BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of) No. 84A-320-PD
FARGO RANCH LAND & CATTLE CO.)

For Appellant: Michael Gilbert
Secretary-Treasurer

For Respondent: Karen D. Smith
Counsel

OPINION

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Fargo Ranch Land & Cattle Co. against proposed assessments of additional franchise tax in the amounts of $1,991, $1,993, and $1,014 for the income years ended February 28, 1979, February 29, 1980, and February 28, 1981, respectively, and a delinquent filing penalty in the amount of $199 for the income year ended February 29, 1980.

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.

At issue is whether certain "commissions" and 'excess" rental payments appellant made to its two shareholders were deductible by appellant as business expenses.

Appellant is a corporation operating a real estate sales agency handling sales of commercial and residential property. Michael and Jayne Gilbert are its officers and sole shareholders, each owning 50 percent-of its shares. During the appeal years, appellant employed approximately 20 sales persons, who worked on commission. There were no set salaries for the officers (the Gilberts), who wrote checks to themselves on appellant's account for different amounts at different times. Some of those checks were posted to commission expense and some were posted to rental expense on appellant's books. Appellant rented its Murrieta office from its officer-shareholders.

At the end of each fiscal year, all appellant's profits remaining after payment of expenses and commissions were paid to the Gilberts, and appellant made an adjusting journal entry which increased the amount in appellant's commission expense account by the amount of that paid-out profit. Those amounts were $20,946, $23,900, and $12,570,. successively, for the the years on appeal. The amounts paid the Gilberts and deducted as rental expenses were $6,000, $3,200, and $2,900, successively for the years on appeal. Appellant reported net incomes of $400, $200, and $73, successively, for the years on appeal and did not make any dividend distributions.

During the examination of appellant's tax returns and corporate records, respondent determined that the end-of-the-year commission payments to the Gilberts were constructive dividends, and, estimating the fair 'rental value of the Murrieta office at $3,000 a year, respondent determined that $3,000 of the rental payments for income year ending February 28, 1979, were also constructive dividends. Respondent disallowed deductions taken for these amounts and issued Notices of Additional Tax Proposed to Be Assessed. Appellant protested, respondent affirmed its assessments, and this appeal followed.

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. ...
>
> (2) Rentals or other payments required to be made as a condition to the continued use or possession ... of property ....

As the California Revenue and Taxation Code subsections cited above are substantially similar to parts of section 162 of the Internal Revenue Code, federal case law and regulations are persuasive as to the proper interpretation of the California statutes. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941); Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).) While compensation for personal services and rentals are deductible expenses, distributions of corporate earnings and profits constitute dividends and are not deductible by the distributing corporation. (Cf. Trinity Quarries, Inc. v. United States, 679 F.2d 265 (11th Cir. 1982).) It is well established that deductions are a matter of legislative grace and that the taxpayer bears the burden of furnishing convincing proof of entitlement to any deductions claimed. (New Colonial Ice Company v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of James M. Denny, Cal. St. Bd. of Equal., May 17, 1962.)

Whether the payments were corporate dividends or were compensation for employee services is a question of fact to be determined from all the circumstances of each particular case.

In this case, the circumstances of the payments are not persuasive that those payments were made as employee compensation and as rent rather than as dividends. First, the payments were made at the end of each year rather than throughout the year during which services of the officers were rendered. Second, the payments were nearly identical in amount to each year's profits, determined at the end of each year. Thus, the payments relate to the profits realized each year by the appellant rather than to the value of the services rendered each year by the officers. Third, the payments deducted by appellant resulted in negligible reported taxable income. (Cf. Tumwater Lumber Mills Co. v. Commissioner, 65 F.2d 675 (9th Cir. 1933).) Fourth, although appellant did not suffer losses, no dividends were paid by appellant so that there was no apparent return on capital invested by the shareholders-employees. (Cf. Am-Plus Storage B. Co. v. Commissioner, 35 F.2d 167 (7th Cir. 1929).) Fifth, because the officers were husband and wife, the payments they received were community property, each owning one-half. Therefore, the ownership of one-half of the payments by each of the Gilberts was equivalent to their interest in the shares of appellant.

Appellant has offered no evidence that respondent's estimation of the fair rental value of the Murriet office was in error and that the "excess" rental paymentsa above that amount were other than constructive dividends.

Since the appellant has not sustained its burden of proof, we must sustain respondent's action. Respondent also assessed a delinquent filing penalty for the second appeal year which appellant has not questioned. Accordingly, respondent's action with respect to the penalty must also be sustained.

Appeal of Fargo Ranch Land & Cattle Co.

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 action of the Franchise Tax Board on the protest of Fargo Ranch Land & Cattle Co. against proposed assessments of additional franchise tax in the amounts of $1,991, $1,993, and $1,014 for the income years ended February 28, 1979, February 29, 1980, and February 28, 1981, respectively, and a delinquent filing penalty in the amount of $199 for the year ended February 29, 1980, 'be and the same is hereby sustained.

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

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

______________________, Member

*For Kenneth Cory, per Government Code section 7.9