



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	}	No. 82R-95-AJ
SHALOR, INC.	}	

For Appellant: James P. Shaw

For Respondent: **Michael** R. Kelly
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), ^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Shalor, Inc., for refund of franchise tax in the amount of \$4,740 for the income year ended March 31, 1980.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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The issue presented by this appeal is whether respondent properly disallowed the deduction of the compensation paid to appellant's employee-shareholders during appellant's income year ended March 31, 1980.

Appellant, a California corporation, owned and operated a **15-room** hotel from April 1978 until November 1979, at which time the hotel was sold. James Shaw and Jeffrey Taylor each owned 50 percent of the corporation's stock and were also employees of the corporation. They lived on the premises and operated the hotel. Apparently, they had operated the hotel as a partnership for one year prior to transferring it to the corporation.

During the entire 19 months appellant owned the hotel, it provided each employee-shareholder with an automobile, food, and lodging. These benefits were worth approximately \$500 per month. During income year 1979, appellant's first year operating the hotel, the **employee-shareholders** were paid only a nominal amount in addition to those benefits. Appellant explains that this was because the hotel was only in its second year of operation and the shareholders were still **making capital** improvements. During the income year ended March 31, 1980, each employee-shareholder received \$25,660 in addition to the benefits.

On its franchise tax **return for the income year** ended March 31, 1980, appellant claimed a deduction for the cost of the automobiles, food, and lodging provided to its employee-shareholders, but did not claim a deduction for any cash payments made to them. Later, appellant filed an amended return on which it claimed a deduction of \$51,320 for compensation **paid to its employee-shareholders**. Respondent's refusal to allow any **portion** of the claimed deduction led to this **appeal**.

Section 24343 provides, in pertinent part:

(A) There shall be allowed as a deduction all the ordinary and **necessary** expenses paid or incurred during the income year in carrying on any trade or business, including --

(1) A reasonable allowance for salaries or other compensation for personal service's **actually** rendered; . . .

This section is identical to section 162 of the Internal Revenue Code. Therefore, federal case law is highly

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persuasive **as to** the correct interpretation of the California statute. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941); Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

In order to be deductible under the statute, payments must be both reasonable in amount and compensatory in character. (Eduardo Catalano, Inc., Pension Trust, et al. v. Commissioner, ¶ 79,183 T.C.M. (P-H) (1979).) The question of what is reasonable compensation is a factual one, depending upon all the facts and circumstances of the particular case. (Charles Schneider & Co., Inc. v. Commissioner, 500 F.2d 148, 151 (8th Cir. 1974); Steel Constructors, Inc. v. Commissioner, ¶ 78,489 T.C.M. (P-H) (1978).)

Respondent concedes that it should have allowed appellant to deduct a portion of the compensation paid to its employee-shareholders, but contends that the amount paid to each, \$25,660, was an unreasonable amount for the seven months the employee-shareholders worked during the 1980 income year. Appellant contends that the amount was reasonable in light of the fact that the **employee-shareholders received virtually** no cash compensation during the 1979 income year.

Payments made to an employee in one year for services in prior years may be deducted in the later year if the services were actually rendered and the compensation would have been reasonable for the prior years. (Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 [74 L.Ed. 733] (1930); R. J. Nicoll Co. v. Commissioner, 59 T.C. 37, 50 (1972).) It is undisputed that although **appellant's** employee-shareholders rendered services during the entire 1979 income year, they received only nominal cash compensation. With that fact in mind, we conclude that the payments made in income year 1980 were intended as compensation for the entire 19 months appellant operated the hotel. Therefore, the question remaining is whether the \$25,660 or \$1,367 per month each employee-shareholder received was unreasonable in amount.

The employee-shareholders performed all the duties associated with operating a small hotel, including maid service, laundry, maintenance, front desk and switchboard operation, bookkeeping, purchasing, and promotion. While operating the hotel, the employee-shareholders spent almost all their time on the premises. A monthly salary of \$1,367 plus **benefits worth** approximately \$500

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does not seem unreasonable as compensation for such employment.

Respondent emphasizes that the payments were not made **periodically** and that relatively large payments were made after the sale of the hotel. **However,** respondent has cited **no** authority indicating that these factors would preclude treatment of the payments as deductible compensation.

Since we have found that the payments constituted reasonable compensation for services **actually** rendered, we conclude that respondent erred in disallowing the claimed deduction. **Therefore,** its action must be reversed.

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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 26077 of the Revenue and Taxation **Code**, that the action of the Franchise Tax Board in denying the claim of Shalor, Inc., for refund of franchise tax in the amount of \$4,740 for the income year ended March 31, 1980, be and the same is hereby reversed.

Done at Sacramento, California, this 4th day of March , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins _____, Chairman
Conway H. Collis _____, Member
Ernest J. Dronenburg, Jr. _____, Member
Walter Harvey* _____, Member
_____, Member

*For Kenneth Cory, per Government Code section 7.9