BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

NATIONAL ENVELOPE CORPORATION

Appearances:

For Appellant: Nathan J. Friedman, Certified Public Accountant

For Respondent: James T. Philbin, Assistant Counsel

O P I N I O N

This appeal is made pursuant to Section 2566'7 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of National Envelope Corporation against proposed assessments of additional franchise tax in the amounts of $30'7.72, $126.41, $157.44, $280.30 and $238.00 for the income years ended September 30, 1952, 1953, 1954, 1955 and 1956, respectively.

Appellant is a family-owned corporation which was formed in California in 1937 for the purpose of manufacturing and selling envelopes. It is located in San Francisco. One-half of its stock is owned by Howard N. Gilmore and one-half by his brother, McClelland Gilmore, Jr. During the years in question, Appellant had about $2,000,000 in sales each year, and its annual net profits averaged about $150,000.

Respondent audited Appellant's records and returns for the years involved. As a result of the audit of Appellant's 1952 return, certain expenditures were capitalized by Respondent and Respondent now concedes that depreciation on the capitalized items should be allowed for the income year ended September 30, 1953, in the amount of $153.63. Respondent concluded that certain claimed expenses were not deductible as ordinary and necessary business expenses. A summary of the disallowed expenses is as follows:

Income Year Ended	9-30-52	9-30-53	9-30-54	9-30-55	9-30-56
Automobile depreciation	$ 960.36	$ 960.36	$ 960.37	$ 960.37	$ 950.00
Travel and entertainment	1,000.00	1,000.00	1,000.00	1,000.00	1,000.00

Income Year Ended	9-30-52	9-30-53	g-30-54	9-30-55	9-30-56
Salary and bonus to Howard N. Gilmore, Jr.	-				4,000.00

The pertinent facts, evidence and our opinion with respect to each item are as follows:

Automobile depreciation. Two cars were placed at the disposal of Appellant's president, Howard N. Gilmore. Respondent disallowed depreciation on one of them based on the belief that it was used for personal needs of Mr. Gilmore.

Mr. Gilmore testified that the second car was driven about 8,000 miles per year and estimated that about two-thirds of this mileage was attributable to use on Appellant's business. He further testified that one reason for having two cars was that salesmen sometimes borrowed one of them. In addition to the two cars which Appellant placed at his disposal, Mr. Gilmore stated that he had his own car at home for purely personal use.

Section 24349 (formerly 2412lg) of the Revenue and Taxation Code provides for a depreciation deduction in the form of a reasonable allowance for the exhaustion, wear and tear of property used in the business. We are of the opinion that the car in question was used, in part, on Appellant's business, and that there should be an allocation. The evidence as to the amount of such use is sketchy, and we do not feel justified in giving full weight to the off-hand estimate of Mr. Gilmore. We conclude that fifty percent of this automobile's use was attributable to Appellant's business.

Travel and entertainment. For each of the years in question, Respondent disallowed $1,000 of the claimed expenses for travel and entertainment on the basis that Appellant's records did not fully substantiate that the deductions were for ordinary and necessary business expenses.

Mr. Gilmore testified that no personal expenses were placed on Appellant's vouchers and that he spent far more than the amounts claimed for travel and entertainment since much of it came out of his own pocket. He also stated that selling was done on a personalized basis with expenditures being made for many dinner meetings, luncheons and cocktail parties with a view toward meeting more people and selling more envelopes. In regard to travel

and entertainment expenses during the year ended September 30, 1956, Appellant submitted a list of expenditures in the total amount of $10,195.11. The list includes such information as that Howard Gilmore spent $167.20 on "entertainment" during October, 1955; that he spent $143.50 on "lunches, parking, cocktails" during May, 1956; and that he spent $130 on a "Sacramento trip" during September, 1956. A large number of items in amounts from $25 to $100 are identified only by the names of restaurants, and expenses of over $3,000 are not identified in any manner. No records were presented as to expenditures for other years.

Section 24343 (formerly 24121a) of the Revenue and Taxation Code allows as deductions all ordinary and necessary business expenses. Deductions are a matter of legislative grace and the burden of proof is upon the taxpayer to show that the expenses are within the terms of the statute, (New Colonial Ice Co. v. Helvering, 292 U.S. 435.) We have been presented with no evidence which upsets Respondent's disallowance of a portion of the travel and entertainment expenses. Truly adequate records will establish the business nature of the expenditure; the date, place and amount of the expenditure; the recipient of the funds expended; and the nature of the product or service received. (Rev. Rul. 60-120, 1960-1 Cum. Bull. 83; Groh, Travel and Entertainment Expenses, 39 Taxes 253.) The records before us fall far short of those standards. If a taxpayer fails to keep detailed records, then he must bear the consequences and settle for an approximation of his expense. (Cohan v. Commissioner, 39 F. 2d 540.)

