BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HENRIETTA SWIMMER, EXECUTRIX OF THE)
ESTATE OF JACOB C. SWIMMER, AND)
HENRIETTA SWIMMER, INDIVIDUALLY)

For Appellant: George M. Bryant, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Wilbur F. Lavelle, Associate Tax Counsel

OPINION

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 Henrietta Swimmer against proposed assessments of additional personal income tax and penalties in the amount of $4,060.40 assessed against her for the year 1951 as Executrix of the Estate of Jacob C. Swimmer, in the amount of $3,867.05 assessed against her individually for the year 1951, and in the amounts of $1,387.25, $891.29, $292.76 and $269.99 jointly assessed against her as Executrix of the Estate of dacob C. Swimmer and individually for the years 1952, 1953, 1954 and 1955, respectively,

The now deceased dacob C. Swimmer, hereafter, "appellant," owned the National Titanium Company, a paint manufacturing business. Appellant's product was made from reclaimed waste paint and was sold to consumers by direct mail solicitation.

At the end of each year, it was appellant's custom to submit to his accountant the details of certain business expenses other than those reflected upon the books and records of the company. These represented amounts claimed to have been personally spent by appellant in the course of his business for automobile, laboratory, advertising, travel and entertainment expenses. These amounts were entered in the company books by a single journal entry. Appellant kept no records or supporting data of the amounts claimed to have been spent and the figures submitted to his accountant were estimates.

Appellant claimed these amounts on his California personal income tax returns as ordinary, and necessary business expenses. Respondent allowed all of the deductions that were substantiated and, with the exception of the travel expense deductions for 1954 and 1955, appellant was also permitted to deduct one-half of the unsubstantiated amounts, The disallowances of the travel expense deductions for 1954 and 1955 were based entirely upon a federal audit report. The following schedule sets forth in detail. the amounts claimed and disallowed:

Appeal of Henrietta Swimmer

Year	Claimed on return	Unsupported except by Journal entry	Amount allowed	Amount disallowed
(1) Automobile Expense				
1951	$ 2,843.70	$ 850	$ 2,418.70	$ 425
1952	2,325.51	750	1,950.51	375
1953	2,376.07	840	1,956.07	420
1954	1,997.95	850	1,572.95	425
1955	2,133.02	950	1,658.02	475
(2) Laboratory Expense				
1951	2,450.00	2,450	1,225.00	1,225
		1,250	690.67	625
1952	1,923.88	1,800	1,023.88	900
1954	1,916.31	1,750	1,041.31	875
1955	2,036.89	1,850	1,111.89	925
(3) Advertising Postage Expense				
1951	29,785.73	1,650	28,960.73	825
1952	25,854.73	780	25,464.73	390
1953	28,371.96	1,200	27,771.96	600
1954	54,097.95	1,100	53,547.95	550
1955	20,103.86	1,050	19,578.86	525
(4) Travel Expense				
1951	7,522.03	2,400	6,322.03	1,200
1952	7,105.63	2,400	5,905.63	1,200
1953	7,563.87	5,670	4,728.87	2,835
1954	12,680.98	2,400	10,880.98	1,800 *
1955	9,007.53	3,650	8,507.53	500 *
(5) Entertainment Expense				
1951	5,207.60	1,800	4,307.60	900
1952	3,102.00	1,800	2,202.00	900
1953	3,886.30	2,400	2,686.30	1,200
1954	3,806.26	-0-	3,806.26	-0-
1955	3,931.26	2,100	2,856.26	1,075

* Based upon a federal audit report

Also included in the data submitted by appellant to his accountant each year were amounts designated. "Purchases of principal Raw material and Buying Commissions,!' which allegedly represented payments in cash to various individuals in connection with the purchase of the waste paint or sludge from which National Titanium manufactured its product. In each case, certain individuals employed by the firms from whom appellant obtained the sludge were responsible for the disposition of the waste materials. Appellant, it is

contended, paid these individuals in order-. to secure a supply of. raw material. These payments were 'made' to insure that al 1 usable paint residues would be col lected and sold to appell ant rather than someone else. Appell ant stated to representatives of the Franchise Tax Board that certain firms reclaimed their own high quality residue, sell ing only the lower grade waste. Me stated that some of his payments went to the persons who were responsible for classifying or labeling these materials and, as a result, he received high qual ity sludge at low qual ity prices,

The purported payments were made in cash and appellant refused to reveal to the Franchise Tax Board any of the names of the recipients, although it appears that he kept a record of al lsuch payments.. Such record has not, however, been submitted to the Franchise Tax Board or us. The only corroborative evidence rel ied on by appellant were bills of lading showing that certain materials had been received.

