

(1) CAP. CONTRI. v. ^{S/H}
(2) DOING BUS. (CO.



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA.

In the Matter of the Appeals of }
LAKEHURST CONSTRUCTION CO., ET AL. }

Appearances:

For Appellants: Harrison Harkins
Attorney at Law

For Respondent: Israel Rogers
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of the following appellants against proposed assessments of additional franchise tax in the amounts and for the taxable years indicated:

<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Lakehurst Construction Co.	9/30/56	\$ 85.98
	9/30/57	44.39
Amboy Construction Co.	9/30/58	1 7 0 . 5 1
Baystate Construction Co.	9/30/58	177.61
Benrus Construction CO.	9/30/56	108.44
	9/30/57	53.38
Boyton Construction Co.	9/30/56	214.10
	9/30/57	95.64
Dorel Construction Co.	9/30/58	184.72
Fleet Construction co.	9/30/56	388.56
	9/30/57	165.42
Gem Construction Co,	9/30/58	1 7 7 . 6 2

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<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Glenare Construction Co.	9/30/56	\$ 426.34
	9/30/57	180.54
Hedda Construction Co.	9/30/56	448.51
	9/30/57	189.24
Jonmark Construction Co.	9/30/56	227.99
	9/30/57	101.19
Laport Construction Co.	9/30/56	638.45
	9/30/57	265.38
Maora Construction Co.	9/30/56	224.62
	9/30/57	99.85
Maruth Construction Co.	9/30/58	191.82
Millbrae Construction Co.	9/30/58	177.61
Neb Construction Co.	9/30/56	52.68
	9/30/57	31.07
Pitt Construction Co.	9/30/58	170.51
Rockwin Construction Co.	9/30/56	141.34
	9/30/57	66.53
Stocker Construction Co.	9/30/56	303.51
	9/30/57	131.40
Westpark Construction Co.	9/30/58	177.61

The twenty corporations involved in these appeals were formed by four individuals, Louis H. Boyar, Mark Boyar, G. Harry Rothberg and Ben Weingart, for the purpose of acquiring certain contiguous parcels of real estate and constructing and selling residential units on that property. In June 1954 appellants' four incorporators began negotiating to purchase the desired tract of land. By September 21, 1954, they had reached a tentative financing agreement with a lending agency under which the promoters were to form a number of separate corporations to carry out the construction project.

All appellants were incorporated under California law on October 4, 1954, and each adopted a fiscal year ending September 30. The capital stock of each appellant was \$782, the four incorporators holding 750 of the 782 shares which were issued.

On October 20, 1954, each appellant became a party to a separate "Loan Agreement" with the lending agency (hereafter referred to as "lender"). Under those contracts lender was to advance \$30,000 to each appellant, to be used to purchase a portion of the desired tract of land. Each appellant gave its promissory note payable in two years at 4 percent annual interest, and also agreed to pay to lender 40 percent of its net profits from the building program. Pursuant to the terms of the agreements the four incorporators personally guaranteed payment of the principal and interest due on each of the notes.

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The agreements further provided that the incorporators would be released from their guarantees when appellants acquired the specified real estate and issued trust deeds to lender. At that time each appellant was to execute a new note, free of the guarantees. If the financial institution furnishing construction financing to the appellant requested the security of the real estate, lender agreed to relinquish its lien on the land,

On the same day that appellants received the funds from lender, they advanced most of the amounts to Louis H. Boyar to acquire the land for them. Within the next few days, Boyar acquired the land and executed trust deeds to lender. In April 1955, he deeded various parcels to appellants, subject to the trust deeds. Subsequently lender released its liens, construction financing was obtained and the planned homes were built. Only eight of the twenty appellants realized a profit on this venture.

During the income year ended September 30, 1957, each appellant repaid the \$30,000 advanced by lender. The lending agency settled for a payment of \$37,500 cash and a commercial lot of unspecified value in lieu of the annual interest, none of which had previously been paid, and the shares of appellants' profits otherwise due it under the agreements. The cash represented about 33 percent of appellants' total net profits. Appellants were dissolved on January 14, 1959.