Salary and bonus to Howard N. Gilmore, Jr. In 1953, 1954 and 1955, Howard N. Gilmore, Jr., the son of Appellant's president, worked part-time for Appellant while attending college and also during summer vacations. He was paid a $3,000 salary and a $250 bonus for each year. He entered the United States Navy on September 15, 1955, as an ensign. Appellant paid him a salary of $3,000 and a bonus of $1,000 for the year ended September 30, 1956, while he was *in* the Navy. Since Appellant's incorporation in 1937, it paid, for a short period, only one other person while he was in the military service. Respondent disallowed the deduction of the amount paid to Howard Gilmore, Jr., for the period that he was in the Navy.

Mr. Gilmore testified that his son travelled all over the world during the year in question and that his ship was gone from its home port of San Francisco about as much as it was there. He further testified that his son rendered considerable service to Appellant in that year and that he did his best to keep him in the business. He stated that he would have paid a similar man more than $4,000 to induce him to come back to the company. Mr. Gilmore stated that he could not say whether his son worked as much in the year in question as in prior years. He said that presently his son successfully heads a Los Angeles subsidiary of Appellant.

Section 24343 of the Code provides, that ordinary and necessary expenses include a reasonable allowance for salaries or other compensation for personal services actually rendered. Pursuant to a ruling adopted by the Bureau of Internal Revenue, the federal courts have allowed deductions for salaries paid to employees while they were in the armed forces even though they rendered no services to the business during those periods. (Kilpatrick v. United States, U.S.D.C., N.Y., Civ. 47-535, April 21, 1952; Berkshire Oil Co., 9 T.C. 903. See also, Ware Knitters, Inc. v. United States, 168 F. Supp. 208.) As stated in Berkshire Oil Co., supra, the salaries "qualify as a business expense, because such payments are justified by past services and an employer's advantage in retaining the services of experienced personnel when released from service." The motives of the employer invite special scrutiny, however, where there is a close family relationship between the head of the business and the employee, and a deduction should be disallowed if the payment was induced by the family connection. (N. B. Drew, 12 T.C. 5.)

There is no indication that Appellant had a general policy of continuing the pay of employees while they were in the armed forces. The testimony as to the exceptional value of Howard Gilmore, Jr., was a conclusion by his father, who would have an understandable bias in favor of his son. The son's only experience prior to his entry into the Navy consisted of part-time employment while he was attending college. It appears that he was amply paid for these past services. (Cf. Berkshire Oil Co., supra.) We do not doubt that the son was a competent young man, but we are not persuaded that he would have been selected as a person whose pay should be continued in the absence of any services by him were it not for the close family relationship that existed.

Appellant is entitled to a deduction, nevertheless, for wages paid to Howard Gilmore, Jr., for any services actually rendered by him during the year ended in 1956. Mr. Gilmore was unable to state that his son worked as much in that year as in prior years when he was paid $3,250 per year. In view of the son's primary obligation to the United States Navy, the fact that he was away from his home port much of the time, and allowing a reasonable amount of time for relaxation and recreation, it is appropriate to conclude that the actual services which he rendered to Appellant in that year were quite limited. We are of the opinion that $1,200 of the amount paid to Howard Gilmore, Jr., is deductible as reasonable compensation for the limited services performed by him.

At the hearing of this matter, after all briefs had been filed, Appellant belatedly raised the claim that any expenditures which were found to be for the personal benefit of its president,

Mr. Gilmore, would be deductible as part of the reasonable compensation paid to him. It is sufficient to observe that there is no evidence whatever that these amounts, even if they had been intended as compensation, would be reasonable additions to Mr. Gilmore's regular salary.

O R D E R

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, pursuant to Section 25667 of the Revenue and Taxation Code, that the Appeal of National Envelope Corporation from the action of the Franchise Tax Board on its protests to proposed assessments of additional franchise tax in the amounts of $307.72, $126.41, $157.44, $280.30 and $238.00 for the income years ended September 30, 1952, 1953, 1954, 1955 and 1956, respectively, be and the same is hereby modified as follows:

(1) An additional depreciation deduction in the amount of $153.63 for the income year ended September 30, 1953, is allowed;

(2) Fifty percent of the depreciation on the second automobile placed at the president's disposal is allowed as a deduction; and

(3) Of the amount paid to Howard N. Gilmore, Jr., while in military service, $1,200 is allowed as a business deduction. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 7th day of November, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Richard Nevins', Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary