

Appeal of Warren N. and Catherine S. Haupt

The sole issue for determination here is whether amounts withdrawn from the Kern Rock Company by the Dan C. Sill Trust, owner of 50 percent of the stock of the Kern Rock Company, were bona fide loans or taxable dividends. A second issue raised in the appeal, concerning an alleged understatement of royalty income received in 1969 by the Dan C. Sill Trust from the Kern Rock Company, has now been conceded by respondent. That concession reduces the proposed assessments of additional personal income tax for the year 1969 to \$139.51 against Warren N. Haupt and \$139.77 against Catherine S. Haupt.

Appellant Catherine S. Haupt and her two sisters are each one-third beneficiaries of the Dan C. Sill Trust. The trust is a simple trust which owns one-half of the stock of the Kern Rock Company, a California corporation. The other one-half interest in the corporation is owned by Gertrude Sill, the sole trustee of the trust and the mother of Mrs. Haupt.

During the years in issue the trust withdrew funds from the Kern Rock Company in order to satisfy federal estate tax liabilities resulting from the death of Dan C. Sill (Mrs. Haupt's father and settlor of the trust), and to pay insurance premiums on a policy covering the life of Gertrude Sill.

In the account books of the corporation the withdrawals were treated as loans to the trust. However, no promissory notes were signed, no security was ever given, no interest was charged, and no repayment dates were specified. The withdrawals and the unpaid balance for each year in issue were as follows:

<u>Year</u>	<u>Withdrawals</u>	<u>Balance</u>
1966	\$12,884.78	\$18,488.00
1967	12,465.10	30,953.10
1968	11,980.01	42,933.11
1969	14,467.63	57,400.74

The company books indicated that the Kern Rock Company's earned surplus account contained \$459,032.00, \$500,669.00, \$571,167.00 and \$610,967.00 during the years 1966, 1967, 1968 and 1969, respectively. However, dividends paid during those years amounted to only \$1,843.92, \$673.61, \$1,843.92 and \$1,843.92, respectively.

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On the basis of the preceding facts, respondent determined that the withdrawals made by the trust were in fact distributions of corporate earnings and profits which constituted taxable dividends. Respondent increased the income of the Dan C. Sill Trust accordingly. Since that trust was a simple trust which distributed its entire income annually, one-third of those additional dividends for each year was allocated to each of the trust's three beneficiaries. As a result, respondent increased appellants' taxable income and proposed the assessments of additional personal income tax which gave rise to this appeal.

Appellants contend that the withdrawals in question were bona fide loans, the proceeds of which are not included in gross income under section 17071 of the Revenue and Taxation Code, or under section 17081 et seq. of that code, **where** items specifically included in gross income are set forth.

It is true that if the withdrawals in question were loans, the proceeds thereof would not be taxable to the borrower who remained liable for their repayment. In the present case, however, we are unable to agree that the **withdrawals in question** constituted bona fide loans. In Appeal of Albert R. and Belle Bercovich, decided by this board on March 25, 1968, where amounts withdrawn were found to constitute taxable dividends, we stated:

Whether withdrawals from a corporation by a stockholder represent loans or taxable distributions depends on all the facts and circumstances surrounding the transactions between the shareholder and the corporation. (Harry E. Wiese, 35 B.T.A. 701, aff'd, 93 F.2d 921, cert. denied, 304 U.S. 562 [82 L. Ed. 15291, reh. denied, 304 U.S. 589 [82 L. Ed. 15491; Elliott J. Roschuni, 29 T.C. 1193, aff'd, 271 F.2d 267, cert. denied, 362 U.S. 988 [4 L. Ed. 2d 1021].) A determination that the withdrawal constitutes a loan depends upon the existence of an intent at the time the withdrawal was made that it should be paid back. (Atlanta Biltmore Hotel Corp., T.C. Memo., Sept. 19, 1963, aff'd, 349 F.2d 677; Clark v. Commissioner, 266 F.2d 698.)

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Special scrutiny is given where the **with-** drawer is in substantial control of the corporation (Elliott J. Roschuni, supra; W. T. Wilson, 10 T.C. 251; Ben R. Meyer, 45 B.T.A. 228), and withdrawals under such circumstances are deemed to be dividend distributions unless the controlling stockholder can affirmatively establish their character as loans. (W. T. Wilson, supra.) Furthermore, family control of a corporation invites careful examination of transactions between shareholders and the corporation. (William C. Baird, 25 T.C. 387; Ben R. Meyer. supra.)

In Bercovich the facts presented were substantially identical to those in the case at hand, except that in Bercovich no formal dividends were paid by the corporation. This distinction is of little significance, however, since the dividends paid by Kern Rock Company between 1966 and 1969, inclusive, were but a nominal fraction of its earned surplus during the same years.

Appellants argue that the withdrawals in question here should not be treated as dividends simply because the formalities which usually attend loan transactions were absent in this case. They argue that it is **the** intent of the parties at the time of the transaction that is determinative of the issue of whether it is a dividend or a loan (Chism's Estate v. Commissioner, 322 F.2d 956), and that in determining the true intent of the parties, "one must look, not alone to book entries. . . or to isolated expressions of witnesses or parties, but one must endeavor to visualize the entire situation as it existed." (Chattanooga Savings Bank v. Brewer, 9 F.2d 982, 987, aff'd, 17 F.2d 79; Ben R. Meyer, 45 B.T.A. 228.)

In support of their position, appellants point to an alleged debtor-creditor relationship which has historically existed between the Dan C. Sill Trust and the Kern. Rock Company. They argue that this relationship has been proved by a solid record of repayment. However, appellants have failed to document any such relationship or history of repayments. Without more than unsupported allegations, and in light of the substantial yearly increase in the earned surplus account

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balance between 1966 and 1969, as well as the almost complete lack of indicia that normally are present in loan transactions, we must conclude that the withdrawals in question were distributions of corporate earnings and profits which were taxable as dividends. We thereby sustain respondent's action in this matter.

O R D E R

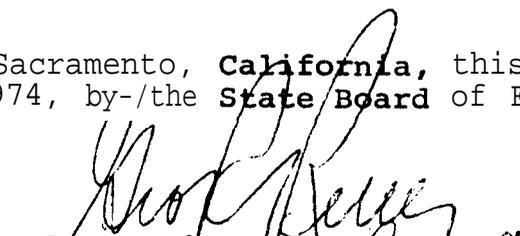
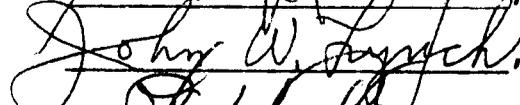
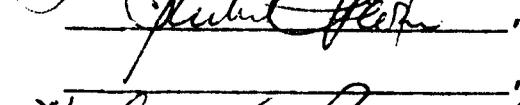
Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Warren N. and Catherine S. Haupt against proposed assessments of additional personal income tax in the amounts and for the years as follows:

<u>Appellants</u>	<u>Year</u>	<u>Proposed Assessment</u>
Warren N. and Catherine S. Haupt	1966	\$ 85.85
	1967	194.28
	1968	224.96
Warren N. Haupt	1969	216.40
Catherine S. Haupt	1969	216.68

be and the same is hereby modified in that the proposed assessments for 1969 against Warren N. Haupt, individually, and Catherine S. Haupt, individually, be reduced in accordance with the respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, **California**, this 19th day of February, 1974, by the **State Board** of Equalization.


_____, Chairman

_____, Member

_____, Member

_____, Member

ATTEST: , Secretary