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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:

) **HEARING SUMMARY<sup>2</sup>**

) **PERSONAL INCOME TAX APPEAL**

12 **DAVID DU TRAN AND**

) Case No. 547815

13 **THUYEN THI TRAN<sup>1</sup>**

)

Year	Proposed Assessments	
	Tax	Penalty
2003	\$32,584	\$8,146
2004	\$78,102	\$ 0

18 Representing the Parties:

19 For Appellants: Kim Le, CPA

20 For Franchise Tax Board: Sonia Deshmukh, Tax Counsel

22 QUESTION: Whether the monetary transfers from Vanco, Inc. (VI) to Vanco Trading, Inc. (VTI)

24 <sup>1</sup> Appellants appear to reside in Orange County, California.

25 <sup>2</sup> This appeal was originally scheduled to be heard by the Board in Culver City on June 22, 2011. When appellants' representative did not respond to the hearing notice, the appeal was moved to the July 27, 2012 nonappearance calendar. Subsequently, appellants' representative requested that the matter be rescheduled for an oral hearing, so it was placed on the oral hearing calendar for the Board meeting in Culver City on October 25, 2011. Appellants' representative requested a postponement, due to a scheduling conflict, and the matter was placed on the January 31-February 2, 2012 Culver City oral hearing calendar. Appellants' representative then requested a postponement of the matter, due his ongoing health problems, and this matter was rescheduled to the Board's July 24-26, 2012 Culver City Board meeting.

1 may be considered shareholder loans from appellants to their S corporation for  
2 purposes of increasing their basis in corporate indebtedness.

3 HEARING SUMMARY

4 Background

5 The proposed assessments result from the Franchise Tax Board's (FTB's) disallowance  
6 of loss deductions to appellants from VTI, an S corporation, for 2003 and 2004. VTI was incorporated  
7 on October 11, 1988 and it elected S corporation status as of January 2000. VTI operated a supermarket  
8 and reported losses of \$1,538,906 in 2003 and \$226,502 in 2004, which losses were reported as having  
9 passed through to appellants as the sole owners of the corporation. The FTB audited appellants and  
10 disallowed the loss deductions, issuing Notices of Proposed Assessment (NPAs) for each of these years  
11 on May 12, 2009.<sup>3</sup>

12 Appellants protested the NPAs and produced board of director minutes from Vanco-Delta  
13 Foods Co. (VDFC) to show that VDFC agreed to repay loans owed to its shareholders (appellants),  
14 which loans were repaid when VDFC made payments directly to VTI. Appellants also submitted two  
15 promissory notes dated December 31, 2003: (1) a promissory note that reflects a loan of \$520,801.05  
16 from VDFC to VTI and (2) a promissory note that reflects a loan of \$999,815.73 from appellant-  
17 husband to VTI. Respondent determined that any advances to VTI from sources other than appellants  
18 were not shareholder loans. Respondent also found that the corporate minutes and the promissory notes  
19 did not evidence shareholder loans that would increase the shareholders' debt basis in VTI. On  
20 August 5, 2010, respondent issued Notices of Action for each of these years, affirming the NPAs. This  
21 timely appeal followed.

22 Contentions

23 Appellants

24 Appellants contend that the assessments are in error and they are entitled to the loss  
25 deductions passed through from VTI. Appellants state that they loaned money to VI, which they  
26 describe as a corporation they own. They contend that they needed to get back the money they had  
27

28 <sup>3</sup> The parties do not raise the late filing penalty (also known as the delinquent return penalty) as an issue in this appeal.

1 loaned to VI so they could loan it to VTI. To avoid delays, appellants assert that VI repaid appellants by  
2 writing a check directly to VTI (rather than VI writing a check to appellants so appellants could then  
3 write a check to VTI).

