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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
BRET A. CURTIS AND	**PERSONAL INCOME TAX APPEAL**
YECENIA M. CURTIS[1]	Case No. 594236[2]

Year	Proposed Assessment
2005	$91,523

Representing the Parties:

For Appellant: Steve Mather, Kajan, Mather & Barish

For Franchise Tax Board: Sean Sullivan, Tax Counsel III

QUESTION: Whether amounts received by appellants from a subchapter S corporation constituted taxable income.

HEARING SUMMARY

Background

Spectra Resources Corporation (Spectra) is a subchapter S corporation that was

[1] Appellants reside in Woodland Hills, Los Angeles County.

[2] This matter was originally calendared for oral hearing at the Board's July 24-26, 2012 Culver City Board meeting. Appellants representative requested a postponement due to a scheduling conflict, therefore this matter was rescheduled to the Board's October 23-25, 2012 Culver City Board meeting.

incorporated in California in 2002. Appellant-husband, Bret Curtis, owns 100 percent of the shares of Spectra and held all corporate officer positions. In 2004, appellant-husband, acting as the sole member of the Board of Directors of Spectra, adopted a corporate resolution whereby Spectra would loan funds to appellant-husband "from time to time" and appellant-husband executed a Revolving Credit Arrangement and Promissory Note (Revolving Note) authorizing him to borrow up to $1 million and setting forth the rate of interest, repayment, and other terms of the loans. The corporate resolution and Revolving Note were both dated January 2004. During 2005, Spectra made various transfers and paid personal expenses of appellant-husband that totaled $1,440,760, which were recorded as distributions on Spectra's accounting records. On December 31, 2005, Spectra reclassified $936,352 of this amount as loans to appellant-husband. (Resp. Op. Br., p. 2.)

Respondent audited appellants' 2005 return and determined that the amounts reclassified as loans were taxable distributions to appellants from Spectra. In response to respondent's request, appellants provided copies of the corporate resolution and Revolving Note. Respondent states that Spectra recorded interest income of $16,152 for 2005 but there is no evidence that appellant-husband made an interest payment to Spectra. Instead, Spectra made a journal entry recording the interest as paid by reducing appellant's annual salary by the same amount. Another journal entry recorded the amount classified as a loan as "repaid" in 2006 when Spectra offset the amount transferred to appellants as a distribution. Respondent determined that appellants received a taxable distribution in the amount of $870,153 rather than a loan and issued a Notice of Proposed Assessment (NPA) dated May 28, 2009, assessing additional tax totaling $91,523. Appellants timely protested the NPA and, after a hearing, respondent concluded that the loan was actually a taxable distribution and issued a Notice of Action (NOA) dated October 17, 2011, that affirmed the NPA. (Resp. Op. Br., pp. 3-4.)

<u>Contentions</u>

<u>Appellants</u>

Appellants contend that respondent bases its determination primarily on Spectra's bookkeeping practices in that Spectra's bookkeeper erroneously posted the advances to an account titled "S-Corp Distributions". In support of their contention, appellants provide as an exhibit a copy of a multi-page schedule titled "SPECTRA Resources Corporation, Transactions by Account, As of

December 31, 2005" with multiple columns identifying the dates, payees and payors, nature of the transactions, debits, and credits, including a column titled "Type, S-Corp Distributions". Appellants contend that the activity in this account establishes that it is not a true distribution account because the account entries establish a consistent pattern of repayments and distributions are not repaid. Appellants assert that the pattern of repayments "virtually precludes a factual determination that these amounts were distributions." (App. Op. Br., p. 3.)

Appellants further contend that the characterization of shareholder loans in the amount of $936,352 as a distribution in 2005 would have violated the California Corporations Code. Appellants reference the first page of its Exhibit B which is titled "Spectra Resources, Book Income and Distributions" and lists years 2002 to 2007 with amounts for book income and distributions in each year. The total of book income is $4,370,534 and the total for distributions is $4,299,430. Appellants state that this document shows the close correlation between book income (and corresponding retained earnings) and the distribution amount which, appellants contend, is consistent with the provision of Corporations Code section 500 prohibiting a California corporation from making distributions in excess of the corporation's retained earnings and/or assets. In addition, appellants cite Corporations Code section 500 as requiring that, after a distribution, the corporation has both total assets which are greater than 1.25 times its liabilities and current assets that are greater than its current liabilities. (App. Op. Br., p. 3 & Exh. B, p.1.)

