

Appeal of Margo Leavin Gallery, Inc.

Appellant was formed as a California corporation on October 1, 1973. The business assets and liabilities of Ms. Margo Leavin, who had been operating an art gallery as a sole proprietorship, were immediately transferred to appellant. The assets transferred to appellant included store equipment valued at \$12,000 and inventory of prints and paintings valued at \$206,000. **In exchange for these assets, Margo Leavin received all of appellant's stock with a stated value of \$25,000. She also received an unsecured demand note from appellant for \$100,000, dated October 16, 1973, bearing interest at the rate of 8 percent per annum commencing October 1, 1974, and a credit on appellant's books of approximately \$34,000 for loans payable. As a part of the transaction, appellant also assumed Margo Leavin's liability for notes payable to a bank for \$15,000 and to Margo Leavin's father for \$44,000.**

During the years in question, appellant paid off the \$15,000 bank loan which it had assumed on behalf of its sole stockholder. Although in the appeal years appellant did pay interest on the \$100,000 demand note payable to Ms. Leavin, as of September 30, 1977, no payment on the **principal** of that note had ever been made. Appellant's earnings during the years in question were apparently used to **maintain** its inventory of art works. Furthermore, when additional operating funds were needed by appellant, the lending bank apparently required **Margo Leavin to guarantee the loan.**

Upon audit; respondent **determined that** the \$100,000 demand note received by Ms. Leavin in exchange for a portion of the gallery assets represented a contribution to capital rather than a loan. **In accordance** with this determination, the interest paid by appellant on the purported loan in the appeal years was disallowed as a deduction and a deficiency assessment was proposed.

The question presented for determination is whether a demand note issued by appellant to its sole stockholder constituted a true indebtedness so that 'purported interest payments made thereon during the appeal years were deductible by appellant.

Section 24344 of the Revenue and Taxation Code provides for the deduction by a corporation of interest paid or accrued during the income year on indebtedness of the corporation. The provisions of this section are substantially identical to those of section 163(a) of

Appeal of Margo Leavin Gallery, Inc.

the Internal Revenue Code. Consequently, federal law is persuasive in determining the proper interpretation and application of the corresponding California law.

(Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941).)

In order to deduct interest paid or accrued, it must be shown that a bona fide debt existed. Thus, in order to be entitled to the interest expense deductions claimed, appellant has the burden of establishing that the relationship of debtor-creditor actually existed between it and its sole shareholder, **Margo Leavin**. (Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695 (4th Cir. 1963).)

It is well-settled that the nature of advances to a closely held corporation is a question of fact. (Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958), affd., 262 F.2d 512 (2nd Cir. 1959), cert. den., 359 U.S. 1002 [3 L.Ed. 2d 10301 (1959); Appeal of Kim Lighting and Manufacturing Co., Inc., Cal. St. Bd. of Equal., June 2, 1969.) When attempting to establish the nature of advances to a closely held corporation, the basic inquiry is whether the funds were placed at the risk of the corporate venture, or whether there was a reasonable expectation of repayment regardless of the success of the business. (Gilbert v. Commissioner, supra; Appeal of Kim Lighting and Manufacturing Co., Inc., supra.) The federal courts have developed numerous **guidelines** for answering this debt versus equity question. (See, e.g., O. H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960).)

Unfortunately, in this case we have only limited facts. All we really know is that a demand note was given by appellant to its sole shareholder at the time appellant was formed, in return for assets transferred to the corporation which were essential to its business operations. No demand for payment of that note was ever made by **Ms. Leavin**, although other corporate obligations apparently were paid. It also appears that **Margo Leavin** was required to guarantee a \$15,000 bank loan on behalf of appellant. In evaluating these facts, we are reminded that transactions between a corporation and its sole shareholder must be subjected to special scrutiny because of the fact that, as is the case here, the sole shareholder is in a position of absolute control. (See Gooding Amusement Co., 23 T.C. 408 (1954), affd., 236 F.2d 159 (6th Cir. 1956), cert. den., 352 U.S. 1031 [1 L.Ed. 2d 599] (1957).)