4 Appellants contend that VI acted as an “incorporated pocketbook” for appellants in this  
5 transaction. Appellants state that their bookkeeper initially recorded this transaction improperly, as if it  
6 had been a loan between VI and VTI. By the end of 2003, appellants contend that their bookkeeper  
7 corrected the record, based on minutes approved by the Board of Directors, to show the funds advanced  
8 from VI to VTI as a loan from appellants to VTI. Appellants contend that they are unsophisticated and  
9 lack a high school education. They argue that the FTB has not properly considered the economic  
10 substance behind this transaction.

#### 11 Respondent

12 The FTB contends that appellants’ loss deductions from VTI were disallowed because the  
13 losses exceeded appellants’ basis in stock and exceeded their basis in debt loaned to VTI. The FTB  
14 asserts that appellants have failed to prove the purported loans to VTI cost them anything or left them  
15 poorer in a material way. The FTB contends that appellants are seeking to interject themselves  
16 retroactively into transactions that occurred between separate business entities they own.

17 The FTB states that it allowed shareholder loans of \$655,000 in 2003 and \$35,500 in  
18 2004 because appellants provided documentation, including canceled checks, showing payments to VTI  
19 from a personal bank account. Those personal loans increased appellants’ debt basis in VTI, so the  
20 corresponding losses were allowed. By contrast, the FTB asserts that there is no evidence of any  
21 economic outlay from appellants to justify treating payments of \$812,649 from VI to VTI during 2003  
22 and 2004 as if such payments were loans from appellants to VTI. The FTB also notes that appellants did  
23 not report any income from the repayment of their alleged loans to VI, which repayment was allegedly  
24 used to make the loans to VTI.

25 The FTB further contends that VI is not an “incorporated pocketbook” for appellants and  
26 appellants have not demonstrated that VI even exists as a separate entity. According to the FTB, the  
27 Secretary of State lists two suspended corporations under the name “Vanco, Inc.,” and those  
28 corporations do not appear to be affiliated with appellants and do not appear to have filed income tax

1 returns. The FTB asserts that appellants did not list VI on their tax returns in 2003 or 2004, nor did they  
2 report any gains or losses from VI. The FTB suggests that appellants might be using the name “Vanco,  
3 Inc.” to refer to VDFC, although the purported loan checks from VI state “Vanco, Inc.” rather than  
4 VDFC. The FTB asserts that if VI is really just a checking account used for receiving funds from and  
5 disbursing funds to VTI, then it cannot be considered a separate business entity and the funds paid to  
6 VTI are not loans at all.

7 Finally, the FTB asserts that documentation provided during the audit shows that VTI had  
8 an outstanding loan of \$206,022.36 to appellants at the beginning of 2003. According to the FTB, many  
9 of the payments from appellants to VTI in 2003 were not loans at all but actually repayments of  
10 principal and interest owed by appellants to VTI. Thus, the FTB asserts that it already permitted  
11 appellants to increase their debt basis excessively because the FTB allowed appellants to treat the  
12 repayment of debt to VTI as if those payments had been loans made by appellants to VTI.

### 13 Applicable Law

#### 14 Burden of Proof

15 The FTB’s determination is presumed correct and appellants have the burden of  
16 proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*,  
17 2001-SBE-001, May 31, 2001.)<sup>4</sup> In the absence of uncontradicted, credible, competent, and relevant  
18 evidence showing an error in the FTB’s determinations, they must be upheld. (*Appeal of Oscar*  
19 *D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)

#### 20 Pass Through of Losses from S Corporations to Shareholders

21 The income and losses incurred by S corporations are passed through to the shareholders  
22 in accordance with section 1366 of the Internal Revenue Code (IRC) and the related provisions of  
23 Subchapter S. Subchapter S of the IRC is incorporated into California law by section 17087.5 of the  
24 Revenue and Taxation Code (R&TC). IRC section 1366(d)(1) limits the losses and deductions that a  
25 shareholder can take in any taxable year to the sum of (a) the shareholder’s basis in the corporate stock  
26 and (b) the shareholder’s basis in any corporate indebtedness. Any losses that are disallowed by this  
27

28 <sup>4</sup> Published decisions of the Board, such as *Appeal of Michael E. Myers, supra*, are generally available on the Board’s  
website: [www.boe.ca.gov](http://www.boe.ca.gov).