Appellants further state that advances were made pursuant to the terms of the Revolving Note during 2005, interest was properly computed and recorded, and in 2006 the principal amount of the loan and interest were repaid. Appellants point to Spectra's 2005 balance sheet which "is based on Spectra's recognition of the shareholder loan" and states that respondent's adjustment would cause an additional $936,352 in distributions, while Spectra had retained earnings of only $9,140 as of December 31, 2005. Appellants contend that a distribution in excess of the $9,140 would violate the first test under California law. Appellants further state that, prior to respondent's proposed distribution adjustment, Spectra's total assets to liabilities ratio was less than 1.25-to-1, so respondent's adjustment which would further reduce assets would also reduce that ratio and also result in total liabilities exceeding total assets, thereby violating both prongs of the second test of Corporations Code section 500. (App. Op. Br., pp. 4-5.)

Appellants contend that the proper treatment of a payment to a shareholder as either a loan or a distribution is determined primarily by the intent of the corporation and the intent of the shareholder to repay the amount and the following facts establish that a bona fide creditor-debtor relationship existed:

- The Revolving Note was executed before the advances were made.
- The advances were treated as loans on Spectra's books.
- Interest was computed, recorded, and paid as provided in the Revolving Note.
- Appellant-husband was financially able to make a repayment at the time the advances were made.
- Appellant-husband always had the intention to make repayment.
- The advances were repaid in 2006 through distributions.

Appellants argue that respondent has almost no contrary evidence to show the absence of an intent to form a debtor-creditor relationship. Appellants contend that respondent appears to rely on the error of an untrained bookkeeper who posted the advances to a shareholder distribution account, which error was corrected during the year by Spectra's more knowledgeable accountants. (App. Op. Br., pp. 5-6.)

Respondent

Respondent contends that it properly treated the payments by Spectra to appellant-husband in the amount of $870,153 as distributions with respect to Spectra's stock in excess of appellant-husband's basis. Respondent states that IRC section 1368(b) provides that a distribution from an S corporation to a shareholder shall not be included in the gross income of the shareholder to the extent it does not exceed the shareholder's adjusted basis in the stock. To the extent the distribution does exceed the adjusted basis, that amount shall be treated as gain from the sale or exchange of property. Thus, respondent concludes that the distribution at issue constitutes taxable income if it exceeds appellant-husband's basis in the stock. (Resp. Op. Br., p. 5.)

Respondent asserts that a transfer of money is a loan for tax purposes if the transferee unconditionally intends repayment and the transferor unconditionally intends to secure the repayment of the amount due. Such a determination requires an examination of facts and circumstances of the transfer and transactions between closely held corporations and its shareholders are given extra scrutiny because of the shareholders' unique opportunity to exercise unfettered control over a closely-held company. Respondent contends that a "mere declaration" by a shareholder that he intends a loan is insufficient evidence without more "reliable indicia of debt." For that reason, respondent contends that appellants must prove by objective facts an unconditional intent at the time of each transfer to repay the amounts received from Spectra. (Resp. Op. Br., p. 5.)

Respondent cites *Jones v. Commissioner* (1997) 74 T.C. Memo 473 (*Jones*) and states that courts generally examine the following ten factors to determine whether a transfer from corporation to a shareholder is a valid loan. Respondent states that these factors are not exclusive and no single factor is determinative. Respondent applies each of the factors to the facts presented and concludes that the parties did not enter into a bona fide debtor-creditor relationship as follows:

