



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
B .M.S. MARINE, INC.) No .81R-1169-VN
)

Appearances:.

For Appellant: Steve C. McElroy
President

For Respondent: Kendall E. Rinyon
Assistant Chief 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 claims of B.M.S. Marine, Inc., for refund of franchise tax in the amounts of \$3,240 and \$3,612 for the income years ended October 31, 1976, and October 31, 1977, respectively.

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

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The **sole issue** presented for our decision is whether appellant is entitled to ordinary and necessary business **expense** deductions for bonus **payments** made to its three shareholder-officers during **the** income years ended in 1976 and 1977.

Organized in 1972, appellant is a closely held California corporation which manufactures and **sells** marine hardware and boat, accessories from **its** offices in the City of Santa **Ana**, County of Orange. The stack of the corporation is owned equally by three shareholders, Robert **R. Bacus**, Steve C. **McElroy**, and Gerald A. Stiles, who are also officers and directors in the company. Mr. McElroy is the **president**, Mr. **Bacus** is the **vice-president** and secretary, and **Mr. Stiles** is the treasurer. For the years 1976 and 1977, these **three shareholder-officers** received ostensibly the same salary from the **corporation.**^{2/}

In addition to the annual salaries, however, appellant **corporation** issued bonuses to its **three** shareholder-office **rs** during the two income years in question, In September 1976 of the first income **year**, the board of **directors** authorized payment of a bonus in the sum of \$36,000 which was divided among the executive officers in three equal **portions**. In the next. income year, the **company** paid them bonuses **totalling \$40,200** of which \$30,000 was awarded pursuant to a **resolution** of the board'of directors adopted on October 5, 1977. These 1977 bonuses were likewise distributed to the shareholder-officers in three equal shares. Until that time, appellant had not declared any dividends in favor of its shareholders.

On its corporation franchise tax **returns** for 1976 and 1977, appellant claimed business expense deductions of \$36,000 and \$40,200, respectively, for the bonuses paid to its three officers. On its Schedule C (**Profit** (or Loss) from Business or Profession) for both income years, appellant listed the claimed expenses on the line for miscellaneous expenses and added the word

2/ Appellant has submitted. copies of the **w-2** forms that **it** provided **the** three employees in years 1976 and 1977, In 1976, Messrs. McElroy and Stiles both received **\$19,200** while Mr. **Bacus** received \$950 **less** due to sick **leave**. In 1977, the **w-2** forms show that all three individuals received **compensation** in the amount of \$26,900.

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"dividends." (Resp. Br., Ex. A at, 1.) Upon review, the Franchise Tax Board determined that the deductions should be disallowed for both years and issued **proposed** assessments of additional tax which, in **part**, reflected the disallowances. Appellant thereupon filed amended returns for its 1976 and 1977 income years. Respondent in turn treated the **amended** returns **as claims** for refund since the allowable adjustments contained therein offset the proposed deficiencies. In its notice denying the refund claims at issue in this appeal, respondent informed appellant that the claimed business expense deductions for the executive bonuses were not allowable based on the available information which indicated the payments did not constitute compensation for services.

Section 24343. of the Revenue and Taxation Code provides, **in part** **in 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 services **actually** rendered; . . .

Because this section is identical to section 162 of the Internal Revenue Code, federal case law and **interpretations** are highly persuasive as to the proper **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)).

To be allowable as an ordinary and necessary business **expense**, compensation must meet a two-prong test of deductibility: it must be reasonable in amount and **paid purely** for personal services actually rendered, (Treas. Reg. § 1.162-7(a); Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 362 (9th Cir. 1974).) Bonuses paid to employees can be also deductible if paid **as** additional compensation for services actually rendered, provided such payments, when **added to salaries**, do not exceed a reasonable compensation.. (Treas. Reg. § 1.162-9; R. J. Kremer Co., Inc. v. Commissioner, ¶ 80,069 T.C.M. (P-H) (1980).) In the present appeal, the Franchise Tax Board does not question the reasonableness of the amounts of the bonuses that appellant paid to its three shareholder-officers. Respondent contends that

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the **payments did** not constitute compensation for services but were actually nondeductible dividends. Appellant argues that the bonuses were part of the compensation package for its executive officers.

It is well **settled** that payments are deductible as compensation only if they were made with the intent to compensate for services. (Paula Construction Co. v. Commissioner, 58 T.C. 1055, 1058 (1972), affd., 474 F.2d 1345 (5th Cir. 1973).) Whether the requisite intent to compensate existed is a question of fact which must be decided on the basis of the facts and circumstances in a particular **case**. (Paula Construction Co. v. Commissioner, supra, 58 T.C. at 1059; Russos v. Commissioner, 77,309 T.C.M. (P-H) (1977).) While the courts have cited numerous factors relevant in determining whether or not bonus payments were intended as compensation for services, including a corporation's failure to pay dividends (Laure v. Commissioner, 70 T.C. 1087, 1100 (1978), affd. in part, revd. in part, on other issues, and remanded, 653 F.2d 253 (6th Cir. 1981)), and the payment of bonuses in exact proportion to the officer's stockholdings (Nor-Cal. Adjusters v. Commissioner, supra), no single factor is decisive and each case must be evaluated in **light of** the totality of its own facts and circumstances. (Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949).) In addition, where officer-shareholders who are in complete control of a corporation set their own compensation-as employees, careful scrutiny of the facts is required to ensure that the alleged compensation was not a distribution of corporate **earnings** and profits, (Logan b e r co; v. Commissioner, 365 F.2d 846, 851 (5th Cir. 1966); Perlmutter v. Commissioner, 44 T.C. 382, 401 (1965), affd., 373 F.2d 45 (10th Cir. 1967).)

