offer to purchase Cal-Mac's tangible assets was made on December 20, 1976; however, negotiations were not concluded until mid-1977.

As of December 31, 1976, appellant had advanced an additional $210,000 to Cal-Mac and, as of March 31, 1977, an additional $124,000 was advanced. As with the previous advances to Cal-Mac, no notes were prepared, no interest assessed, no security sought, and no repayment date established.

The assets of Cal-Mac were sold in May 1977 for a purchase price of $20,000 payable upon execution and a balance of $180,000 upon closing. (Resp. Br., Ex. B.) Cal-Mac has not been dissolved or suspended and remains in existence.

On his 1976 California personal income tax return, appellant deducted, as a nonbusiness bad debt, the 5342,040 in advances to Cal-Mac, with a capital loss carryover of $438,585 to 1977. Respondent disallowed the 1976 and 1977 nonbusiness bad-debt deductions on the basis that the amounts constituted contributions to capital which did not become worthless in either appeal year rather than deductible bad debts. This appeal followed.

Appellant contends that Cal-Mac was hopelessly insolvent as of the end of taxable year 1976 and that as a result, his advances were uncollectible. Appellant also offers the alternative contention that the claimed nonbusiness bad debts were worthless in 1977, rather than 1976.

Section 17207, subdivision (a)(l), provides that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." In order for a taxpayer to take a bad debt deduction, two requirements must be fulfilled: a bona fide debt must exist and the debt must become worthless in the taxable year for which the deduction is claimed. The taxpayer has the burden of proving that both of these requirements have been satisfied, (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976; Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18, 1970.) In a situation such as the instant case where the loans or advances are made to a corporation of which the taxpayer is a major or principal

stockholder, the basic question is whether the advance creates an unconditional obligation on the part of the corporation to repay a definite sum of money. (Appeal of Estate of John M. Hiss, Sr., Deceased, and Ella N. Hiss, Cal. St. Bd. of Equal., Sept. 23, 1974.) Despite the form of the advance, if there is no genuine expectation of repayment unless the business venture succeeds, the advance is considered a contribution to capital. (Appeal of George E., Jr., and Alice J. Atkinson, supra.)

The first question to be addressed is whether appellant's advances satisfy the first requirement for a deductible bad debt: the existence of a bona fide debt.

Whenever large advances are made to a corporation by a principal stockholder, the question arises whether the advances are loans or contributions to capital. This is a question of fact and the taxpayer-stockholder has the burden of establishing that a bona fide debt existed and that he is, therefore, entitled to a deduction upon its becoming worthless. (Matthiessen v. Commissioner, 16 T.C. 781 (1951), affd., 194 F.2d 659 (2d Cir. 1952); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.) Although the courts have stressed a number of factors which are to be considered in determining the nature of a stockholder's advance to the corporation, the basic inquiry appears to be whether the funds have been put at the risk of the corporate venture or whether there is a genuine expectation of repayment regardless of the success of the business. (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).) The entire factual background must be examined in order to answer this question.

By March 31, 1976, appellant had advanced a total of $542,040 to Cal-Mac. Most of the advances lacked the usual indicia of indebtedness such as a definite date for repayment, issuance of notes, and the imposition of interest. In addition to the amount and form of the advances, there is the additional factor that appellant participated in the management of the corporation. Each of these factors taken alone would not be, per se, indicative that the advances were contributions to capital rather than debt; however, taken together, they have been identified as factors relevant to determining whether the advances were bona fide loans and

not contributions to capital. (Matter of Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976).) All of these factors taken together strongly lead to our conclusion that the advances were contributions to capital rather than bona fide debts.

Perhaps most significantly, appellant continued to make advances to Cal-Mac at times when it was obvious that Cal-Mac did not have the resources to repay them. In such cases where the advanced funds have been put at the risk of the corporate venture, that is, when their repayment is contingent upon the success of the business, it is an indication that the advance is investment capital and not a *loan* for which a bad debt deduction may be taken. (Midland Distributors, Inc. v. United States: 481 F.2d 730, 733 (5th Cir. 1973); Appeal of George E., Jr., and Alice J. Atkinson, supra.) As such, we must conclude that the advances made to Cal-Mac by appellant were not bona fide debts.

