

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
MOTOWN RECORD CORPORATION,) No s. 79A-58, 79A-59,
JOBETE MUSIC COMPANY, INC.,) and 79A-60-MW
AND MULTI-MEDIA MANAGEMENT)
CORPORATION)

Appearances:

For Appellants: Joel McCabe Smith
Attorney at Law

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

These appeals are made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protest of Motown Record Corporation against proposed assessments of additional franchise tax in the amounts of \$60,375.76 and \$90,436.35 for the income years 1972 and 1973, respectively; on the protest of Jobete Music Company, Inc., against proposed assessments of additional franchise tax in the amounts of \$5,343.96 and \$10,482.81 for the income years 1972 and 1973, respectively; and on the protest of Multi-Media Management Corporation against proposed assessments of additional franchise tax in the amounts of \$4,663.44 and \$3,819.28 for the income years 1972 and 1973, 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 question presented by these appeals is whether the compensation paid to two officer/shareholders of Motown Record Corporation (**Motown**) in 1972 and 1973 was reasonable. Jobete **Music** Company, Inc., and **Multi-Media** Management Corporation are involved in these appeals only because they were engaged in a unitary business with Motown and the adjustments for reasonable compensation affected the payroll factors used to compute their income attributable to California. "Appellant" herein shall refer to 'Motown.

Berry Gordy, Jr., (**Gordy**) was controlling shareholder, president, and chairman of the board of Motown. Esther G. Edwards (Edwards) was a minority shareholder and a vice president. **Motown** deducted **\$3,329,999** and **\$3,774,999** as **Gordy's** compensation for 1972 and 1973, respectively and \$312,500 and \$275,000 as Edwards' compensation for those years. Respondent originally disallowed deductions for about 80 percent of **Gordy's** salary for each year and substantial portions of Edwards' salary and the salary of another corporate officer. The disallowed amounts were treated as nondeductible dividends. Appellant protested the disallowance and proposed a compromise **settlement** 'using the compensation figures allowed by the Internal Revenue Service in its audit of Motown for the income years 1972 and 1973. Respondent declined to settle the matter, apparently' because of other conditions attached to appellant's proposal. On appeal, respondent now is willing to conform to the federal adjustments, with one exception which is favorable to appellant. Appellant now argues that the federal audit adjustments should not be controlling and that the entire amounts claimed as deductions constituted reasonable compensation for Gordy and **Edwards**.

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 services actually rendered; ...

The burden of proving that compensation was reasonable is on the taxpayer. (Botany Worsted Mills v. United States, 278 U.S. 282, 289-290 [73 L.Ed. 3791 (1929).] In order to be deductible under the statute,

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payments made 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).) 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. (Perlmutter v. Commissioner, 44 T.C. 382, 401 (1965); Niagara Falls Coach Lines, Inc. v. Commissioner, ¶ 77,269 T.C.M. (P-H) (1977).)

The federal audit **adjustments** upon which respondent now relies were not made for the purpose of determining the amount deductible by the corporation as reasonable compensation, but to determine the amount of the taxpayer's income from the corporation which was "earned" income for purposes of the maximum tax rate then in effect. However, the criteria for reasonable compensation and "earned" income appear to be the same and have been treated as such by the federal courts. (See Cromer v. Commissioner, ¶ 80,263 T.C.M. (P-H) (1980).)

Respondent states that "[I]t is well settled that a determination by respondent based upon a federal audit is presumed to be correct and the burden is on the taxpayer to overcome that presumption." (Resp. Br. at 6.) However, this rule applies to a deficiency assessment issued by respondent on the basis of a federal audit report. (See Appeal of Jackson Appliance, Inc., Cal. St. Bd. of Equal., Nov. 6, 1970.) In this case, it was not **respondent's** proposed assessment which was based on the federal audit, but only its proposed concession on appeal. Therefore, respondent cannot rely on any presumption of correctness arising out of the federal audit adjustments.

Appellant has detailed the many services provided to Motown by Gordy and Edwards. That they devoted their time fully to the large and complex business operations of **Motown**, and created and sustained an extremely successful enterprise in the highly competitive recording industry has not been disputed by respondent. Appellant argues that the compensation paid to Gordy and Edwards was reasonable in light of their knowledge, experience, and skills, the time which they devoted to Motown, the

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nature and scope of the services which they performed, the size and complexity of the business operation. involved, the ability of Motown to pay such salaries, and the unique nature of the entertainment business.

In answer to appellant's justification of Gordy's and Edwards' salaries, respondent speculates that "it is arguable that not all of Motown's success was due to Gordy 'genius' but may have been the result of a generally healthy record industry." (Resp. Supp. Br. at 6.) Respondent also alleges that, at some undefined time, appellant's protest attorney stated that Gordy withdrew funds from Motown as needed and in December of each appeal year, Gordy's salary would be computed on the basis of sales information and all income would be eliminated from **Motown**.

Respondent argues that appellant's statements are unsupported. However, appellant's statements are supported by sworn affidavits, provided in lieu of testimony at the hearing on this matter. We find these statements as to Gordy's and Edwards' worth **to Motown** to be far more persuasive than the speculation and wholly undocumented allegations made by respondent. In short, we find that appellant has provided sufficient evidence to show that the payments made were reasonable in amount and compensatory in character and that respondent has presented no credible evidence or legal argument to show that **they were** not. Respondent's action, therefore, 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 25667 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protest of Motown Record Corporation against proposed assessments of additional franchise tax in the amounts of **\$60,375.76** and **\$90,436.35** for the income years 1972 and 1973, respectively; on the protest of Jobete Music Company, Inc., against proposed assessments of additional franchise tax in the amounts of **\$5,343.96** and **\$10,482.81** for the income years 1972 and 1973, respectively; and on the protest of Multi-Media Management Corporation against proposed assessments of additional franchise tax in the amounts of **\$4,663.44** and **\$3,819.28** for the income years 1972 and 1973, respectively, is hereby reversed.

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

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

*For Kenneth Cory, per Government Code section 7.9