It is well settled that the taxing agency's determination that certain payments are not deductible as compensation is presumed correct, and the burden of proving entitlement to the **compensation deduction rests** with the **taxpayer**. (Botany Worsted Mills v. United States, 278 U.S. 282, 292 [73 L.Ed 379] (1929); Appeal of Southland Publishing Co., Inc., Cal. St. Bd. of Equal., Jan 7, 1964.) In the instant matter, **appellant** contends that **the bonuses** were awarded to properly compensate the **three shareholde'r-officers** who had **worked long hours** at minimal salaries marketing the company's products and managing its **manufacturing operations**. While this board does not doubt that **Messrs. Bacus, McElroy, and Stiles** performed these duties assiduously, **we find no evidence**

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in the record to establish that the bonuses were intended as compensation for services rendered during the appeal years. **Appellant** implies that the bonuses were awarded by its board of directors in order to provide fairer compensation but it has failed to submit any minutes of corporate meetings or resolutions adopted by the board of directors which might show that the payments were made with compensatory intent, (American Foundry v. Commissioner, 59 T.C. 231 (1972), affd. in part., rev. in part., 536 F.2d 289 (9th Cir. 1976); Harry Fox, Inc., v. Commissioner, ¶ 78,453 T.C.M. (P-H) (1978); Appeal of Cali-Clubs, Inc., Cal., St. Bd. of Equal., Feb. 8, 1979.) Appellant also notes that the executives received minimal, noncompetitive salaries, but its argument is hindered by the failure to submit any information demonstrating what its executives would be paid for their **services to like business enterprises under similar** circumstances. (Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner, 61 T.C. 564, 569 (1974), affd., 528 F.2d 176 (10th Cir. 1975).) Yet, even if we were to assume that the executives could have obtained higher salaries elsewhere, unless it can show the payments to have been compensation for services, appellant still would not be entitled to deduct the payments. (Klamath Medical Service Bureau v. Commissioner, 29 T.C. 339, 347 (1957).) **Here**, the only evidence which possibly supports appellant's position that the bonuses constituted additional salaries is the fact that the bonuses, like the salaries of the officers, were divided into three equal shares. However, since the stock of the corporation was also divided equally among the three shareholder-officers, this single fact is not **conclusive**, for bonuses paid in proportion to the owners' interests in a corporation are often found to have been dividend distributions instead of compensation. (Nor-Cal Adjusters v. Commissioner, *supra*; Bruce Oil Co., et al. v. Commissioner, § 84,230 T.C.M. (P-H) (1984).)

Upon examination of the facts in this appeal, we thus find that there is greater support for respondent's determination that the bonuses were **dividends**. First, the absence of formal dividend distributions, the **lack** of a pre-existing bonus agreement with the officers, and the payment of the **bonuses** at the end of the income years in question when annual profits could be estimated are factors tending to show that the bonuses represented distributions of corporate earnings and profits, (See, e.g., Owensby & Kritikos, Inc. v. Commissioner, ¶ 85,267 T.C.M. (P-H) (1985); Bruce Oil Co., et al. v. Commissioner, *supra*; Rich Plan of Northern New England,

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Inc. v. Commissioner, ¶ 78,514 T.C.M. (P-H) (1978).) Second, appellant's treatment of the bonus payments indicates that they were dividend distributions. At the very outset, appellant characterized the payments as "dividends" on its returns for the appeal years. Although it claims this description was a mistake by its tax preparer, - appellant also did not include any of the payments as wages or compensation on the W-2 forms provided to the executives and apparently failed to withhold income taxes -from the payments, **demonstrating** that the payments were not made with compensatory intent, **(See Russos v. Commissioner, supra.)** In view of **the** evidence to the contrary, we cannot find that the bonuses were intended as compensation for services,

Based on **the** foregoing, we must conclude that appellant has failed to **carry** its burden of proving that **the bonus payments were deductible as compensation for** services. Accordingly, respondent's action in this matter will be sustained.

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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 claims of **B.M.S. Marine, Inc.**, for refund of franchise tax in the amounts of \$3,240 and \$3,628 for the income years ended October 31, 1976, and October 31, 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of November , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

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

*For Kenneth Cory, per Governmetn Code section 7.9