1. The extent to which the shareholder controls the corporation. As in *Jones*, appellant-husband caused Spectra to distribute money in accordance with the "blanket promissory note" which allowed appellant-husband to deposit and withdraw funds at will for personal expenses. The court in *Jones* held that such transfers are properly treated as distributions rather than loans.
2. Magnitude of the withdrawals and whether a ceiling or other limit exists on the amount of the withdrawal. Although the Revolving Note states a limit of $1 million, appellant-husband had the authority as the sole shareholder and corporate officer to increase the limit at any time, simply by issuing a new note. Thus, only in form but not in substance was there a borrowing limit to appellant-husband, so this factor weighs in favor of a distribution.
3. How the parties recorded the withdrawals on their books and records. At the time of each withdrawal, Spectra recorded the amount as a distribution on its accounting records throughout 2005 which indicates that Spectra intended a distribution at the time of each withdrawal. Although appellants claim that the bookkeeper made an error and he had no accounting background, there is no objective evidence the transfers were incorrectly recorded as distributions. Appellants' claim is less credible in view of the fact that, on the last day of the 2006 tax year Spectra, reclassified a shareholder loan to distributions when appellant-husband had sufficient basis to repay the "loan". This factor weighs strongly in favor of a distribution.

4. Whether the parties executed a promissory note. Appellant-husband did not execute a promissory note contemporaneously with the purported loan and the other documentary evidence, including Spectra's accounting records, indicates the transfers were intended as distributions. Furthermore, it is unlikely that Spectra would loan substantial amounts to its shareholder over the course of a year without documenting each as a separate loan. Thus, the transfers appear more like a series of distributions for personal expenses and this factor weighs in favor of a distribution.
5. Whether interest was paid or accrued. There is no record that appellants ever paid interest and instead appellant-husband improperly reduced his salary by the amount of the interest due and thereby reduced his gross income which effectively made his repayment "tax-free". In addition, there is no fixed repayment schedule for interest and the Revolving Note provides that if interest is not paid within five days after demand for payment is made, Spectra may treat the unpaid interest as an additional advance. The Tax Court has held that failure to pay interest is not overcome by a journal entry reflected accrued interest on net withdrawals made by the shareholder, with a corresponding credit to interest income of the corporation, if the shareholder makes no interest payments. In addition, the terms of the Revolving Note called for the computation of interest from the date of the disbursement but the interest was actually computed by taking the total loan balance at the end of the year, dividing it by two and using that amount as the average loan balance during the year. However, the actual loan balance exceeded that "average loan balance" amount at all times from February 22, 2005 through the end of the year, indicating that interest was not charged in accordance with the terms of the Revolving Note. This estimate of interest indicates no debtor-creditor relationship existed because a true creditor would demand all interest due, so this factor weighs in favor of a distribution.
6. Whether collateral was given. Appellant-husband did not pledge any collateral to Spectra and the Tax Court has held that the absence of security for an advance is an indication of a distribution.
7. Whether there was a fixed maturity date. According to the Revolving Note, the maturity date was December 31, 2008, but there are three facts indicating that this date was not fixed. First,

the arrangement was a revolving line of credit so appellants could withdraw and deposit money at will and December 31, 2008, was simply the last date that appellants had that credit facility. Second, only the line of credit but not the individual advances had a fixed maturity date so appellant-husband was able re-characterize withdrawals as loans at the end of the year. Third, appellant-husband controlled Spectra and had the authority to modify the Note or draft a new one to suit his personal needs.

8. Whether the corporation attempted to collect the debt. Appellants have not asserted that Spectra attempted to collect on the loan and it is unlikely, based on appellant-husband's control, that appellants would cause the wholly-owned corporation to demand collection unless appellant-husband wanted to contribute additional capital to Spectra. Thus, this factor weighs in favor of a distribution.
9. Whether the shareholder had the ability to repay as would be determined by a third-party lender. The evidence in the record does not disclose appellants' financial position at the time of each transfer, thus, this factor is not indicative of the existence of a loan.
10. Whether there is an indication the shareholder attempted to repay. Appellants have not provided any evidence of a transfer to funds to repay the amounts advanced other than offsetting the amount of the distribution appellant-husband received in 2006 as a loan repayment. This offsetting contradicts the terms of the Revolving Note, which provides that payments are deemed made only when "immediately available funds" are received by Spectra.

Respondent concludes that substantially all of the foregoing factors weigh in favor of treating the transfers to appellant-husband as taxable distributions rather than as loans. (Resp. Op. Br., pp. 5-13.)

Appellants' Reply

Appellants contend that under California law the advances cannot be a distribution and Spectra's bankers would not have allowed them to be a distribution. In response to respondent's analysis of the ten factors, appellants evaluate them as follows:

1. Control. Appellant-husband controlled Spectra and respondent seems to believe this is the sole factor.
2. Limits. There was a limitation on the amount of the loan in the Revolving Note.

