



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
C, Q. BRADY & CO. }

Appearances:

For Appellant: C. Q. Brady, President, Los Angeles

For Respondent: A. A. Manship, 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 (Chapter 13, Statutes of 1929) from the action of the Franchise Tax Commissioner in overruling the protest of C. Q. Brady & Co. against a proposed assessment of an additional tax in the amount of \$237.06 based upon the return of said corporation for the year ended December 31, 1929.

The sole point involved in this appeal is whether or not the Franchise Tax Commissioner proceeded legally in his determination that the tax as disclosed by this return should be increased to the extent proposed by him because of what he regard as **an excessive deduction on account of' salaries in the calculation of the net income of the corporation.** The pertinent provisions of the act are as follows:

"Sec. 7. The term 'net income!, as herein used, means the gross income less the deductions allowed.

"Sec. 8. In computing 'net income' the following deductio. shall be allowed:

"(a) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * * *"

We have already had occasion to consider the extent to which this Board may examine the question of what is a "reasonable allowance" for salaries in the appeals of Miss Saylor's Chocolates, Inc. (opinion filed August 4, 1930) and Palo Alto Hardware Company (opinion filed August 4, 1930). Therefore, we shall not review the problem at length here but shall content ourselves with the observation that once an appeal has been dul prosecuted it is the duty of this Board to determine from the facts before us, through the exercise of our own judgment, what the correct amount of the tax should be. Necessarily, this involves the determination of whether or not the amounts claime as salaries are reasonable.

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The facts are not disputed, C. O. Brady, President of the corporation, owns all of its shares save two which are issued to the Secretary-Treasurer and the Legal Counsel for the corporation, respectively. The business of the company is that of insurance brokerage. Mr. Brady testified that he had been engaged in the solicitation of insurance in Los Angeles for twelve years, ten years as an individual and two years under the corporate arrangement above outlined. It further appears that all of the solicitations and outside contacts are made by him; that he employs no solicitors or outside salesmen and that the only other persons performing services for the corporation are clerks who watch expirations and attend to other office detail.

During the year 1929, the gross earnings of the corporation were \$36,507.72 and after meeting the other expenses of the business there remained \$17,289.32 with which to pay the salaries of the officers of whom there are only two as above indicated. Mr. Brady, the President, and Hurst M. Ross, the Secretary-Treasurer. Out of this amount, Mr. Ross, whose services were of a clerical nature, was paid a salary of \$3,600.00 and the remaining \$13,689.32 was paid to Mr. Brady as salary for his services as President of the corporation.

The Commissioner deemed the salary of Mr. Brady so fixed as excessive and reduced the deduction for salaries to \$10,800.00, thereby determining that in his opinion a reasonable salary to be allowed to Mr. Brady would be \$7,200.00.

As stated in our opinion in the matter of the Appeal of Miss Saylor's Chocolates, Inc. (supra), there is no necessary relationship between the value of services and the amount of stock owned and whenever it appears that salaries are paid in proportion to stockholdings there is strong evidence of an intent to distribute profits as salaries. This presumption may be overcome, however, by evidence showing that the salaries were reasonable for the services rendered and that the value of the services and not the stockholdings measured the compensation (G. S. v. Reitmeyer, 811 Fed.) (2d) .

Mr. Brady frankly explained that the theory upon which he had been allowed the salary of \$13,689.32 was that inasmuch as his personal efforts contributed primarily to the profits of the corporation he should be allowed whatever remained after the payment of all other expenses of doing the business as his compensation. We cannot assent to the use of such a measurement for determining the reasonableness of the compensation of a president of a corporation even after taking into account the entire circumstances above related. However, it is clear to us from a review of the facts that Mr. Brady's ability as an insurance broker is of a high order and that if he were to devote his services to another corporation engaged in similar business he would be in a position to command a salary of substantially more than \$7,200.00 annually. It is common knowledge that ability to secure insurance contracts commands substantial compensation. While it is true that payments for such services

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are ordinarily made to a large extent on a commission basis we do not believe that this circumstance precludes the possibility of determining with a fair degree of accuracy what would be a reasonable salary to be paid to Mr. Brady as a flat sum for his services rendered to the Appellant corporation in 1929. We think that it is our duty to do this in order to prevent the tax from becoming an imposition upon his personal earning capacity which would be a result not contemplated by the law inasmuch as there is no state personal income tax in California.

In the light of all of the circumstances, we conclude that a reasonable allowance for the salary of Mr. Brady as President of the Appellant corporation during the year 1929 would have been \$12,000. We believe that the \$1,689.32 paid him in excess of this sum must be regarded as his profit taking as shareholder rather than his compensation as President of the corporation.

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 the Franchise Tax Commissioner in overruling the protest of C. Q. Brady & Co., a corporation, against a proposed additional assessment based upon the return of said corporation for the yearended December 31, 1929, under Chapter 13, Statutes of 1929, be and the same is hereby modified. It is further ordered adjudged and determined that a deduction of \$12,000.00 is a reasonable allowance for the salary of C. Q. Brady as President of said corporation for said year and said Commissioner is hereby ordered to calculate the tax liability of said corporation by disallowing \$1,689.32 of the \$17,289.32 claimed as deductible by C. Q. Brady & Co. for salaries, the additional assessment to be determined on this basis, plus the interest required by law.

Done at Sacramento, California, this 1st day of July, 1931,
by the State Board of Equalization.

Jno. C. Corbett, Chairman
R. E. Collins, Member
Fred E. Stewart, Member
H. G. Cattell, Member

ATTEST: Dixwell L. Pierce, Secretary