Appellants argue that the advances constituted bona fide loans to them by the lending agency, and that all amounts accrued or paid to the lender in excess of principal are therefore deductible as interest. Respondent disallowed those deductions on the ground that the advances constituted capital contributions by the lending agency rather than loans, or, alternatively, if they were true loans, they were in substance loans to the shareholders rather than to appellants.

Section 24344 of the Revenue and Taxation Code provides for the deduction of interest paid or accrued during the income year on indebtedness of the taxpayer. There is no provision by which a corporation may deduct dividends paid by it based on contributions to its capital.

Whenever loans are made to a corporation which is "thinly capitalized," i.e., when it is financed with a nominal investment in its stock and a large amount of ostensible loans, the inference arises that part of the loans are, in fact, investments in capital. (Gilbert v. Commissioner, 248 F.2d 399; Isidor Dobkin, 15 T.C. 31, aff'd per curiam, 192 F.2d 392; R. M. Gunn, 25 T.C. 424, aff'd sub nom. Perrault v. Commissioner, 244 F.2d 408, cert. denied, 255 U.S. 830 [2 L. Ed. 2d 42].) In

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such a situation the transaction will be looked through to determine its true substance. (Gilbert v. Commissioner, supra, 248 F.2d 399.)

In Appeals of Agate Construction Co., et al., Cal. St. Bd. of Equal., March 7, 1961, the same lending agency involved here made similar advances under similar terms to launch the construction operations of a group of inadequately capitalized corporations formed by Mark Boyar and G. Harry Rothberg, also incorporators and stockholders in the instant case. There were no written, personal guarantees in evidence in the Agate case. We concluded there that the **advances** made to the corporations amounted in substance to loans to the shareholders, who in turn contributed to the capital of the corporations, and that the profits and interest paid to the lender were therefore not deductible because they were in the nature of dividends to the stockholders.

Appellants here, as in the Agate appeals, had not commenced construction operations at the time they each received the \$30,000 from the lender. The total assets of each did not exceed the \$782 contributed by the shareholders. As we stated in the Agate case, supra, "It requires no expertness in financial matters to recognize that loans by a commercial lending institution to . . . [appellants], solely on their own credit, in an aggregate amount of some . . . [\$600,000] would have constituted a departure from sound financial practices."

The only feature' that distinguishes **this** case from the Agate appeals is the presence of documents which, if taken at face value, would indicate that the shareholders were no longer responsible for the loans after appellants acquired the land and issued trust deeds. At that time appellants were to execute new notes free of the guarantees. If the agreements were followed, the loans would have been wholly unsecured when construction financing was obtained.

The written agreements, however, lose significance in view of the fact that the parties themselves ignored them in paying the amounts due on the loans. The new notes that were supposed to be issued by appellants free of the guarantees, moreover, are not in evidence.

In the Agate appeals, two of the shareholders who are also' shareholders in this case accommodated the same lending agency here involved by paying off the loans at the end of a particular year so that the loans, ostensibly made to the corporations, could be eliminated **temporarily from** the lender's books. The lending agency was similarly obliging in this case by refraining from enforcing the payment of interest when due and in settling for less than the full amount of **interest** and

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profits specified in the agreements. The informality and leniency which mark the dealings of the parties leave scope for the same inference that we drew in the Agate appeals, that is, that the lender in fact relied upon the shareholders for repayment at all times.

Authorities cited by appellants for the proposition that they were entitled to deductions because they were at least equitably obligated to pay the loans and the interest (United States Fidelity and Guaranty Co., 40 B.T.A. 1010; New McDermott, Inc., 44 B.T.A. 1035; Howard Gould, 14 T.C. 744) are not relevant here. None of those cases involved the issues of whether the loan proceeds were contributed to capital and whether the payments were therefore nondeductible dividends.

Appellants have also called our attention to a recent Tax Court decision, Ray A. Myers, 42 T.C. 195, in which it was stated that the "thin corporation" doctrine was not there applicable. The advances involved in Myers, however, **were** necessary in order to complete construction projects already well under way, rather than to get such operations started, as in this case.

Since the material facts in the instant case are substantially identical to those in the Agate appeals, we see no reason to reach a different result.