Because we have concluded that the advances in question were not bona fide debts, we need not decide the second issue of whether the debts become worthless in the taxable year 1976 or 1977. Suffice it to say that even if the debts were found to be bona fide, for the reasons stated below, we could not conclude that such debts became worthless in those years. This same analysis would preclude our finding that appellant was entitled to take a worthless stock deduction for either 1976 or 1977.[3/]

The determination that a debt became worthless in a given year must be made by objective standards. (Appeal of Fred and Barbara Baumgartner, supra.) Total worthlessness in the taxable year must be established before any deduction is allowable. (Rev. & Tax. Code, § 17207, subds. (d)(1)(A) and (d)(1)(B); Pierson v. Commissioner, 27 T.C. 330 (1956), affd. on other grounds, 253 F.2d 928 (3d Cir. 1958); Appeal of Roy E. and

3/ In his appeal letter, appellant claimed a 1976 or 1977 worthless stock deduction for the first time. According to respondent, it has never received an amended return for 1976 or 1977 claiming a worthless stock deduction, thus there is a question as to whether the statute of limitations has run, at least as to the 1976 taxable year. However, because of our decision in this matter, we need not decide whether a valid claim for refund was filed.

Evelyn B. Klotz, Cal. St. Bd. of Equal., Oct. 28, 1980.) Section 17207, subdivision (d)(l)(B), provides that where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange during the taxable year of a capital asset held for *not* more than *one year.* The taxpayer must establish that some identifiable event, or series of events, occurred during the taxable year which formed a reasonable basis for abandoning any hope that any portion of the debt would be paid in the future. (Appeal of Harry B. and Maizie E. Breitman, Cal. St. Bd. of Equal., Feb. 18, 1964,) If the nonbusiness bad debt has some reasonably foreseeable potential value, the debt is not worthless. (Appeal of Roy E. and Evelyn B. Klotz, supra.)

Appellant has not cited an event or series of events which occurred during 1976 which formed a reasonable basis for abandoning any hope that any portion of the advances would be paid in the future. Appellant relies solely on his own conclusion that Cal-Mac was "hopelessly insolvent" based on his examination of the findings of his auditors. However, a deficit or the insolvency of a corporation does not, of itself, establish the worthlessness of a debt. (Appeal of Harry B. and Maizie E. Breitman, supra.) There has been no showing of any identifiable event which occurred in *1976* which would cause one to conclude that the advances would never be repaid.

Appellant's actions negate any finding that he thought the advances would not be repaid. Appellant continued to advance sums of money to Cal-Mac even after he concluded the corporation was "hopelessly insolvent." Records indicate that as of December 31, 1976, appellant advanced to Cal-Mac an additional $210,000: as of March 31, 1977, he advanced still an additional $124,000. Such advances are inconsistent with a claim of worthlessness. (Appeal of Barry B. and Maizie E. Breitman, supra.)

Appellant cites Polizzi v. Commissioner, 265 F.2d 498 (6th Cir. 1959) as support for his contention that worthlessness occurred in 1976. This case is clearly distinguishable. In Polizzi, the Court of Appeals recognized that in some cases an identifiable event other than bankruptcy can clearly evidence that a loss had been sustained. In Polizzi, however, the identifiable event was partially triggered by the report of an independent third party, a court-appointed trustee. In the instant case, appellant points only to his own

conclusion made after the auditor's report that Cal-Mac was insolvent as the identifiable event and yet negates this conclusion by his subsequent acts of continuing to advance substantial sums to Cal-Mac to secure its continued operation.

In the alternative, appellant claims that his debts became worthless in 1977. However, according to respondent, even during Cal-Mac's taxable year ended March '31, 1978, Cal-Mac retained considerable assets mainly in the form of accounts receivable due from various entities in which appellant owns large interests. This negates a theory that the advances became worthless during 1977. For the same reason that appellant's advances to Cal-Mac cannot be considered to have become worthless in 1976, his claim that the advances became worthless in 1977 is also without foundation. For the same reasons, we also conclude that even if appellant filed a valid claim for refund claiming a worthless stock deduction for the years 1976 and 1977, the claim would be properly denied on the basis that appellant did not show that worthlessness of the stock occurred in 1976 or 1977.

For the reasons stated above, we conclude that respondent's action in this matter should be sustained.

Appeals of Richard P. and Maureen McCarthy

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 protests of Richard P. and Maureen McCarthy against proposed assessments of additional personal income tax in the amounts of $21,830.47 and $35,684.87 for the years 1976 and 1977, respectively; be and the same is hereby sustained.

Done at Sacramento, California, this 20th day Of August , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

, Member

*For Kenneth Cory, per Government Code section 7.9