In computing the income of National Titanium, appellant included in the cost of goods sold the amounts of the cash payments he allegedly made in connection yith the,, purchases of sludge. Respondent d i sallowed these amounts as foll ows: 1951 - $26,800; 1952 - $18,350; 1953 - $5,880. Buying commissions were not claimed in 1954 or 1955.

The Franchise Tax Board also disallowed a portion of the deduction taken for the salaries paid to two of Nat ionalTitanium's officers , Sol and Bertram Barnett, in 1951.

Sol Barnett married appellant's daughter, Elinore, in 1943 and was employed by National Titanium for a short time in that year. He was reempl oyed in 1945 and the following. year was given the position of general manager of Nat ionalTitanium. He entered into a contingent compensation agreement with appel 1 ant, in 1946, under which Sol agreed to devote his full t ime and energy to his work in exchange for 30 percent of the annual net profits of the business. Sol 's education consisted of high school , including a two-year chemistry course,. and a two and one-half year college course in electrical engineering. He had a few years' experience as an electrical repairman. His knowledge of the paint business consisted of having read two books on resins, some wartime laboratory experience of undetermined nature, and a short. period of employment with appellant in 1943. In 1952, Sol and El inore were divorced.

Sol 's brother) Bertram, was also employed by appellant in 1945 and the following year he married appellant's other daughter, Annette.' Bertram's employment agreement, which was identical to Sol 's, was introduced in evidence, It is in the form of a letter, dated December 31 ,1946, and states in part: "this letter is to confirm the arrangement under which you entered my employ and under which you will continue to be employed, by me." The agreement required Bertram'to devote his full, time and best efforts to his duties as assistant manager of National Titanium and in exchange, his compensation was to be an amount equal to. 30 percent of the net profits of the business. His employment was to continue from year to year, terminable by either party at the end of any calendar year upon thirty days' written notice. Bertram's education and experience consisted of high school, a five-month night school course in mechanical. drawing, and five years' employment in defense work. He had no experience in the paint business.

Appeal of Henrietta Swimmer

Appellant had over twenty years' experience in the paint business. In 1922 he became a vegetable oil jobber in New York; then he commenced operations under the name of General Turpentine Company. In 1925 he became a partner in the Erie Paint and Varnish Works. He later engaged in business under the names of Standard Solvents Company and Nitrosol Company, In 1934 he became a partner in National Lacquer Manufacturing Company of New York and in 1937 he began operations under the National Titanium name, transferring his headquarters to Los Angeles three years later. Appellant did all the purchasing of sludge, the principal raw material, and all sales were handled by direct mail solicitation. Appellant's plant employed approximately twenty persons. A survey conducted by the Franchise Tax Board of nine paint manufacturers in the Los Angeles area reveals that the average salary paid in 1950 or 1951 for a general manager with a chemical background was $10,567 per year.

The total salary for a portion of 1945 paid to Sol and Bertram Barnett was $12,537.76. The compensation deductions claimed by appellant for later years were as follows:

	Sol Barnett	Bertram Barnett
1946	$32.250	$19,800
1947	27,550	27,550
1948	27,600	27,650
1949	32,600	32,600
1950	32,600	32,600
1951	62,600	62,600
1952	10,800	10,800
1953	4,500	13,400
1954	-0-	9,300
1955	-0-	4,200

In 1951, when questioned about the large salaries paid to the Barnetts, appellant stated to the Franchise Tax Board auditor that he wanted to pay 60 percent of his net profits to his sons-in-law since he would rather let them have it then instead of keeping them waiting until they inherited it.

Respondent determined that a salary of $16,300 for Sol and Bertram, each, constituted reasonable compensation for the services performed by them and disallowed the balance of the amount claimed as a deduction in appellant's 1951 return..