These appeals raise a second issue in the case of twelve of the appellants, i.e., whether or *not* those appellants were engaged in business for a full 12-month period prior to September 30, 1955, the end of their first taxable year.' If so, as appellants contend, their tax for the year ended September 30, 1956, is to be measured by their income for the previous year; if not, as respondent has concluded, their tax for the year ended September 30, 1956, is to be computed on the basis of their income for that same year. (Rev. & Tax. Code, § 23222.) Applying its own regulation (Cal. Admin. Code, tit. 18, reg. 23221-23226, subd. (b)), which at the time here involved provided that a period of more than 15 days would be considered as one month, respondent concedes that if appellants commenced business operations on or before October 16, 1954, they may be considered to have been doing business for a full 12 months prior to September 30, 1955, the close of their first taxable year.

Section 23101 of the Revenue and Taxation Code defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." Respondent's regulations provide:

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The first taxable year begins when the corporation commences to do business, which may be at any time after the articles of incorporation are filed and generally subsequent to the time the first board of directors meeting is held. Since the corporate powers are vested in the board of directors under the Corporations Code, it is rarely true that a corporation will be doing business prior to the first meeting of the board. However, if preincorporation activities are ratified at the first meeting of the board and the activities would normally constitute doing business, the taxable year will be deemed to have commenced from the date of incorporation, but not prior to that date. Each case must be decided upon its own facts. (Cal. Admin. Code, tit. 18, reg. 23221023226, subd. (c).)

The first directors' meetings were held on October 11, 1954'. The minutes of those meetings reveal no formal ratification of any preincorporation promoter activity, and all such activities are thus irrelevant in determining whether **or** not appellants were "doing business."

The events shown by the record to have occurred after incorporation and on or before October 16, 1954, consist of the preparation by a shareholder on October 4 of a memorandum directed to the accountant who was to handle appellants' records, setting forth the proposed plan of operations; the first meetings of the boards of directors on October 11, 1954, at which by-laws were adopted and officers elected; and the second meetings of the directors on October 13, 1954, at which resolutions were adopted authorizing the opening of bank accounts.

We believe it is clear that these activities were preliminary to "doing business" and did not constitute "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." They are readily distinguishable in both scope and nature from the activities carried on in behalf of the corporation during a similar post-incorporation period by the sole promoter-stockholder in Appeals of Kleefeld & Son Construction Co., et al., Cal. St. Bd. of Equal., June 9, 1960, on which appellants rely..

Having considered the entire record carefully, we conclude that respondent's treatment of the issues raised was proper.

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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 theref or,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board *on* the protests of the following appellants against proposed assessments of additional franchise tax in the amounts and for the taxable years indicated, be'and the same is hereby sustained:

<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Lakehurst Construction Co.	9/30/56	\$ 85.98
	9/30/57	44.39
Amboy Construction Co.	9/30/58	170.51
Baystate Construction Co.	9/30/58	177.61
Benrus Construction Co.	9/30/56	108.44
	9/30/57	53.38
Boyton Construction Co.	9/30/56	214.10
	9/30/57	95.64
Dorel Construction Co.	9/30/58	184.72
Fleet Construction Co;	9/30/56	388.56
	9/30/57	165.42
Gem Construction Co.	9/30/58	177.62
Glenare Construction Co.	9/30/56	426.34
	9/30/57	180.54
Hedda Construction Co.	9/30/56	448.11
	9/30/57	189.24
Jonmark Construction Co.	9/30/56	227.99
	9/30/57	101.19
Laport Construction Co.	9/30/56	638.45
	9/30/57	265.38
Maora Construction Co.	9/30/56	224.62
	9/30/57	99.85
Maruth Construction Co.	9/30/58	191.82
Millbrae Construction Co.	9/30/58	177.61

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<u>Appellant</u>	<u>Taxable Year</u>	<u>Amount</u>
Neb Construction Co,	9/30/56	
	9/30/57	\$ 52.68 31.07
Pitt Construction Co.	9/30/58	170.51
Rockwin Construction Co.	9/30/56	141.34
	9/30/57	66.53
Stocker Construction Co.	9/30/55	303.51
	9/30/5 8	177.61 131.40
Westpark Construction Co.		

Done at Sacramento, California., this 5th.
 day of October, 1965, by the State Board of Equalization.

John W. Lynch, Chairman
Richard Klein, Member
Paul R. Lester, Member
George J. [unclear], Member
Scott Perry, Member

Attest [Signature], Secretary