



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
PALO ALTO HARDWARE COMPANY }

Appearances:

For Appellant: Avery J. Howe, Palo Alto

For Respondent: Reynold E. Blight, 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 overruling the protest of Palo Alto Hardware Company against a proposed assessment based upon the disallowance to the extent of \$4,421.60 of the deduction claimed for compensation of officers during the year ended December 31, 1928.

No oral hearing was held in the matter as both parties expressed a desire to have the appeal submitted upon the showing made in their respective memoranda and there appears to be no substantial controversy concerning the facts. The sole question before the Board for determination is whether the salaries paid the officers of the Appellant were deductible within the meaning of subdivision (a) of Section 8 of the act, providing for "a reasonable allowance for salaries or other compensation for personal services actually rendered."

Upon authority of our decision in the matter of the Appeal of Miss Saylor's Chocolates, Inc. (filed August 4, 1930), we conclude that the duty devolves upon us to determine for ourselves whether or not the salaries in question were reasonable compensation for the services performed, in order that we may decide what is the correct amount of the tax. Therefore, it becomes necessary to consider the facts surrounding the business of the Appellant and nature and extent of the services which the officers are rendering,

Palo Alto Hardware Company is a close corporation. A very substantial portion of its capital stock is owned by W.B. Allen who is president of the company. A comparatively small block of stock is owned by L. J. Allen, who is vice-president. Both men devote their entire time to the business of the corporation

Ever since the organization of the company in 1903, W. B. Allen has been actively connected with it, and the Appellant has shown that he has acted as its president and general manager at an annual salary of \$9,000 from 1924 to 1927, inclusive. In addition, he received for each year during that period a bonus of \$375, being one-half of a month's salary. This appears to

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have been in accordance with the established practice of the corporation in rewarding its employees for faithful service. 'At a meeting of the directors of the company on January 9, 1928, the salary of W. B. Allen was increased to \$12,000 per annum. The addition of the bonus mentioned made his total compensation for that year \$12,523.30.

L. J. Allen became associated with the firm as **its vice-president** in 1926, and has continued to serve in that capacity since then. He acts as assistant manager of the business. In 1926, his compensation was \$2,112.50. This was increased to \$2,500 the following year and in 1928 he was paid \$3,773.30, inclusive of the bonus, for his services.

During the time which has elapsed since the organization of Palo Alto Hardware Company in 1903, the business of the corporation has increased to a large extent. W. B. Allen has made a commendable showing as manager and enjoys a wide reputation as a hardware man of exceptional ability. In 1928 the gross income from the business of the company was \$233,769.28, of which 96.23% was from sales of merchandise. It is obvious that the management of a merchandising business of this magnitude requires a man of ability, capable of commanding a substantial salary.

However, the Commissioner takes exception to the salary of \$12,523.30 paid W. B. Allen, and proposes to reduce the allowance for this to \$9,375, which was the salary paid for each of the four years prior to 1928. At the same time, the Commissioner seeks to allow only \$2,500 for the salary of L. J. Allen instead of the \$3,773.30 which was actually paid to him. No reduction has been attempted in the allowance of \$3,773.30 for the compensation paid to the only remaining salaried officer C. H. Dobbel, who is secretary-treasurer of the corporation.

In support of these reductions, which aggregate \$4,421.60, the Commissioner says that he considers the salaries excessive because the total deduction of \$20,069.90 for compensation of officers (including Mr. Dobbel) constitutes 91% of the net income exclusive of such compensation. We are not impressed with the comparison between salaries and net income. If the reasonableness of salaries were to be determined from such a comparison, many large concerns which obviously require capable executives would be in a position to pay only a small fraction of what the services of their officers were worth during years of depression. It is in just such times that efficient management is all the more essential.

Whether the amounts paid constitute compensation for personal services actually rendered or an attempt to distribute profits as salaries for the purpose of tax avoidance', is a question of fact to be decided from all the circumstances, . . . (U. S. v. Philadelphia Knitting Mills Co., 273 Fed. 657; Appeal of Woodcliff Silk Mills, 1 B. T. A. 715). The action of the Board of Directors in fixing the salaries of the officers was taken in January, 1928, long before there had been any suggestion of the Bank and Corporation Franchise Tax Act (Supra). From

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this action it must be presumed that the salaries are reasonable (Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42, Aff'd. 50 Sup. Ct. Rep. 273.)

No evidence has been adduced by the Commissioner overcoming this presumption. On the contrary, the Appellant has shown that under the management of its president it has built up a hardware business of exceptional size for a city of the population of Palo Alto; that the officers' salaries have not increased disproportionately with reference to the volume of the sales; and that there has been a creditable profit considering general business **conditions**. So far as the salary of L. J. Allen, as vice-president is concerned it does not appear that the Commissioner contends seriously that the allowance for his compensation could have been unreasonable. A salary of \$300 per month in return for the entire time of a man of mature age and considerable experience in the hardware business, serving in the capacity of vice-president and assistant manager of the corporation does not seem excessive.

Therefore, we conclude that the disallowance of the full deduction claimed for salaries of officers was not warranted and that the tax was correctly calculated by the corporation in the first instance.

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, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of Palo Alto Hardware Company, 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