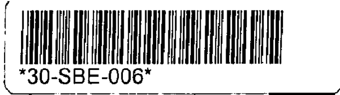

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
E. A. TEST, INC.)

Appearances:

For Appellant: L. H. Penny, San Francisco

For Respondent: A. A. Manship, Assistant Franchise Tax Commissioner

O P I N I O N

This is an appeal, pursuant to Section 25 of the California Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929), from the action of the Franchise Tax Commissioner in disallowing as a deduction for computing net income under the Act, the amount of $3,600, being part of the compensation paid to officer

The sole point involved is the reasonableness of the salary of $19,200 paid E. A. Test, president and active manager of the corporation. Upon authority of our decision in the matter of the Appeal of Miss Saylor's Chocolates, Inc., (filed August 4, 1930), we believe that the determination of this question is to be considered by us through the exercise of our judgment as applied to the facts in order that we may decide what is the correct amount of the tax.

The Appellant, from the time of its incorporation in 1922, has operated the Dodge automobile distributorship in San Joaquin County, with principal place of business in Stockton. During recent years it has maintained branches in Lodi and Tracy. Its gross sales in 1928 were $940,938.33. In that same year E. A. Test received a salary of $19,200, which the Commissioner has regarded as unreasonable. This is the same salary which he has received for several years past. The total compensation paid to all officers in 1928 was $22,500, and there remained a net profit, after the payment of all expenses, of $5,659.59.

There are 1,000 shares of the capital stock of the corporation outstanding; of these E. A. Test owns 987 shares. The value of services and the amount of stock owned have no necessary relationship to each other. (See Appeal of Twin City Tile & Marble Co., 6 B. T. A. 1238; Twin City Tile & Marble Co. v. Commissioner, 32 Fed. (2d) 229; H. L. Trimyer & Co. v. Noel, 28 Fed. (2d) 781.) Therefore, we should be careful to ascertain whether the stockholdings of Mr. Test have so influenced his salary as to make it represent more than compensation for personal services. If his salary is to any extent a diversion of profits then it is plainly "unreasonable" within the meaning

of the law.

Even though the amount of stock held is taken into consideration, this element alone does not make the salary paid unreasonable so as to preclude the taxpayer from claiming deduction for it, provided, that the stockholding is not the vital factor in fixing the salary. (U. s. v. Reitmeyer, 11 Fed. (2d) 648). In an automobile sales agency such as this the personalit of the management is of prime importance. It is common knowledg that ability to promote sales, handle "trade-ins" on a basis satisfactory to the dealer, and develop "prospects" commands substantial compensation along "automobile row." The record of the business done by this corporation during the past five years speaks eloquently of the possession of such ability by Mr. Test. We do not find his salary excessive in view of all of the surrounding circumstances.

The only reason advanced on behalf of the Commissioner as to why he deems the salary paid Mr. Test unreasonable is that it is too large in comparison with the net income. In our opinion in the matter of the Appeal of Palo Alto Hardware Compar (filed August 4, 1930) we have discussed at some length why we think such a comparison is of little value in testing the reasonableness of salaries. We are inclined to believe that the Commissioner himself has failed to find it an infallible guide. His action with reference to the determination of this particul tax impels us to that conclusion.

When the first notice of proposed additional assessment was sent out by the Commissioner it was based upon a reduction o the salary of Mr. Test by $7,200, i. e., from $1,600 to $1,000 a month. Later the Commissioner decided that $1,300 a month would be "reasonable." We must assume that he was not merely "splitting the difference", because obviously that would be an improper method of procedure under a law designed to permit the calculation of taxes with mathematical accuracy removed from the caprice of the administrator. However, it is not clear to us by what process of reasoning the Commissioner concluded first that $1,000 a month was the maximum allowable as a reasonable salary for Mr. Test and then revised his views to arrive at the figure of $1,300. The only test which he has suggested to us, viz., comparison of the salaries and the net profits, is presumably the basis of his action.

If the application of this test is susceptible of so much variation in'its results, it does not appear to us as a dependable criterion of what is reasonable. It is our judgment, from a consideration of the entire situation that the salary paid E. A. Test constituted compensation for'his personal services anc not a diversion of profits to him as the major stockholder of the company. We think that his salary should be included in a "reasonable allowance"for salaries,

Appeal of E. A. Test, Inc.

ORDER

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, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of E. A. Test, Inc., a corporation, against a proposed additional assessment based upon the return of said corporation for the year ended December 31, 1928, under Chapter 13, Statutes of 1929, be and the same is hereby reversed. Said ruling is hereby set aside and said Commissioner is hereby directed to proceed in conformity with this order.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman
H. G. Cattell, Member
Jno. C. Corbett, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary