



Appeal of U.S. Pottery Mfg., Inc.

The question presented by this appeal is whether respondent properly disallowed the deduction of a portion of the compensation paid to appellant's ~~shareholder-~~officers during appellant's income years ended in 1975, 1976, and 1977.

Appellant is a California corporation, incorporated in 1953, which manufactures and sells pottery products. For several years before its incorporation, the business was operated as a partnership. The five partners became the corporation's only shareholders and they all apparently held executive offices in the company. In the early years of operation, the partners (later the shareholders) worked long hours with little or no compensation, doing all the work themselves. When they could finally afford to hire additional workers, they took small salaries from the money that was left after paying their employees. **By 1968, the shareholder-officers** were apparently drawing regular salaries.

By 1971, Frank and Ada **Bernat**, husband and wife, were the only remaining shareholders, the others having died or left the business because of ill health. **Frank** then became appellant's president. Although Ada had not been directly involved in the business before this time, she became the vice-president and secretary-treasurer. Since 1971, Frank and **Ada** have performed virtually all executive functions for the company.

Frank and appellant entered into an employment contract, beginning in 1974, which stated that he would receive a salary of **\$260,000 a year**, with his full salary to be continued for the remaining term of the contract if he became disabled. In addition, the contract provided Frank with the use of an automobile, reimbursement of his family's medical and dental expenses, a \$300,000 life insurance policy, and **\$7,500** each year for entertainment expenses. Frank was required by the contract to reimburse to **appellant** any portion of his compensation which was disallowed as an income tax deduction for appellant. In spite of the contract terms, Frank did not begin receiving the agreed-upon salary amount until January 1975, when his salary was raised from **\$1,000** per week to **\$5,000** per week. There is no indication in the record that Ada had an employment contract with the company.

Appellant apparently paid no dividends until 1975, when dividends of \$4,000 were paid. Dividends of \$10,000 were paid each year in **1976 and 1977**. Other

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pertinent financial information for the income years ended August 31, 1971 through August 31, 1977, is as follows:

	<u>Gross Sales</u>	<u>Gross Income</u>	<u>Net Income</u>	<u>Compensation</u>		<u>Total Officers'</u>
				<u>Frank's</u>	<u>Ada's</u>	
		<u>Not Available</u>	<u>Not Available</u>			
1971	\$ 582,000	Available	Available	\$ 32,550	\$24,500	\$ 57,050
1972	742,000	"	"	47,750	24,850	72,600
1973	1,100,000	"	"	67,750	31,400	99,150
1974	1,538,000	\$ 951,043	\$187,137	100,000	62,000	162,000
1975	2,021,000	1,287,151	23,503	245,000	200,000	445,000
1976	2,119,000	1,246,130	2,345	275,000	156,000	431,000
1977	1,808,000	1,147,918	(4,856)	275,000	111,000	386,000

During the income years ended August 31, 1975 and August 31, 1976, part of the compensation paid to Frank and Ada consisted of bonuses. The bonuses were paid in varying amounts at irregular intervals, with Ada receiving total bonuses of \$82,000 in fiscal 1975 and \$10,000 in fiscal 1976 and Frank receiving total bonuses of \$62,000 in fiscal 1975 and \$25,000 in fiscal 1976.

Upon audit, respondent disallowed part of appellant's claimed deductions for officers' compensation. For the income years ended in 1975, 1976, and 1977, deductions for reasonable officers' compensation were allowed in the amounts of \$178,200, \$196,020, and \$215,622, respectively. The amounts allowed were computed by adding a 10 percent increase for each year to the compensation paid in 1974. The 1974 income year was chosen as a base period because the Internal Revenue Service had audited appellant's return for that year and had not made an adjustment for unreasonable compensation. The disallowed amounts were treated as nondeductible dividends.

Section 24343 of the Revenue and Taxation Code 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 services actually rendered: . . .

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This section is identical to section 162 of the Internal Revenue Code. Therefore, federal case law is highly persuasive as to the correct interpretation of the California statute. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428] (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 made must be both reasonable in amount and compensatory in character. (Eduardo-Catalano; Inc., Pension Trust, et al., ¶ 79,183 P-H Memo. T.C. (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., ¶ 78,489 P-H Memo. T.C. (1978).) The burden of proving the reasonableness of the compensation is on the taxpayer. (Botany Worsted Mills v. United States, 278 U.S. 282, 289-290 [73 L.Ed. 379] (1929).) Where the recipients of the compensation were the sole shareholders and executive officers of the appellant, the facts and circumstances of a case must be closely scrutinized to ensure that the payments were not distributions of corporate profits. (Ben Perlmutter, 44 T.C. 382, 431 (1965); Niagara Falls Coach Lines, Inc., ¶ 77,269 P-H Memo T.C. (1977).)

Appellant contends that compensation paid to Frank and Ada during the appeal years was reasonable because they handled all of the executive duties, performed a number of other functions for the company, and were entitled to that much compensation because of the increase in gross sales in 1975 and 1976. Additionally, or alternatively, appellant argues that part of the amounts paid were to compensate Frank and Ada for prior years when they were undercompensated. While recognizing the important roles these two individuals played in the corporation, both before and during the appeal years, we do not believe that appellant has borne its burden of proving that its claimed deductions, to the extent they exceeded the amounts allowed by respondent, were allowable as reasonable compensation.

A substantial increase in compensation without a corresponding increase in duties may be indicative of the unreasonableness of the compensation. (Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 607 (9th Cir. 1968); Castle Ford, Inc., ¶ 78,157 P-H Memo. T.C. (1978).) In 1975, Frank's compensation increased 145% and Ada's increased 223%; together their compensation increased 175%. Although Ada's compensation decreased somewhat in 1976 and

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1977, Frank's increased another 12% in 1976 and remained at that level during 1977. There is no evidence whatsoever that there was any increase in the officers' duties which would warrant such large increases.

Appellant attempts to justify the compensation by stating that Frank and Ada performed numerous functions for the corporation and if "these offices would be shared by several individuals each drawing a salary . . . [those] salaries, if cumulated, would far exceed the salaries enjoyed by the President and the Vice President." Appellant, however, presented no evidence regarding what salaries might be paid if a number of additional individuals had been employed to fill the positions that Frank and Ada held. Even if it had done so, such evidence would not be determinative. Reasonable compensation for one person performing numerous tasks "is not necessarily the sum of amounts paid to numerous full-time employees who perform similar tasks." (Castle Ford, Inc., supra, ¶ 78,157 P-H Memo T.C. at 78-688. See also Niagara Falls Coach Lines, Inc., supra; C. A. White Trucking Co., Inc., ¶ 77,006 P-H Memo. T.C. (1977).)

Appellant contends that Frank and Ada were responsible for the increased sales in 1975 and 1976 and should be rewarded for this with increased compensation. We have no doubt that Frank and Ada worked hard to develop and maintain this business. However, Frank's testimony at the hearing indicated that the increase in sales was due in large part to an increased interest in houseplants and a concomitant expansion in the market for pots.

In any case, no special incentive is usually necessary in order to ensure the best efforts of a sole shareholder, for he will receive the fruits of success through his ownership of the corporation. (Charles Schneider & Co., Inc. v. Commissioner, supra, 500 F.2d at 152-153.) When large increases and bonuses are paid to employees who control the corporation, special scrutiny is needed because the payments "may be distributions of earnings rather than payments of compensation for services rendered; even if they are reasonable, they would not be deductible." (Charles Schneider & Co., Inc., v. Commissioner, supra, at 153.) Although appellant argues that the success of the company during the appeal years justifies the salaries as reasonable, it is equal justification for the position that larger dividends should have been paid and that the large salaries paid were "merely a method of draining off corporate profits at a tax

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advantage.' (Pacific Grains, Inc. v. Commissioner, supra, 399 F.2d at 606.)