Respondent also disallowed a loss claimed by appellant on his 1951 return in the amount of $4,926.45. According to a federal revenue agent's report, this loss was carried over to 1951 from 1950.

On his 1954 return, appellant claimed a casualty loss in the amount of $3,602.35 resulting from flood and frost damage to the garden and grounds surrounding his home. A federal revenue agent determined that $1,000 of this amount represented an improvement rather than a replacement of the original loss. Based upon the federal report, respondent disallowed $1,000 of the loss claimed.

Appellant claimed a deduction on his 1955 return in the amount of $1,000 for legal expense. A federal revenue agent determined that this amount represented legal fees incurred by the Gary Investment Company which were paid for by appellant. The agent determined that this amount constituted an additional investment rather than an expense item. Respondent disallowed the deduction on the basis of the federal agent's report.

Appeal of Henrietta Swimmer

Auto, Laboratory, Advertising Postage, Travel and Entertainment Expense

In regard to the disallowance of portions of the deductions claimed for automobile, laboratory, advertising postage, travel and entertainment expense, it is argued on appellant's behalf that although he kept no records of the expenditures and his deductions were based upon estimates made at the end of the year, he is entitled to the full amount of his deductions under the rule established in Cohan v. Commissioner, 39 F.2d 540. The reliance on that case is misplaced for the Cohan rule merely permitted the deduction of a reasonable portion of unsubstantiated expenses. Here only a portion of appellant's deductions have been disallowed. Generally speaking, respondent permitted appellant to deduct 50 percent of the amounts he was unable to substantiate, Where the respondent has allowed part of a deduction, we will. not alter its determination unless 'facts appear from which a different approximation can be made. (Robert L. Rowland, T.C.Memo, Dkt. Nos. 48472, 48661, 48662, March 23, 1956, aff'd, 244 F.2d 450; Neils Schultz, 44 B.T.A. 146, 151.) We perceive no such facts in the record before us.,

Buying Commissions

On appellant's behalf, it is contended that the secret cash payments he allegedly made in connection with the purchases of sludge are part of the cost of goods sold and as such, are not subject to tax. We need not decide whether such payments are properly classifiable as cost of goods sold or business expenses, for we are of the opinion that appellant's representative has failed to sustain the burden of proving that any payments of this kind were actually made. Bills of lading which show that certain materials were received do not establish the fact of such payments.

The position taken in support of appellant appears to be based upon the novel theory that if a taxpayer engages in activities of such a nature that he prefers to keep them secret, he is thereby relieved from the normal burden of proof, Obviously, this places an impossible burden upon the government.

The cases cited on appellant's behalf, Lela Sullenaer, 11 T.C. 1076, and Hofferbert v. Anderson Oldsmobile, Inc., 197 F.2d 504, stand only for the proposition that payments made in excess of ceiling prices set by the OPA are properly includible in cost of goods sold. The fact that over-ceiling payments were actually made was never in issue.

When an item is questioned, the taxpayer has the burden of supporting his claim by adequate evidence* When, as is the case here, the taxpayer has the needed information or has access to the necessary evidence but refuses to produce it, he is not in a position to complain of an adverse decision. (Stanley Rosenstein, 32 T.C. 230,238.)

Salaries

Section 17202 (formerly section 17301) of the Revenue and Taxation Code provides:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,. including -
>
> (1) A reasonable allowance for salaries or other compensation for personal services actually rendered;. .. (Emphasis added.)

The question of reasonableness is one of fact. (Geiger & Peters, Inc., 27 T.C. 911, 920.) While each case of this kind stands upon its own particular facts and circumstances, several factors have been considered,by the courts in

reaching a decision, These factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexity of the business; a comparison of salaries paid with gross income' and net' income; the prevail ing general economic conditions; and the prevail ing rates of compensation for comparable positions in comparable concerns. The situation must be considered as a whole with no single factor decisive. (Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119.) On addition, if the. compensation is. contingent, as is the case here, such compensat ion must be' pa id pursuant to a "free bargain" between the employer and employee. and, in any event, it must be reasonable under all the circumstances existing at the time the contract was entered into. (Schuckl & Co., T.C. Memo., Dkt. No. 19868, Dec. 9, 1949.)