3. Books. The year-end accounting records reflect that the advances were recorded as a loan and the daily activity in the general ledger account also reflects loans and repayments rather than distributions.
4. Notes. A written promissory note was executed.
5. Interest. Interest was accrued and paid.
6. Collateral. The debt was unsecured.
7. Maturity. The loan had a fixed maturity date and was repaid before that date.
8. Collection. The loan was repaid.
9. Repayment Ability. Appellants were able to and did repay the loan.
10. Attempted Repayment. Appellants made numerous actual transfers of funds and incurred an "economic cost" to repay the entire balance.

Appellants conclude that respondent's position has no support other than the fact that appellant-husband controlled Spectra and appellants contend that respondent has not cited any case law authority in which this single factor was sufficient to sustain respondent's determination. (App. Reply Br., pp. 1-2.)

<u>Applicable Law</u>

The FTB's determination is presumed correct and an appellant has the burden of proving it to be wrong. (*Todd v McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Richard Byrd*, *supra*.) Unsupported statements are insufficient to carry this burden of proof. (*Appeal of Ismael R. Manriquez*, 79-SBE-077, Apr. 10, 1979.)

California conforms to the federal subchapter S rules of the IRC "relating to the tax treatment of S corporations and their shareholders, except as otherwise provided." (Rev. & Tax. Code, § 23800.) Therefore, if the transfer is treated as a distribution under IRC section 1368(b), as alleged by respondent, then it would be taxable as capital gain to appellants to the extent that it exceeded appellant-husband's adjusted basis.

Corporations Code section 500, subdivision (a), in relevant part, prohibits a corporation or any of its subsidiaries from making any distribution to the corporation's shareholders unless the board of directors has determined in good faith either of the following:

(1) The amount of retained earnings of the corporation immediately prior to the distribution equals

or exceeds the sum of

(A) the amount of the proposed distribution plus

(B) the preferential dividends arrears amount.

(2) Immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

Corporations Code section 506, subdivision (a), provides, in part, that "any shareholder who receives any distribution prohibited by this chapter with knowledge of facts indicating the impropriety hereof is liable to the corporation for the benefit of all of the creditors or shareholders entitled to institute an action under subdivision (b) . . ." Under subdivision (b), a court action may be brought in the name of the corporation to enforce the liability

> (1) to creditors arising under subdivision (a) for a violation of Section 500 or 501 against any or all shareholders liable by any one or more creditors of the corporation whose debts or claims arose prior to the time of the distribution to shareholders and who have not consented thereto, whether or not they have reduced their claims to judgment, or (2) to shareholders arising under subdivision (a) for a violation of Section 500 against any or all shareholders liable by one or more holders of shares having preferential rights with respect to cumulative dividends in arrears, . . .

Whether a transfer from a corporation to a shareholder is a bona fide loan is a question of fact, the answer to which must be based upon a consideration and evaluation of all surrounding circumstances. (*Jones v. Comm'r,* T.C. Memo 1997-400.) In *Jones v. Commissioner, supra*, the Tax Court considered whether disbursements that the taxpayer received from an S corporation constituted loans or taxable distributions. The taxpayer was the sole shareholder of the S corporation. During a three-year period, the S corporation disbursed over $700,000 to the taxpayer. The disbursements were recorded as loans on the books and records of the corporation and portions of the loans were purportedly repaid through the taxpayer's assumption of the corporation's other debt and the reclassification of some amounts as salary. However, the Tax Court noted that the taxpayer made numerous withdrawals from the corporation, and there did not appear to be any limit on the amount that the taxpayer could "borrow." Also, the taxpayer did not execute any notes to evidence the debt or provide any security for the debt, and the corporation never set a date for repayment of the debts or demanded repayment of the debt.