At the hearing on this appeal, Frank Bernat stated that "when we didn't have nothing, we took nothing. When it was there, I figured I was entitled to it. For many years, we got zero. Even today, when it's not there, I don't take anything. . . . But when it's there, I can take it." During the appeal years, Frank and Ada drew between 34% and 35% of the corporation's gross income as compensation and their compensation greatly exceeded the corporation's net income for those years. This certainly does not indicate the type of arms-length transaction with predetermined methods for fixing contingent or incentive compensation which has been upheld in several cases. (See, e.g., Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949); Steel Constructors, Inc., supra.) This appeal is also distinguishable from Eduardo Catalano, Inc., Pension Trust, et al., supra, where compensation paid to the corporation's sole shareholder was held fully deductible by the corporation. In that case, the sole shareholder was the only employee of the corporation and his personal services were the sole source of the corporation's income. In addition, his salary increases were set at the beginning of the income year and his total compensation for each year was a smaller percentage of his corporation's gross income than the percentages of appellant's gross income which were drawn by Frank and Ada.

We believe that appellant has not established that the full amounts claimed were deductible as reasonable compensation for the income years ended in 1975, 1976, and 1977. Appellant, however, argues strenuously that part of the compensation paid during those years was compensation for services which Frank and Ada had rendered in previous years without adequate compensation,

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., 59 T.C. 37, 50 (1972).) The burden is on the appellant to show that the compensation was intended to be for prior services rendered. (Pacific Grains, Inc. v. Commissioner, supra, 399 F.2d at 606; Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F.2d 289, 293 (8th Cir. 1960).)

There were numerous statements both in appellant's brief and at the hearing indicating that Frank

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received very little compensation in the first years of the business. Ada, of course, did not become an employee until 1971. Appellant has not shown the prior years for which compensation was purportedly **being** paid, how much the compensation for those years should have been, or the amount of compensation paid during the appeal years which was attributable to prior services. Additionally, in this appeal there is no contemporaneous indication that the bonuses or salaries for the appeal years were intended to compensate for prior years. It was not until respondent's auditor requested the minutes of the board of directors' meetings that the corporate minutes were amended to justify bonuses and salary increases. The amendment itself is unpersuasive on this point because it states only that the increases were "in payment of the contributions which [Frank and Ada] have personally made on behalf of the [corporation] in order for the [corporation] to enjoy the growth potential which it has experienced over the past years." Appellant has shown neither that the payments would constitute reasonable compensation for prior years nor that any of the payments were intended to compensate for prior years' services. These factors lead us to believe that appellant's contention that the compensation was for prior years was merely an afterthought when the reasonableness of the compensation was already under attack.

Appellant has made other arguments in support of its position. However, upon examination, we find them to be unsupported by statutory or case law. In sustaining the Franchise Tax Board's determination, we do not question the ability or industry of appellant's officers. We note that our decision has no effect on the tax treatment of the income received by the individuals involved, but only on the tax treatment accorded the corporation. The basic principles on which this decision has been made were well stated in the Appeal of Southland Publishing Co., Inc., decided by this board on January 7, 1964:

A sole shareholder may pay himself whatever salary he wishes, but in order to deduct the entire amount from his corporation's income for tax purposes, he must be prepared to demonstrate that it is reasonable and in line with compensation for similar services rendered in similar businesses in which the restraining influence of other owners assures that the salary is not excessive. Where a corporation is closely held, the taxing authorities are the only restraining influence protecting the **revenues.**

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, While they should not be unduly strict, to be unduly generous not only breaches their obligation to the state but permits an unwarranted tax advantage over competing corporations which are not **closely** held and whose stockholders draw their profits as normal, nondeductible dividends.

For the reasons stated in this opinion, the action of the Franchise Tax Board is sustained.