In support of the salary deductions it is contended that in 1945 the Barnetts developed a method of using waste materials to substitute for non-obtainable paint ingredients, The method involved the reclamat ion of sludge through the use of "tall oil." It is urged that the large additional earnings of the company 'were in great measure directly due to' the efforts of. the Barnett brothers . Reference is al so made' to a l arge number of innovat ions and devices which were purportedly 'designed by the Barnetts and which are said to have greatly improved' the f irm's efficiency and profitability.

Respondent has pointed out, however, that the sludge reclamat ion process was not invented by the, Barnetts; that it is covered 'by United States patent' No. 2,086,367, applied for October 21 ,1935. We are not incl ined to give any great weight to the self-serving assertions of appellant's behalf. They are lacking in important factual detail and are unsupported by any evidence.

We are of the opinion that viewed in the light of the circumstances existing at the time 'the agreement was made, the cont i ngent compensat ion plan adopted by appel 1 ant for his two sons- in-law was not an arm's length transact ion - "a free bargain" - and cannot be said to be fair or reasonable. In reaching this conclusion, we are impressed by the 1 ack of experience and know1 edge of the Barnetts, particularly the apparent lack of qualification of Bertram. This fact becomes even more significant when compared with the fact that both men were given equal compensation. The fact that appellant was will ing to pay 60 percent of the net profits of his business to two unproven young men, when managers with a chemical background were receiving an average of less than $11,000 per year, suggests that appellant was motivated by other than business reasons. From the facts before us, we conclude that respondent's determination must be upheld.

Carryover 1 oss

It is undisputed that the $4,926.45 loss disallowed on appellant's 1951 return had been carried over from 1950. California has no provision for the carryover of net operating losses and respondent's action was, therefore, correct .

Casual tv 1 oss

The respondent's action in disallowing $1,000 of the casualty loss claimed by appellant for 1954 was based upon a federal agent's report. No evidence has been offered in support of appellant's claim. The Franchise Tax Board's determination of a deficiency, based upon a federal audit report , is

presumed to be correct and it is necessary for the taxpayer to show 'that it' is erroneous. (Appeal of Nicholas H. Obritsch, Cal. St. Bd.' of Equal., February 17, 1959, -2 CCH Cal .Tax Cas. Par. 201-252, P-H State & Local Tax' Serv. Cal. Par. 58154.) In the absence of any, evidence on this point, appellant's representative has failed to meet the burden of proof and respondent's action must be sustained.

Legal expense

It is not denied that the legal fees appellant paid in 1955 wore" incurred by the Gary Investment Company, but it is argued that he paid them in order to protect his investment. Appellant's representative offered no further explanation or details concerning this transactionnor any evidence in support of the latter statement.

The right of a taxpayer to any deduction from gross income does not turn upon general equitable considerations, but is entirely a matter of legislative grace, A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. (New Colonial Ice Co. v. Helvering, 292 U.S 435, (78 L. Ed. 1348); Deputy v. du Pont, 308 U.S. 488 (84 L. Ed. 416).) This, appellant's representative has failed to do. More important,, 'however, it appears from the meager facts contained in the record that the payment in question proximately resulted not from the appellant's business but from the business of the Gary Investment Company. Thus, 'if the expenditure is deductible at all, only the latter is entitled to deduct it. The business of a corporation may not be blended with that of its stockholder. (Deputy v. du Boat, supra; Andrew Jergens, 17 T.C. 806.) Thus respondent's action was correct

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 US HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code,' that the action of the Franchise Tax Board on the protest of Henrietta Swimmer against proposed assessments of additional personal income tax and penalties in the amount of $4,060.40 assessed against her for the year 1951 as Executrix of the Estate of Jacob C. Swimmer, in the amount of $3,867.05 assessed against her individually for the year 1951, and in the amounts. of $1,387.25, $891.29, $292.76 and $269.99 jointly assessed against her as Executrix of the Estate of Jacob C. Swimmer and individually for the years 1952, 1953, 1954, and 1955, respectively, be and the same is hereby sustained,

Done at Sacramento, California, this 10th day of December, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: H.F. Freeman, Secretary _____, Member