In reviewing these facts, the Tax Court provided the following non-exclusive list of factors to be considered:

> "(1) The extent to which the shareholder controls the corporation, (2) the earnings and dividend history of the corporation, (3) the magnitude of the withdrawals and whether a ceiling existed to limit the amount the corporation advanced, (4) how the parties recorded the withdrawals on their books and records, (5) whether the parties executed notes, (6) whether interest was paid or accrued, (7) whether security was given for the loan, (8) whether there was a set maturity date, (9) whether the corporation ever undertook to force repayment, (10) whether the shareholder was in a position to repay the withdrawals, and (11) whether there was any indication the shareholder attempted to repay withdrawals. [Citation omitted.]" (*Jones v. Commissioner, supra.*)

Weighing these factors, the Tax Court concluded that the disbursements at issue constituted distributions, rather than loans. In reaching its conclusion, the Tax Court noted that the distributions were recorded as loans on the books of the corporation, but accorded little weight to that fact in light of the lack of other evidence demonstrating the existence of a bona fide debt. (*Id.*) The factors noted by the Tax Court in *Jones v. Commissioner*, *supra,* and similar factors have been cited by many courts. (*See Cepeda v. Commissioner* T. C. Memo 1993-477; *Alterman Foods, Inc. v. United States* (5th Cir. 1974) 505 F.2d 873.)

In the *Appeals of Raymond J. and Lillian I. Lull* (87-SBE-045), decided June 17, 1987, this Board considered an appeal in which a corporation disbursed funds to its stockholders over a period of years. On appeal, the taxpayers argued the disbursements were loans. In support of this contention, the taxpayers noted the disbursements were treated as loans on the corporate books and notes were issued to evidence the loans. In considering the taxpayers' arguments, the Board stated:

> "[s]pecial scrutiny of the situation is invited where the withdrawer is in substantial control of the corporation [citation omitted] and withdrawals under such circumstances are deemed to be dividend distributions unless the controlling stockholder can affirmatively establish their character as loans. [Citations omitted.]" (*Id.)*

This Board noted that the specific question in such cases is "whether at the time of each withdrawal there existed an intent by each shareholder to repay the purported loan and by the corporation to enforce the obligation." (*Id.*) The Board further explained that it attached little significance to the issuance of notes because the notes lacked a fixed schedule for repayment and it had not been established that the taxpayers actually paid interest on the notes. (*Id.*) In light of these facts, and the fact that the corporation had not paid any dividends despite the existence of substantial earnings, the Board concluded that respondent's determination that the disbursements were not bona fide loans must be sustained. (*Id.*)

STAFF COMMENTS

As in the *Appeals of Raymond J. and Lillian I. Lull*, *supra*, here appellant-husband was in control of Spectra so the withdrawals are presumed to be distributions unless appellants establish that they should be characterized as loans. Moreover, similar to the facts presented in *Jones v. Commissioner*, appellant caused Spectra to distribute money in accordance with the "blanket promissory note" which allowed appellant-husband to deposit and withdraw funds at will for personal expenses. The court in *Jones v. Commissioner* held that such transfers are properly treated as distributions rather than loans. At the hearing, appellants should be prepared to distinguish the loans made by Spectra and the conditions under which the loans were made from the purported loan arrangement in *Jones v. Commissioner*.

Although the terms of the Revolving Note provide that appellant-husband had the right to request advances in minimum increments of $1,000, the schedule and the bank statements provided by appellants appear to show that Spectra made advances to appellant-husband in varying amounts, some of which were less than $1,000. In addition, it appears that interest was estimated rather than being accrued in accordance with the terms of the Revolving Note. At the hearing, the parties should be prepared to address the significance and effect of appellant-husband's failure to abide by the terms of the Revolving Note.

Appellants argue that Spectra was prohibited from making distributions to appellant-husband pursuant to Corporations Code section 500 and cite the conditions with which Spectra was required to comply in order to make a valid distribution. Corporations Code section 506 provides that any shareholder who receives a prohibited distribution with knowledge that it was prohibited is liable to the corporation and affords aggrieved creditors and shareholders the remedy of a court action for such violations. However, there is no statutory provision in the Corporations Code of which we are aware that would affect the characterization or tax treatment of a corporate advance to a shareholder as either a distribution or a loan. At the hearing, appellants may wish to explain their rationale for reliance on Corporations Code section 500 as a basis for a determination that the advances were loans.

Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, it should be provided to the Board's Board Proceedings Division at least 14 days prior to the oral hearing.[3]

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[3] Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.