1 limitation may be carried forward to future tax years. The shareholder's basis in stock is the price paid  
2 for the stock, increased by any income passed through to the shareholder and decreased by losses,  
3 deductions, expenses, and distributions. (Int. Rev. Code, §1367.)

#### 4 Basis in Corporate Debt

5 The key issue in this appeal is the shareholders' basis in corporate indebtedness.  
6 Shareholder loans to an S corporation do not increase the shareholder's basis in the stock, but they do  
7 increase the shareholder's basis in debt. (Treasury Regulations, section 1.1367-2.) Even when a  
8 taxpayer has no basis in corporate stock, the taxpayer can continue to deduct losses from an  
9 S corporation to the extent the taxpayer still has a basis in debt. (Int. Rev. Code §1367.)

10 To increase a shareholder's debt basis, the shareholder must make an actual economic  
11 outlay to the corporation. (*Estate of Leavitt v. Commissioner*, (4th Cir. 1989) 875 F.2d 420.) Where the  
12 loan came from an entity controlled by the taxpayer, rather than the taxpayer himself, the taxpayer bears  
13 a heavy burden to prove the loan should be treated as if it came directly from the taxpayer. (*Ruckriegel*  
14 *v. Commissioner*, T.C. Memo 2006-78.) The taxpayer must demonstrate that he personally bore the  
15 economic burden for the loan, in terms of economic substance rather than mere form. (*Griffith v.*  
16 *Commissioner*, T.C. Memo 1988-445.)

#### 17 "Incorporated Pocketbook"

18 In certain situations, courts have found that a taxpayer increased his basis in a corporation  
19 by means of a loan to that corporation by another corporation, wholly owned by the taxpayer, based on  
20 the theory that the lending corporation was really an "incorporated pocketbook" for the taxpayer. (*Yates*  
21 *v. Commissioner*, T.C. Memo 2001-280, *Culnen v. Commissioner*, T.C. Memo 2000-139.) The term  
22 "incorporated pocketbook" refers to a factual situation where a taxpayer habitually uses a wholly owned  
23 corporation to make payments to third parties on his behalf. (*Ruckriegel, supra.*) "Whether that practice  
24 is habitual and whether it is probative of whether any ambiguous payment is being made by the  
25 corporation on behalf of its owner (as opposed to on its own behalf) are questions of fact to be resolved  
26 on the basis of the particular facts of the case." (*Id.*, p. 29.)

#### 27 STAFF COMMENTS

28 The status of VI is unclear. Appellants should be prepared to show proof that it existed

1 as a corporation, that appellants owned it, and that appellants controlled it. In order to prove that VI can  
2 be considered an “incorporated pocketbook,” appellants should be prepared to demonstrate that VI had  
3 after-tax earnings and that appellants habitually used VI to make payments to third parties on behalf of  
4 appellants themselves (rather than on behalf of VI as a business entity).

5 Appellants should be prepared to trace the funds loaned to VTI by VI to show that at  
6 some point appellants had possession of those funds or had an immediate right to them.  
7 Contemporaneous records and documentation would be helpful because there is almost nothing in the  
8 record for this appeal. The Board does not have access to documents that might have been presented to  
9 the FTB during the audit or during the protest process.

10 Both appellants and the FTB should be prepared to explain the allegedly outstanding loan  
11 of \$206,022.36 from VTI to appellants at the beginning of 2003. Appellants should explain why  
12 payments to VTI should be considered loans rather than the repayment of an outstanding loan from VTI  
13 to appellants.

14 If appellants wish to provide additional information and documentation, it should be  
15 provided at least fourteen days prior to the hearing to:

Claudia Madrigal, Board of Equalization  
Board Proceedings Division  
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Sacramento, California 94279-0080

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