BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) Na. 84A-1288-MA
MICHAEL J. AND MARIA GALARDO)

Appearances:

For Appellants: Roger-J. Filene
Certified Public Accountant

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 fram the action of the Franchise Tax Board on the protest of Michael J. and Maria Gallardo against proposed assessments of additional personal income tax in the amounts of $8,477.88, $1,375.00, $2,142.00, and $1,061.00 for the years 1979, 1980, 1981, and 1982, 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 issue to be resolved in this appeal is whether distributions by one closely held corporation to another constituted constructive dividends to appellant,[2] the major shareholder of each of the corporations.

For the years under appeal., appellant was a majority shareholder, officer, and director of Elite Upholstery Corporation (EU). During and after the appeal years, EU was involved in the manufacture and sale of upholstered furniture. In 1979, EU wished to expand its product line by establishing a new division of its corporation to make end tables, coffee tables, wall units and game tables which would complement EU's upholstered furniture line. However, the principal shareholders, appellant and his sons, did not want to sell an interest in EU to a Mr. Hsu whose expertise was needed ta produce and market the tables. A new corporation, (EW), was. established. Although all funds to establish and operate EW were apparently advanced by EU, appellant and his sons received 60 percent of EW's stock while Mr. Hsu received 40 percent.[3] According to appellant, the entire EW enterprise was conceived and seen as an adjunct to, and an expansion of, EU's business. EW was never successful and ceased active operations on November 30, 1981.

In July 1979, the EU's board of directors passed a resolution authorizing up to $100,000 in advances to EW to enable it to start operations. Thereafter, between 1979 and 1982, EU advanced a total of $154,579 to EW as follows:

1979 - 77,069
1980 - 12,510
1981 - 30,000
1982 - 35,000

2/ Appellant-wife, Maria Galardo, is a party to this action only by virtue of having filed joint tax returns with her husband. Accordingly, all references to appellant in this opinion will be to appellant-husband, Mr. Galardo.

3/ While the record is not entirely clear-whether Mr. Hsu was given his share of the stock, there is no indication that he paid for it,

There were apparently no notes, stated interest, repayment schedules or dates, or actual repayments in connection with any of these advances.

Following an audit, respondent determined that no valid indebtedness was created or intended by the advances and treated them as constructive dividends to appellant because the advances allowed appellant to capitalize a new business.. Respondent contends that funds were advanced primarily for appellant's benefit in order to enhance his investment in EW and that there was no business purpose on EU's part for making the advances. Appellant protested and this timely appeal followed.

Appellant contends that the advances made to EW were bona fide Loans for the purpose of establishing the business. He further contends that no direct benefit accrued to him because of the advances, that a substantial business purpose existed, and, in fact. the only purpose for establishing EW was directly related to the conduct of EU's business.

It is well settled that advances between related corporations may result in constructive dividends to the common shareholders. (Simmons v. Commissioner, ¶ 83,349 T.C.M. (1-a) (1983); Joseph Lupowitz Sons, Inc. v. Commissioner, 437 F.2d 862 (3d Cir. 1974).) However, the courts have made it clear that transfers between related corporations will not result in constructive dividends to the common shareholders solely by reason of their common ownership. (Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972).) In. situations, such as here, where there has been a transfer of funds from one corporation to another, the courts have said that a subjective test of purpose must be satisfied before dividend characterization results. . . . [This] subjective test must necessarily be utilized to differentiate between the normal business transactions. of related corporations and those transactions. designed primarily to benefit the stockovner. (Sammons v. Commissioner, supra, 472 F.2d at 451.)

The advances under scrutiny in the instant-case were the result of the start-up of EW. At the time, EU was an established upholstered furniture manufacturer and wished to expand its product line by including tables for integrated family room or Living room sets. It was thought that the complementary lines of furniture would increase sales for 'oath companies.

Appellant, as the principal shareholder-of EU, recognized that expertise was needed in the wood furniture business but was unwilling to sell an interest in EU to an outsider. As a consequence, a new corporation was established; owned 40 percent by the wood expert, Mr. asu, and 60 percent by appellant and his sons. Appellant, as controlling shareholder, wanted to expand EU's product line and needed the expertise of Mr. Hsu, but did not want to dilute his ownership interest in EU. By establishing a new company, Mr. Bsu could have an ownership interest in the new company and EU could limit its liability if the new venture proved unsuccessful.

