



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
GEORGE F. AND SYLVIA A. CASHMAN)

Appearances:

For Appellants: Peter R. Palermo
Attorney at Law

For Respondent: David M. Hinman
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of George F. and Sylvia A. Cashman against proposed assessments of additional personal income tax in the amounts of \$762.00, \$694.94, \$32.99 and \$60.11 for the years 1968, 1969, 1970 and 1972, respectively.

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The proposed assessments arise out of the activities of George F. Cashman, who will hereinafter be referred to as "appellant". The issues to be decided are: (1) whether payments appellant made pursuant to a bank loan guaranty are fully deductible as business bad debts, and (2) whether the rent-free use of a home owned by a corporation in which appellant was the sole shareholder of record constituted a constructive dividend.

Bad Debt Deduction

During the early 1960's, appellant was involved in the organization and promotion of approximately 25 corporations engaged in various enterprises. Although appellant also owned an automobile dealership during that time, he alleges that his primary source of income was derived from his promotional activities, which consisted of procuring financing for and building up corporate businesses for eventual sale. Appellant did not manage the day-to-day operations of the corporations, which were handled by a general manager who was usually the buyer of the business. In return for his promotional efforts, appellant was to receive a percentage of each corporation's net profits. Of the 23 corporations whose names were introduced at the oral hearing on this matter, appellant testified that approximately six were sold, while a few others were liquidated or merged. The only direct fee reported received by appellant was for his services in connection with one merger.

Financing of the corporations was obtained in part through bank loans, some of which appellant was required to guarantee personally. One such guaranty was executed on behalf of Hallmark Financial Corporation (hereinafter "Hallmark"), which was incorporated in 1961 with appellant as the sole shareholder. Appellant and Hallmark had an unwritten agreement that appellant would be paid ten percent of Hallmark's annual net profits in return for promoting Hallmark.

By 1966, Hallmark was delinquent on its loan and appellant assigned to the bank as payment under his guaranty, his rights in a \$100,000 consulting fee contract which was payable at \$20,000 per year. Later, a judgment was entered against appellant for the balance due on the loan. Appellant included \$20,000 in income on his 1968 and 1969 returns and deducted \$20,000 each year as a business bad debt. Respondent disallowed the deduction on the ground that the debt was not related to a trade or business of appellant, and treated the payments

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as nonbusiness bad debts resulting in short-term capital losses. Appellant's position is that he was in the business of promoting corporations for a fee and that the loss was incurred in connection with that activity.

It is well established that respondent's determination to disallow a deduction is presumed correct and the burden is on appellant to establish his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.)

For purposes of the bad debt deduction, a loss incurred in discharging a guaranty of a corporate obligation is a nonbusiness bad debt deductible only as a short-term capital loss (Cal. Admin. Code, tit. 18, reg. 17207(h), subd. (2)), unless the debt **was** created or acquired in connection with the taxpayer's trade or business, or unless the worthlessness of the debt results in a loss incurred in the taxpayer's trade **or** business. (Rev. & Tax. Code, § 17207, subd. (d)(2)(A)-(B).) Thus, in order to deduct the payments in question as ordinary losses, appellant must demonstrate that as a promoter, he was carrying on a business and was not simply managing personal investments. In this regard, appellant must show that he profited by developing the corporations as "going businesses for sale to customers in the ordinary course" or by receiving income "directly for his own services" rather than by the indirect return through the corporate enterprise which typifies the investor's reward. (Whipple v. Commissioner, 373 U.S. 193 [10 L. Ed. 2d 288] (1963) For the reasons which follow, we believe appellant has failed to carry his burden of proof on this issue.

Appellant has shown that for a period of five or six years, he was instrumental in the organizing of several corporations, usually in concert with others. In that sense, he was a "promoter" as that term is used in corporate or securities law. (See Townshend v. United States, 384 F.2d 1008, 1012 (Ct. Cl. 1967) for a discussion of this point.) However, it is firmly established **under the principles announced in Whipple**, that in order for a promoter to be considered as engaged in a trade or business for tax purposes, he must receive direct income in the form of fees, commissions or profits from the sales of corporations.

When the only return is that of an investor, the taxpayer has not satisfied his burden of

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demonstrating that he is engaged in a trade or business since investing is not a trade or business, and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business, but from that of the corporation. (Whipple v. Commissioner, supra, at 202.) ^{1/}

We acknowledge that the taxpayer in Whipple did not intend to sell the corporations he served. However, in discussing the circumstances under which promotional activity might support a finding of a trade or business, the court in Whipple relied on the case of Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) where the taxpayer's activities included actively seeking out business opportunities, organizing and financing them, and contributing 50 percent of his time to their development for sale. In the instant case, appellant assumed a more passive role, at times merely acting as a conduit for the ideas of others and never involving himself in the actual operation of the corporations. Further, the number of loan guarantees appellant claims to have executed is not supported by the evidence. (See Plaintiff's Exhibits Nos. 3, 4, 5.) Under the circumstances, we must sustain respondent's action on this matter.

Rent-Free Residence

During the appeal years, appellant was vice president and the sole shareholder of record of Drake Oil Corporation. In 1964 the corporation purchased a residence in Rolling Hills, which appellants leased for \$400 per month. Appellants made the monthly payments until 1967, when personal financial difficulties caused them to cease paying rent. However, they continued to occupy the home and the corporation has not taken any action to enforce the lease obligations.

Respondent determined that appellants' rent-free use of this residence constituted a constructive dividend from Drake of 54,800 a year. Appellant contends that in 1965 he assigned his Drake shares to a third party as

^{1/} This principle has been affirmed in several cases, under varying factual circumstances. (See e.g., United States v. Byck, 325 F.2d 551 (5th Cir. 1963); Townshend v. United States, supra; Earl M. Smith, 62 T.C. 263 (1974) .)

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security for a loan, and that Drake has an enforceable debt against him for the back rent. Respondent and appellant agree that use of the home was not tax-free lodging furnished to an employee within the meaning of Revenue and Taxation Code section 17151 and the regulations thereunder. For the following reasons, we believe respondent's action must be sustained.

It is not disputed here that making corporate owned property available to a stockholder for his personal benefit may result in the receipt of constructive dividends by the stockholder in amounts equal to the fair market value of the benefits conferred. (Macri Corporation, et al., 1176,273 P-H Memo. T.C. (1976).) Here, there is no evidence to corroborate appellant's contention that he relinquished his ownership rights in Drake stock to Francis Ryan. Ryan's affidavit states that the stock was "pledged" to him, which indicates that the parties simply created a form of bailment for security and appellant retained legal title to the stock and any dividends on it. (See 2 Witkin, Summary of Cal. Law (8th ed. 1973) pp. 1422-1434.) Nor have corporate records been produced to prove that anyone other than appellant owned the shares in question. (See Corp. Code, §§ 701, 702, 705.)

While we agree that the copy of the lease submitted as Plaintiff's Exhibit 7 herein is some evidence of appellant's indebtedness to the corporation, the failure of the corporation to take any action against appellant for nearly 10 years, at least to remove him from the residence, if not to collect the unpaid rent, is of greater weight in our determination. The usual indicia of indebtedness are not present here, e.g., security, interest or repayment, and it appears that the statute of limitations has run on any action against appellants under the lease. (Code Civ. Proc., § 337.) Under the circumstances, we must conclude that appellant has failed to substantiate his position.

For the above stated reasons, respondent's actions in this matter must be sustained.

