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Pot **Appellant:** Jennifer Miller Moss  
Attorney at Law

For Respondent: **Carl Knopke**  
Counsel

O P I N I O N

This appeal is made pursuant to section 18593<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Ronald E. and Margaret D. Porter against proposed assessments of additional personal income tax in the amounts of \$3,774.36, \$3,669.74, and \$222.48 for the years 1974, 1975, and 1976, respectively,

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

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The issue presented in this appeal is whether payment of Mr. Porter's personal expenses by his solely owned corporation constituted **constructive** dividends. **Mr. Porter's wife, Margaret, is a party to this appeal only because** she filed a joint income tax return with him. For purposes of this appeal, **only Ronald E. Porter** will hereinafter be referred to as "appellant".

**Mr. Porter began** his business of selling automobile and farm equipment repair parts as a **sole proprietorship**. In 1973, he incorporated his business and **established** himself as the sole shareholder. The exchange was tax free because all the property of the proprietorship was transferred solely **for all the** corporation's stock. The inventories transferred to the corporation **totalled \$201,404.49**. The exchange also **included** \$75,001) in equity **and an unsecured 10-year note** in the amount of **\$241,147.43**. The terms of this note provided **that it was to be paid** off within **10 years**, but that the **11-percent** interest on the note was due annually.

Soon after incorporating, the corporation began paying for the **personal expenses** of Mr. Porter- Payments for 1973 through 1976 **totalled \$138,392.12**. Of this amount, **\$58,797.56** was reported by appellant as income, on the **ground** that it constituted rent on the building he rented to the corporation, interest on the incorporation note, and **bonus** income.

The following amounts of personal expenses were paid for by the corporation, but were not reported by Mr. Porter:

\$ 9,905.60	in 1973
34,312.44	in 1974
33,357.62	in 1975
2,018.90	in 1976
<u>\$79,594.56</u>	TOTAL

Appellant initially contends that these amounts constituted repayment of the **\$241,147.43** incorporation note. <sup>2/</sup>  
In **the alternative**, appellant contends that the **above-**

<sup>2/</sup> **Although** the discussion in this appeal includes the **\$9,905.60** considered by respondent to be constructive dividends distributed in 1973, this amount is not part of the assessments because respondent is precluded by the statute of limitations from **issuing an assessment** for this year.

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listed amounts were loans made to him by the corporation. In March of 1976, appellant alleges that the corporation charged these amounts back to **the incorporation** note and reclassified the amounts as loans **to Mr. Porter evidenced** by a note payable by him for the amount of **\$73,654.98.**<sup>3/</sup> This note had a 7-percent interest rate. Interest was due annually for the first three years and then **\$17,963.76** of interest and principal was due annually until the note was paid. No security was given for the note.

Respondent's position is that at the time appellant had the **corporation** pay for his personal **expenses**, the only intention he had was that the corporation pay his expenses. After the payments were made, appellant's accountant determined how to divide up the payments into various accounts. Respondent **consequently classified** these payments as **constructive dividends** distributed to appellant by the corporation. When respondent had affirmed its proposed assessment, this appeal resulted.

In support of his initial position that the payment of the personal expenses was repayment of the incorporation debt, appellant states that the treatment of the transactions on the books of the corporation as repayments of the incorporation **loan** is documentary evidence of the necessary intent. Appellant argues that this treatment is sufficient documentation that the payments were not dividends.

A distribution of property, including money, by a corporation to a shareholder with respect to its stock shall be included in gross income **to** the extent the amount distributed is considered a dividend.. (Rev. & Tax. Code, §§ 17321, 17323, subd. (a), 17383.) "Dividends" are defined in section 17381 as any distribution to a shareholder made by a **corporation** out of its earnings and profits. The mere **fact** that appellant is a creditor of the corporation does **not** preclude the payments from being classified as **dividends**. (Appeal of Joel Bellman, Cal. St. Hd. of Equal., Feb. 2, 1976.) In the present case, appellant is the sole shareholder and individual in absolute control of **the** corporation. In asserting this control, appellant **has** directed the

<sup>3/</sup> The difference between the **\$79,594.56** credited to the **incorporation** note and the **\$73,654.98** note payable by appellant is unexplained.

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corporation to pay his personal expenses as these expenses arise. These payments were random payments that do not appear to be part of a structured program of repayment of the incorporation debt. Appellant has not produced any written documents or corporate **minutes** that were prepared prior to the payments which clearly state that the payment of these personal expenses was the agreed upon method of repaying the incorporation loan. **Historically**, payments of personal expenses of a shareholder by a corporation have been held to constitute dividends. (Reisberg v. Commissioner, ¶ 79,420 T.C.M. (P-E) (1979).) When a corporation makes payments to its controlling shareholder, these payments are deemed to be divided distributions unless the **controlling** shareholder can affirmatively establish their character. (Wilson v. Commissioner, 10 T.C. 251 (1948), affd., Wilson Bros. & Co. v. Commissioner, 170 F.2d 423 (9th Cir. 1948).) Accordingly, the burden of proof is on appellant to show that the payments of his personal expenses were not taxable dividends. (Appeal of Richard M. and Beverly Bertolucci, Cal. St. Bd. of Equal., May 4, 1976.) We must conclude that appellant has not carried his burden of proving that the payment of his personal expenses by the corporation was in fact repayment of the incorporation loan. In so concluding, we note that at all times the corporation had sufficient retained earnings to warrant a distribution even though no dividends were declared for the taxable years in issue.

Appellant's alternative position is that the payments -were loans from the corporation to appellant. In March of 1976, the amounts in question were charged back to the incorporation note and reclassified as loans to appellant. These alleged loans were evidenced by a note payable by appellant for **\$73,654.98**.

Whether payments from a corporation to a stockholder represent loans or taxable dividends depends upon all the facts and circumstances surrounding the transactions between the shareholder and the **corporation**. (Appeal of Albert R. and Belle Bercovich, Cal. St. Bd. of Equal., Mar. 25, 1968.) Specifically, the question is what was the intent of the parties at the time each payment was made. (Appeal of Lynn P. and Sandra K. Jensen, Cal. St. Bd. of Equal., July 29, 1986) In ascertaining this intent, special scrutiny **must** be given to situations, such as the present appeal, where the shareholder is in complete control of the corporation. (Baird v. Commissioner, 25 T.C. 387 (1955).)

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As was discussed previously in this appeal, appellant was in complete control of the corporation. The reclassification of the payments as "loans" is evidence of the control asserted by appellant. It is not convincing evidence that at the time the payments were made, appellant intended them to be loans. Rather, we must again conclude that when the payments were made, the intent was to pay appellant's personal expenses. The classification of the payment was simply left to a later date. We do not find it persuasive evidence that appellant's accountant subsequently changed the corporate books to reflect the payments as loans. In the Appeal of Albert R. and Belle Bercovich, decided by this board on March 25, 1968, we stated that the treatment of withdrawals as loans on corporate books is not conclusive evidence of their ultimate character, but "merely one fact to be considered within the total factual picture." Given all the facts, we must conclude that the payment of appellant's personal expenses constituted dividends to appellant. The action of respondent must be sustained.