Respondent argues that the advances were a direct and primary benefit to appellant sufficient to constitute a constructive dividend. It raises the point of law that if the transfer can be seen as primarily for appellant's personal benefit rather than for a corporate benefit, and if any corporate benefit was merely derivative, then the advances will be seen as a constructive dividend. (The J. F. Stevenhagan Co., *et* al,. v. Commissioner, 75,198 T.C.M. (P-3) (1975); Sammons v. Commissioner, supra.) In support 0f its argument, responaent points to the fact that the advances *in* question were not bona fide debts of the corporation but were more readily characterized as contributions to capital, and to the fact that the transfers in question diluted the net worth of the corporation without any corresponding benefit to the corporation.

Appellant relies upon several factors to support his position that the advances were intended to be bona fide debts. The first is that the advances were treated as loans by EU. Appellant has offered a copy of the corporate minutes of a special meeting of the board of directors of EU indicative of the intent to create a bona. fide debt. (Resp. Br., Ex. A.)

While we agree that the minutes provide some evidence of an intent to create a debt, they are not determinative. Several factors negate a finding of a bona fide debt in this situation. The funds were unsecured and at risk. No promissory note or security agreement, other than the minutes referred to preoiousfy, established the advances as a loan. No interest repayment was set and there was no reasonable expectation of repayment. The minutes merely state that the advances would be repaid at some indefinite date in the future when EW's tables were mass-produced_ The return of the total amount of advances to EU was dependent on the

success of EW. Even after EW discontinued business on November 30, 1381, EU made advances of $30,000 and $35,000 without recourse to security. All of these factors taken together lead to the conclusion that the advances in question were contributions to capital rather than bona fide debts.

The fact that the advances constitute contributions to capital does not prove incontrovertibly that appellant received the funds as constructive dividends. It does subject the advances to closer scrutiny and provides some evidence that the advances were dividends. (See generally Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 7.05 (4th Ed. 1979).) A constructive dividend will be found only if the primary purpose of the transfer was personal shareholder benefit rather than a corporate benefit. (Sammons v. Commissioner, supra.) A finding that appellant received a direct benefit would support the conclusion that a constructive dividend had been conferred.

Essentially, the test is to differentiate between the normal business transactions of related corporations and those transactions designed primarily to benefit the shareholder (Sammons v. Commissioner, supra.) Where, as here, the transferorcorporation has a significant interest in the success of the transferee, the courts are sometimes reluctant to find that a constructive dividend accrued. (Simmons v. Commissioner, supra; Rushing . Commissioner, 52 T.C. 888 (1969), affd. on another issue, 441 F.2d 593 (5th Cir. 1971).) In such cases, the courts have found that the transfer of funds served a predominantly corporate business purpose and the benefit, if any, accruing to the taxpayer was far too remote to give rise to a dividend,

When the initial advances were made to EW, there was every reason to believe the new venture would be profitable. There were sound business reasons to start a line of complementary wood furniture to go with EU's existing line. A capital outlay or other investment by the corporation (for its own-purposes) is not ordinarily treated as a constructive distribution to its shareholders, since the transaction changes the character of the assets held by the corporation without affecting its net worth or bringing the shareholder any closer to personal enjoyment of the enterprise's earnings. (Bittker and Eustice, supra.) In the instant case, we have a capital outlay by the corporation combined with a

clear business purpose, however there is a change in the net worth of the corporation because EU did not receive shares in EW, the new corporation. Instead, appellant and his sons became the main shareholders of the new enterprise. In effect, the transaction was no different than if EU had distributed cash to appellant and appellant then purchased stock from EW for the cash. Because EU received no equity interest in EW, its contributions acquired an interest in EW for its shareholders and were clearly for their direct benefit. (The J. F. Stevenhagen Co., et al. v. Commissioner, supra.) While it is true that EU stood to garn if EW became a viable concern, this benefit was derivative to appellants' direct benefit. (Id.) Consequently, we must conclude that the advances in question constituted a constructive dividend to the shareholders.

One final question remains. That is whether appellant, as principal shareholder of the two corporations, could properly be assessed the total amount of the advances made to **EW** as constructive dividends. We think not. Although he was the principal shareholder, there were other parties who were also shareholders of both corporations; therefore, it would seem a proper course of action to apportion any constructive dividends between all of the shareholders according to their percentage ownership in the transferring corporation, (See Joseph Lupowitz Sons, Inc. v. Commissioner, supra, at fn. 14.) We must, therefore, modify the amount of appellant's assessment accordingly.

For the reasons stated above, respondent's action is modified in accordance with this opinion.

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 Baard on the protest of Michael J. and Maria Galardo against proposed assessments of additional personal income tax in the amounts of $8,477.88, $1,375.00, $2,142.00, and $1,061.00 for the years 1979, 1980, 1981, and 1982, respectively, be and the sane is hereby modified in accordance with this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 19th Jay of November , 1986, by the Stale 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