BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BUYER INVESTMENT CO.)

Appearances:

For Appellant: Harold B. Pool, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the protests of Buyer Investment Co. to proposod assessments of additional franchise taxes for the income years ended April 30, 1947, 1948, 1949, 1950, and 1951, in the respective amounts of $1,146.08, $1,133.06, $707.22, $544.82, and $525.17.

Appellant is a California corporation which incorporated and commenced doing business in 1940. It owned several pieces of property (apartment buildings, hotels, and residential property) during the years in controversy. Its stock was initially held by four sisters, Florence Buyer, Ruby Rowland, Maude Devitt, and Pearl Coe, and during the period in question was held by three of the sisters. Mrs. Genevieve Pearson, a sister of the stockholders was an employee of Appellant and managed the properties until January 1, 1945. She received a salary of $4,400.00 for the fiscal year ended April 30, 1941, and $4,800.00 for the following fiscal year,, The salaries for fiscal years 1943 and 1944 were not segregated on the tax returns for those years and we do not know their amounts,

Under the terms of an agreement effective January 1, 1945, Appellant leased its properties to Mrs. Pearson for a rental of 40 percent of the net operating income. By amendment, the rental was at some subsequent time changed to 60 percent of net operating income. Mrs, Pearson was made responsible for the expenses of operation, Under the lease agreement she received annual net profits ranging from a low of $15,929.38 to a high of $30,603.59. During this same period, Mrs. Pearson lived, apparently without payment of rent, in houses belonging to the corporation, including one built at a cost of $37,175.00.

Throughout the period in question, salaries were paid to other individuals and deducted as expenses of operating the properties. These salaries were apparently paid to resident managers and averaged approximately $14,000.00 per year.

Taxes and depreciation were not deducted from operating revenues in computing the net amounts divided by Mrs. Pearson and Appellant. These items, accordingly, accounted for a substantial portion of the amounts received by it. In each of the two years immediately prior to the execution of the agreement with Mrs, Pearson, Appellant reported net income in excess of $17,000, exclusive of capital gains, Its highest annual net income, exclusive of capital gains, in the five succeeding years, the period here under consideration, was $4,853.54. In one of these years a net loss of $473.51 was sustained,, The sharply reduced net income of Appellant was directly attributable to the unfavorable terms of its lease with Mrs. Pearson.

The Franchise Tax Board determined that the lease agreement was, in substance, an agreement to manage Appellant's properties, It based its proposed assessments on the theory that Mrs. Pearson's compensation for managing the properties was excessive and hence not allowable as an ordinary and necessary business expense. It has included in Appellant's income the entire gross revenues of the properties and has allowed as a deduction for managerial services five percent of the gross rentals, which was then the going rate for such services in the Los Angeles area.

If a transaction is not "in fact what it appears to be in form" it may be disregarded for tax purposes. Chisholm v. Comm., 79 Fed. 2d 14. See also: Gregory v. Helvering, 293 U. S.465; Griffiths v. Helvering, 308 U. S. 355; and Higgins v. Smith, 308 U. S. 355; and Higgins v. Smith, 308 U. S. 473.

Agreements between members of a family group are subject to especially close scrutiny. And where contracts are evidently not entered into in an arm's length transaction, they may be disregarded for tax purposes. Thus in 58th Street Plaza Theatre, Inc., 16 T. C. 469, aff'd. 195 Fed. 2d 724, cert. den. 344 U. S. 820, the Tax Court refused to recognize a sublease by a family corporation to the wife of the principal stockholder. The court said, "It is unreasonable to believe that Plaza, having just acquired such a valuable lease, would have entered into a sublease of this kind with any stranger or in an arm's length transaction .... The sublease was obviously bad business for Plaza ...." See also Floridan Hotel Operators, Inc., T. C. Memo., Docket Nos. 24426 and 27033, Feb. 16, 1953, where excessive rent paid by a corporation to relatives and associates of its organizers was held not deductible.

It is not reasonable to believe that Appellant, just when O.P.A. rent ceilings were removed, would have entered into a contract with a stranger under which it would pay from three to seven times as much as previously for managerial services, the cost of which diminished net income by more than 75 percent. In the words of the Tax Court set forth above, this "was obviously bad business" for Appellant. We conclude that the Franchise Tax Board was justified in refusing to recognize such an improvident lease agreement with a sister of the stockholders. All the income from the operation of the properties was, accordingly, attributable to Appellant,

Having determined that the income from the operation of the properties should be treated as Appellant's income, the Franchise Tax Board allowed it to deduct the expenses of operation, But it disallowed certain items which had been treated as deductible repair and maintenance charges by Mrs. Pearson. The Franchise Tax Board states that the items it disallowed fall into two categories: (1) payments to officers or their relatives; and (2) payments which appeared to be *for* capital improvements or additions. Appellant has submitted checks covering some of these expenditures but has not attempted to introduce any evidence as to the purpose for which the checks were drawn. We have examined the schedules of charges and are unable to determine which, if any, of the amounts paid were for repairs and maintenance, In this state of the record we can only conclude that Appellant "entirely failed to sustain its burden that certain claimed repairs ... were not in fact capital improvements or addition." Raymond L. Klinck, T. C. Memo., Docket Nos. 20731, 22511, 20751 and 22515, Dec. 31, 1952.

ORDER

Pursuant to the views expressed in tho Opinion of the Board on file in this proceeding, and good cause 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 in denying the protests of Buyer Investment Co. to proposed assessments of additional franchise taxes for the income years ended April 30, 1947, 1948, 1349, 1950 and 1951 in the respective amounts of $1,146.08, $1,133.06, $707.22, $544.82, and $525.17 be, and the same is hereby, sustained.

Done at San Francisco, California, this 29th day of December, 1958, by the State Board of Equalization,

George R. Reilly, Chairman

Robert E, McDavid, Member

Paul R. Leake, Member

J. H. Quinn, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L, Pierce, Secretary