76-SBE-003

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ARMORED TRANSPORT, INC.)

Appearances:

For Appellant: Richard B. Newton
Attorney at Law

For Respondent: Marvin J. Halpern
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Armored Transport, Inc., against a proposed assessment of additional franchise tax in the amount of $4,093.80 for the income year ended April 30, 1967.

Appeal of Armored Transport, Inc.

Appellant, Armored Transport, Inc. , is a California corporation engaged primarily in intrastate transportation of money and valuables. Prior to 1966, appellant relied upon independent air carriers to handle its long distance shipments. Because this arrangement was unsatisfactory, appellant's directors decided to acquire ABC Airlines (hereafter ABC), a California corporation engaged in air transport of freight and passengers. The acquisition was completed in February 1966 pursuant to an agreement which provided, in part, that appellant would purchase all of the outstanding capital stock of ABC for $1,000, and that appellant would deposit $49,000 into escrow. According to the terms of the agreement, a portion of the escrow fund was to be distributed to ABC to the extent necessary to balance its current assets and current liabilities, and the remainder was to be distributed to the previous stockholders of ABC in full satisfaction of indebtedness due them from ABC. At various times subsequent to the acquisition, appellant advanced a total of $79,459 to ABC to enable it to meet current operating expenses. In February 1967, a plan to dissolve ABC was adopted. Upon liquidation appellant received assets valued at $16,425.

In its franchise tax return for the fiscal year ended April 30, 1967, appellant claimed capital losses in the amounts of $1,000 and $49,000, on the basis that its initial investments in ABC became worthless in that year. Appellant also claimed a bad debt deduction of $63,035, representing the difference between the advances made to ABC and the value of assets received by appellant upon liquidation. Respondent disallowed the claimed deductions on the basis of section 24502 of the Revenue and Taxation Code.

'Section 24502 of the Revenue and Taxation Code, as applicable to the factual situation presented by this appeal, denies recognition of loss on receipt by a corporation of property distributed in complete liquidation of its, controlled subsidiary. The provision is operative only with respect to a distribution of assets to the parent corporation in cancellation of its capital or stock interest in the subsidiary. A distribution of assets to the parent corporation entirely attributable to its claim as a bona fide creditor of the dissolved subsidiary does not come within the statute. (Cal. Admin. Code, tit. 18, reg. 24502(g).) The parent's capital investment and bad debt losses are fully deductible in that situation.

Appellant contends that its advances to ABC in the amount of $79,459 were loans, that it received assets upon dissolution of the subsidiary in satisfaction of that indebtedness, and, therefore, that the transaction does not fall within the provisions of section 24502. Respondent, on the other hand, contends that the advances constituted capital investment in the subsidiary, that appellant received assets upon dissolution of ABC in cancellation of its stock interest, and that section 24502 applies in this situation to disallow recognition of appellant's stock investment and purported bad debt losses. The narrow issue presented for our determination is whether the advances made by appellant to its subsidiary constituted loans or capital investment.

A determination of whether an advance to a closely held corporation creates a true debtor-creditor relationship or actually represents a contribution to capital depends upon the particular facts of each case. (John Kelley Co. v. Commissioner, 326 U. S. 521 [90 L. Ed. 278]; Gilbert v. Commissioner, 262 F. 2d 512, cert. denied 359 U. S. 1002 [3 L. Ed. 2d 1030].) There is no comprehensive rule by which the question may be decided in all cases, and it would serve little purpose to compare the myriad details that distinguish the cases cited by appellant and respondent in support of their respective positions. (See generally, Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal (1971) 26 Tax L. Rev. 369.)

The primary consideration with respect to proper characterization of advances made to a closely held corporation is whether the parties genuinely intended to create and maintain a debtor-creditor relationship. (Gooding Amusement Co. v. Commissioner, 236 F. 2d 159, 166, cert. denied 352 U. S. 1031 [1 L. Ed. 2d 599]; Matthiessen v. Commissioner, 194 F. 2d 659.) The determinative intent, however, is necessarily the objective intent as disclosed by all relevant facts and circumstances surrounding the transaction. (A. R. Lantz Co. v. United States, 424 F. 2d 1330, 1333; Wilshire & Western Sandwiches v. Commissioner, 175 F. 2d 718, 720.) In attempting to deal with this problem, the courts have isolated criteria by which to ascertain the true nature of the advances. (See 4A Mertens, Law of Federal Income Taxation §§ 26. 10a, 26. 10c.) Of the criteria or factors bearing on the intention to create and maintain a debtor-creditor relationship, the following are relevant to this appeal: whether the parties

formally characterized the advances as representing indebtedness, whether there was payment of interest or repayment of principal by the subsidiary, and whether there was voluntary subordination of the purported indebtedness.

A debt is ordinarily represented by "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." (Gilbert v. Commissioner, 248 F. 2d 399, 402.) At the hearing of this appeal, appellant's controller testified that the advances to ABC were carried on appellant's books as accounts receivable. No statement was made regarding treatment of the advances on the books of the subsidiary. Appellant also produced, as documentary evidence, ABC's promissory note in the amount of $10,000 bearing interest at six percent, payable to appellant upon demand. Appellant's representative explained that similar notes were issued in conjunction with all advances made to ABC, but that the other notes had been lost. However, there is some doubt whether the note actually pertains to the advances in question. In a letter to respondent dated December 27, 1972, appellant's controller stated that "[i]n conformity with long established company policy, the open account indebtedness of ABC to appellant was neither evidenced by written agreements, nor bore interest, nor contained specific repayment provisions." Since the letter was written in response to respondent's request for specific information concerning the purported indebtedness, it is apparent that the statement refers to the advances in question. The contradictory nature of the evidence precludes a determination based solely upon the parties' characterization of the advances that a true debtor-creditor relationship was intended. As will be developed below, ABC was in precarious financial condition throughout the period of appellant's ownership, and prompt payment of either interest or principal on the purported indebtedness was unlikely. Under the circumstances, whether the purported debt was represented by demand notes or an open account, the absence of a realistic maturity date raises a strong inference of equity contribution. (See Tyler v. Tomlinson, 414 F. 2d 844, 849; Wachovia Bank and Trust Co. v. United States, 288 F. 2d 750, 754.)

The record on appeal is not clear with respect to the subsidiary's repayment of the advances. Within the communication referred to above, appellant's controller stated that "payments on open indebtedness were made to ABC in minor amounts at such times as cash was available. " Appellant did not establish the date or amount of any alleged payments, or whether they constituted payment of interest or repayment of principal. Appellant's relatively casual attitude toward repayment of the advances suggests an intention generally attributable to an investor to leave the funds at the risk of the business. (Tyler v. Tomlinson, supra; 0. H. Kruse Grain & Milling Co. United States, F. 2d 123, 126.)

Equity investment, as opposed to debt, is also indicated where, in combination with other adverse factors, it appears that the purported debt has been subordinated to the claims of general creditors. (Reef Corp. v. Commissioner, 368 F. 2d 132, cert. denied 386 U. S. 1018 [18 L. Ed 2d 454]; P. M. Finance Corp., v. Commissioner, 302 F. 2d 786,' 789.) At the hearing of this appeal, appellant established that it received assets valued at $16,425 upon dissolution of ABC. However, it is not clear from the record whether and to what extent the consideration received by appellant represented a pro rata distribution to a general creditor of the subsidiary. Appellant's controller testified that appellant paid off all of the obligations of ABC upon its dissolution. This evidence clearly suggests that appellant satisfied all of ABC's outside debt at the expense of its own recovery, and, in effect, subordinated its own claim against the subsidiary.

In light of the facts and circumstances surrounding appellant's characterization and treatment of the advances to its subsidiary, we must conclude that the parties did not intend to create and maintain a true debtor-creditor relationship, Our conclusion in this regard is confirmed by consideration of another major test or criteria for distinguishing debt from equity investment: whether, as a matter of "substantial economic reality, " the funds were "advanced with reasonable expectations of repayment regardless of the success of the venture. " (Gilbert v. Commissioner, supra, 248 F. 2d at 406.)

Appellant contends that ABC was in financially sound condition at or near the time it acquired ownership and that it reasonably expected repayment of advances out of the subsidiary's future operating profit. In support of its contention, appellant

submitted a document entitled "Statement of Current Assets and Liabilities of ABC as of March 1, 1966" which shows a net excess of current assets. However, included within the current asset column of this statement is the depreciated value of aircraft, a fixed asset. Excluding the value attributed to the aircraft,[1] the statement tends to show that, contrary to appellant's assertion, ABC was not in sound financial condition at the outset of appellant's ownership. Furthermore, appellant's advances to ABC were made to enable the subsidiary to continue to meet its current operating expenses. Under the circumstances, the continued advances from appellant to its faltering subsidiary must be viewed as contributions of risk capital for which repayment was reasonably expected only upon the ultimate success of the venture. (See Diamond Bros. Co, v. Commissioner, 322 F. 2d 725, 732.)

The burden of proving that its advances to ABC were in fact loans rests upon appellant. (White v. United States, 305 U. S. 281 [83 L. Ed. 172]; Appeal of George E. Newton, St Bd. of Equal. , May 12, 1964.) After a careful assessment of the evidence produced on appellant's behalf, we are of the opinion that appellant has not sustained its burden.

Accordingly, we must sustain respondent's action in this matter.

1/ Proper evaluation of a corporation's financial condition based upon its net current assets' necessarily requires exclusion of fixed or nonliquid assets from consideration. (See Accounting Research and Terminology Bulletins, Final Edition (1961), AICPA, pp. 20-21.)

Anneal of Armored Transport. Inc.

ORDER

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

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 protest of Armored Transport, Inc. , against a proposed assessment of additional franchise tax in the amount of $4,093.80 for the income year ended April 30, 1967, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of February, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____ Executive Secretary