

Appeal of West Mayfair Company

An arrangement, evidenced by the minutes of the meetings of the board of directors, was entered into whereby Southwood was to be paid \$600 per house for supervising construction, Appellant constructed 441 houses by January, 1948, and sold them all by June, 1948. In its returns for the years in question it deducted a total of \$264,600 as accrued to Southwood for supervision of construction, This amount was distributed by Appellant directly to the stockholders of Southwood in the period from September 28 to October 6, 1948.

Southwood occupied the same office as Appellant, It apparently kept no books or records, Its only asset was cash in the approximate amount of \$2,000. It neither paid nor incurred liability for any salaries, wages or commissions. On its returns it reported no income, an expense of \$1.50 for the year ended July 31, 1946, an office expense of \$51.50 for the year ended July 31, 1947, the same amount of office expense for the payment of a city license tax in the amount of \$229.60 for the year ended July 31, 1948. It dissolved on October 1, 1948.

Mr. Trousdale was vice-president of Appellant and president of Southwood, During the period of construction Appellant paid him the sum of \$75,000 "to supervise the architectural and construction problems [of the houses constructed by Appellant] and to expedite the flow of critical materials." We are not informed of the nature and extent of the supervision by Southwood,

Acting under Section 14 of the Bank and Corporation Franchise Tax Act (hereafter referred to as the Act), the Franchise Tax Board purported to recompute the net income of Appellant and Southwood by combining the net income of both corporations and treating the combined net income as the net income of Appellant, In addition to this adjustment the notice of additional tax proposed to be assessed stated that "Any deductions or charges to costs of sales on account of fees alleged to have accrued in favor of Southwood Construction Company on account of services alleged to have been rendered to West Mayfair Company are disallowed on the further ground that they did not constitute ordinary and necessary expenses or costs of sales."

Appellant contends that Section 14 of the Act is not applicable and the Franchise Tax Board is without authority to combine the income of the two corporations because there was no evasion of taxes and Appellant's income was clearly reflected. Furthermore, it alleges that the Franchise Tax Board in fact did not combine incomes but merely disallowed as a deduction to Appellant the amount of the fees which

Appeal of West Mayfair Company

accrued to Southwood. Although Appellant apparently reported the fees as a part of the cost of goods sold, it argues that the only question at issue is whether the payment of the fees constituted an ordinary and necessary business expense.

Under ordinary circumstances the fees claimed as deductions from income by Appellant would have been included in the measure of Southwood's tax for the year in which they were received. Under the circumstances here, however, if the fees are allowable deductions to Appellant they have escaped taxation in the hands of either corporation. Since Appellant was on the accrual basis it claimed deductions from income as the fees accrued. As Southwood was on the cash basis the fees were not includible in its income until they were received. Appellant, however, paid the fees in the year of Southwood's dissolution. Under Section 13(k) of the Act, Southwood's tax for the year of dissolution was measured by income of the preceding income year, a year in which it had no income. Whether upon these facts the Franchise Tax Board could properly invoke the provisions of Section 14 of the Act, however, is a question which we are not required to resolve,

Former Section 8 of the Act, as it read during the period in question, allowed the deduction of "all the ordinary and necessary expenses paid or incurred during the income year in carrying on business . . ." Appellant's position appears to be that supervision of construction is ordinary and necessary and that where supervision is authorized and payments are made they are deductible. The fallacy of this position is immediately apparent. Quite obviously the extent to which expenditures for supervision of construction constitute ordinary and necessary expenses is a question of fact which must be determined in the light of existing circumstances. Certainly an expenditure made for supervisory services which have been authorized but not performed is not an ordinary or necessary expense of doing business.

A brief review of the record before us shows a complete absence of evidence of any services performed by Southwood for Appellant. On the other hand, the evidence shows that Appellant paid Mr. Trousdale a substantial salary for supervising its building activities. Although Appellant states that the supervision of its activities by Mr. Trousdale was not the same type of supervision as that rendered by Southwood, no attempt is made to explain the distinction, or to establish the nature and extent of the supervision by Southwood.

Southwood's only asset was cash in the amount of \$2,000. During the years in question it had no employees and no income. Except for the cost of a city license its annual

Appeal of West Mayfair Company

expenditures did not exceed the aggregate sum of \$51.50. It kept no books or records. The mere recital of these facts would seem to refute the contention that the corporation performed supervisory services worth \$264,600, or any substantial part of that sum. When coupled with a record barren of any evidence of the services performed, the contention is untenable. Since Appellant has failed to meet its burden of proof, we conclude that the fees in question did not constitute ordinary and necessary expenses of doing business.

Appellant has alleged error in imposing a tax for its first and second taxable years based on income for the income year ended October 31, 1947. This allegation has not been amplified. No tax for its first taxable period, ended October 31, 1946, is involved. Under Section 13(c) of the Act, since Appellant's first taxable year was less than twelve months, the tax for its second and third taxable years is based on income of its second year. There is nothing to show that the Franchise Tax Board did not act in accordance with the statute.

ORDER

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of West Mayfair Company to proposed assessments of additional franchise tax in the aggregate amount of \$8,627.78 for the taxable years ended October 31, 1947, and 1948, and \$5,078.01 for the taxable year ended October 31, 1949, respectively, be and the same is hereby sustained.

Appeal of West Mayfair Company

Done at Sacramento, California, this 27th day of
November, 1956, by the State Board of Equalization.

Paul R. Leake ✓, Chairman

Robert E. McDavid, Member

James H. Quinn, Member

Geo. R. Reilly ✓, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary