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10 **BOARD OF EQUALIZATION**
 11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of:) **HEARING SUMMARY**
 13) **CORPORATION FRANCHISE TAX APPEAL**
 14 **APPLIED COMPANIES¹**) Case No. 526527

	<u>Tax Years Ending</u>	<u>Claims</u>
	March 31, 1991	\$15,744.05
	March 31, 1993	\$39,555.12

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 19 ¹ Appellant appears to be headquartered in Los Angeles County, California. This appeal was originally scheduled for an oral
 20 hearing on February 2, 2012. At appellant’s request, this appeal was rescheduled for the Board’s April 24-26, 2012 oral
 21 hearing calendar to give appellant additional time to prepare for the oral hearing. Subsequently, appellant filed a reply brief
 22 and several exhibits, which the Board Proceedings Division received on April 16, 2012. In response, Appeals Division staff
 23 (staff) requested that this appeal come off calendar so the Franchise Tax Board (FTB or respondent) could have an
 24 opportunity to file a reply brief. On May 10, 2012, the FTB requested 30 additional days to file its reply brief, and the appeal
 25 was later scheduled for the Board’s October 23-25, 2012 oral hearing. In October of 2012, the FTB requested that the
 26 hearing be postponed to allow the FTB to file a corrected reply brief (since its initial reply brief, filed on June 20, 2012,
 27 attached and referenced tax returns for years not at issue). On December 4, 2012, staff sent appellant a letter requesting that
 28 appellant file a supplemental brief in response to the FTB’s corrected reply brief. Appellant did not file the requested brief
 and, on February 14, 2013, Board Proceedings informed appellant that time had passed to file a supplemental brief. Board
 Proceedings then scheduled this appeal for the Board’s July 17-18, 2013 oral hearing calendar. However, pursuant to
 appellant’s subsequent request, this appeal was then moved from the July 2013 calendar to the Board’s October 2013 oral
 hearing calendar. At respondent’s request, this appeal was removed from the October 2013 Culver City Board meeting
 calendar to address additional materials submitted by appellant. Board Proceedings Division staff rescheduled the hearing
 for the next available hearing at Culver City, which was the first Culver City meeting in 2014. However, at appellant’s
 request, the hearing was then rescheduled for the November 19-20, 2013 oral hearing calendar. Other than the foregoing
 additional procedural history and the last paragraph of Staff Comments on page 10 (regarding additional briefing that is
 expected to be received after this Hearing Summary is distributed), this Hearing Summary is unchanged from the Hearing
 Summary previously distributed on October 23, 2013.

1 Representing the Parties:

2 For Appellant: Marcus Frishman²

3 For Franchise Tax Board: Eric R. Brown, Tax Counsel III

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5 QUESTIONS: (1) Whether the FTB's proposed assessments, which are based on federal
6 determinations and/or adjustments, are barred by the statute of limitations.

7 (2) Whether appellant has substantiated its employee compensation deductions for
8 the tax years ending March 31, 1991, and March 31, 1993.

9 HEARING SUMMARY

10 Background

11 Appellant filed timely federal and California returns for the tax years ending March 31,
12 1991, and March 31, 1993 (hereinafter sometimes referred to as the 1991 and/or 1993 tax years),
13 reporting a minimum tax due of \$800 for each year. (FTB OB, p 1.)

14 Appellant's sole shareholder and Chief Executive Officer (CEO), Mr. Barney Klinger,
15 received compensation of \$1,194,210 for the tax year ending March 31, 1991 (as represented on
16 appellant's original California tax return for the tax year ending March 31, 1991), and at least
17 \$1,219,000 for the tax year ending March 31, 1993.³ (FTB Corrected Reply Br., p. 2, fn. 4.)

18 Later, the Internal Revenue Service (IRS) audited appellant. (FTB OB, p. 1.) During the
19 audit, the IRS disallowed deductions related to officer compensation on the basis that appellant's officer
20 compensation amounts were excessive. (*Id.*) The IRS disallowed \$450,000 of the claimed officer
21 compensation for 1991 and \$600,000 of the claimed officer compensation for 1993. (*Id.*)

22 In or about April of 1998, the IRS issued a Form 5278 that shows changes made by the
23 IRS's Appeals Office, wherein the IRS agreed to reduce the previously disallowed officer compensation
24 amounts by \$106,498 for 1991 and \$130,072 for 1993. Thus, after the issuance of the Form 5278, the
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27 ² Appellant was previously represented at various times by Howard Rosenblatt, Esq., Dennis Brager, Esq., Joseph Klinger,
and/or Michael Dooley.

28 ³ See FTB Corrected Reply Br., Ex. A., pp. 14 – 15 (which constitutes pp. 15 – 16 of the IRS agent's narrative report, listing
an amount of \$1.219 million); App. Reply Br., p. 4 (listing an amount of \$1,275,159). The FTB states that it does not have a
copy of appellant's original California return for the tax year ending March 31, 1993.

1 disallowed officer compensation totaled \$343,502 (i.e., \$450,000 - \$106,498) for 1991 and \$469,928 for
2 1993 (i.e., \$600,000 - \$130,072). (*Id.* pp. 1-2.). In addition, the IRS allowed the use of net operating
3 losses from 1992 to eliminate the federal tax that would have been due for 1991 and 1993, but which net
4 operating losses did not apply for California purposes. (FTB Corrected Reply Br., Exhibit C, p. 5; FTB
5 OB, pp. 4-5, fn.'s 6 - 8.)

6 Appellant did not report the IRS changes to the FTB. Later, on June 1, 1998, the FTB
7 received notice of the IRS's changes. (*Id.* p 2.)

8 According to appellant's federal transcripts, the IRS issued assessments for the 1991 and
9 1993 tax years on June 8, 1998. (FTB OB, Exhs. F & G.) Specifically, for 1991, appellant's federal
10 transcript shows that the IRS issued an additional tax assessment (IRS Transaction Code 300) in the
11 amount of \$22,525 on June 8, 1998, and then simultaneously, on June 8, 1998, the IRS issued a credit
12 (IRS Transaction Code 309) of \$22,525. (*Id.*, Ex F., pp 4-5.) In its opening brief, the FTB states that
13 the credit was issued due to a net operating loss carryback from the 1992 tax year. (*Id.*, p. 4, fn. 6.) For
14 1993, appellant's federal transcript shows the IRS issued an additional tax assessment (IRS Transaction
15 Code 300) in the amount of \$0.00 on June 8, 1998. (*Id.*, Ex G, p 3.) In its opening brief, the FTB states
16 that there was no additional tax assessed at the federal level for the 1993 tax year due to a net operating
17 loss carryforward from the 1992 tax year. (*Id.*, p. 4, fn. 7.)

18 On August 25, 1998, the FTB issued Notices of Proposed Assessments (NPAs) based on
19 the federal determinations and/or adjustments above by adding \$343,502 to appellant's 1991 California
20 taxable income and \$469,928 to appellant's 1993 California taxable income (amounts which reflected
21 the amount by which IRS Appeals reduced the disallowed deductions). (FTB OB, Exhs. D & E.)
22 Appellant did not timely protest the FTB's proposed assessments, and thus, the FTB's proposed
23 assessments became final after the expiration of the 60-day time periods. (*Id.* p 2.)

24 Approximately ten years later, in 2008, appellant paid the FTB assessments and filed
25 timely claims for refund. (*Id.* p 3.) When the FTB denied appellant's claims for refund, appellant filed
26 this timely appeal. (*Id.*)

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1 **Issue No. 1: Whether the FTB's proposed assessments, which are based on federal determinations**
2 **and/or adjustments, are barred by the statute of limitations.**

3 Contentions

4 Appellant's Appeal Letter

5 Appellant argues that the FTB's assessments are time barred. (App. Ltr., p 2.)
6 Specifically, appellant asserts that it did not have to report the federal changes to the FTB because (i) a
7 final determination would have occurred if and only if there had been a "determination or adjustment of
8 a taxpayer's federal tax liability" (citing former Cal. Code Regs., tit. 18, (Regulation) section 18586.3),⁴
9 and (ii) appellant's federal transcripts show there was no change in appellant's federal tax liability. (*Id.*)
10 Thus, appellant asserts that a "final determination" was never issued and, accordingly, there was no
11 extended statute of limitations for the FTB to issue the NPAs. (*Id.*)

12 FTB's Opening Brief

13 The FTB contends that the final federal determination is the date on which the federal
14 adjustment is "assessed" by the IRS, citing to R&TC section 18622, subdivision (d), and IRC section
15 6203. (FTB OB., p. 4.) The FTB argues that, according to appellant's federal account transcripts, the
16 adjustment was assessed, and thus the final federal determination occurred, on June 8, 1998 (citing to its
17 Exhibit F, page 4, Transaction Code 300 and Exhibit G, page 2, Transaction Code 300). The FTB
18 argues and provides documentation indicating there was additional tax assessed but then removed due to
19 the application of net operating losses from 1992. (*Id.*, fn. 6 and Exhibit C, p. 5 (Form 5278).)

20 The FTB notes that appellant cites to Regulation 18586.3 for the assertion that there must
21 be a change to the taxpayer's federal tax liability for a "final determination" to occur. (FTB OB.,
22 pp. 4-5.) The FTB argues that Regulation 18586.3 does not address what constitutes a federal
23 determination or adjustment that necessitates a reporting requirement. (*Id.* p. 5.) Specifically, the FTB
24 contends that Regulation 18586.3 is simply the predecessor to Revenue and Taxation Code (R&TC)
25 section 19059 (and the regulation thereunder), which "has to do with the period of limitation for
26 proposing a deficiency assessment following federal changes that are properly reported within the six
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28 ⁴ Staff notes that this regulation was renumbered in 1998 and is now Regulation 19059.

1 month period prescribed by section 18622.” (FTB OB., p. 5.)

2 Next, citing to the current version of R&TC section 18622, the FTB states that R&TC
3 section 18622 requires corporate taxpayers to report federal changes to “any item” required to be shown
4 on a federal return (including gross income, deductions, etc.), and the FTB asserts that appellant was
5 required to report the federal changes to the FTB “even though these changes did not result in additional
6 tax due at the federal level because of allowed Net Operating Loss Carrybacks and Carryforwards.”
7 (*Id.*) In addition, the FTB states that “due to differences between federal and state law with respect to
8 Net Operating Loss Carrybacks and Carryforwards, these [federal] changes resulted in additional tax
9 due at the state level.” (*Id.*)

10 Appellant’s Reply Brief

11 Appellant asserts that a close analysis of the relevant statutory sections make clear that
12 the NPAs were issued too late and the assessments were improper. Specifically, appellant states that the
13 current version of R&TC section 18622 contains a subdivision (d), which provides that “the date of each
14 final federal determination shall be the date on which each adjustment or resolution resulting from an
15 Internal Revenue Service examination is assessed . . .” Appellant states that the prior version of R&TC
16 section 18622 did not contain the above-listed subdivision (d), and, instead, the definition of a final
17 federal determination was provided by Regulation 18586.3 (the predecessor to Regulation 19059),
18 which provided that a final federal determination occurs if and only if there is a “determination [or]
19 (sic) adjustment of a taxpayer’s federal tax liability.” (App. Reply Br., pp. 10 - 12.)

20 After providing the foregoing background, appellant then contends that (i) pursuant to
21 Regulation 18586.3 (the predecessor to Regulation 19059) a final federal determination occurs if and
22 only if there is a “determination [or] (sic) adjustment of a taxpayer’s federal tax liability” and (ii) “as the
23 IRS transcripts for both years make clear there was no change in the [federal] tax liability of this
24 taxpayer.” (*Id.*, p. 12.)

25 FTB’s Corrected Reply Brief

26 The FTB asserts that (i) Regulation 19059 (the successor to Regulation 18586.3) simply
27 offers guidance as to when a federal determination is final, and (ii) according to Regulation 19059, an
28 irrevocable determination or adjustment of a taxpayer’s federal tax liability is not limited to the three

1 examples provided in the regulation (i.e., a closing agreement, a 90-day deficiency notice, and an
2 assessment of a deficiency pursuant to a waiver where no 90-day deficiency notice is issued). (FTB
3 Corrected Reply Br., p. 10.)

4 In addition, the FTB asserts that contrary to appellant's assertion, subdivision (d) of the
5 current version of R&TC section 19622 does not define what a federal determination is, but rather,
6 subdivision (d) simply clarifies when a federal determination is final by stating that a final federal
7 determination date that triggers the six month notice period is the date on which each federal
8 determination is "assessed" to the federal account by the IRS. (*Id.*)

9 Applicable Law

10 Statute of Limitations

11 As noted above, the IRS issued assessments for the 1991 and 1993 tax years on
12 June 8, 1998. Accordingly, we shall first summarize current law and then we will address portions of
13 the applicable law for 1998.

14 *Current Law*

15 In general, the FTB must issue an NPA within four years of the date a taxpayer filed his
16 or her California return. (Rev. & Tax. Code, § 19057.) However, there are special statutes of
17 limitations when federal adjustments are involved.

18 A taxpayer is required to report to the FTB any changes by the IRS to a taxpayer's gross
19 income, deductions, or tax within six months after the date of the final federal determination. (Rev. &
20 Tax. Code, § 18622, subd. (a).) If the taxpayer complies with that requirement, the FTB may issue the
21 NPA within two years of the date of notification, or within the general four-year period, whichever
22 expires later. (Rev. & Tax. Code, § 19059, subd. (a).) If the taxpayer notifies the FTB more than six
23 months after the date the federal changes became final, then the FTB may issue the NPA within four
24 years of the date of notification. (Rev. & Tax. Code, § 19060, subd. (b).) Finally, if the taxpayer fails to
25 notify the FTB of the federal changes, then the FTB may issue the NPA at any time. (Rev. & Tax.
26 Code, § 19060, subd. (a); *Ordlock v. Franchise Tax Board* (2006) 38 Cal.4th 897.)

27 *Portions of Applicable Law—as it existed in 1998 and as it exists currently*

28 Prior to being amended in 1999, the relevant portion of R&TC section 18622, subdivision

1 (a), stated:

2 If the amount of gross income or deductions for any year of any taxpayer as returned to
3 the United States Treasury Department is changed or corrected by the Commissioner of
4 Internal Revenue or other officer of the United States or other competent authority, . . . that
5 taxpayer shall report the change or correction . . . within six months after the final federal
6 determination The changes or corrections need not be reported unless they increase
7 the amount of tax payable under this part.

8 Section 18622, subdivision (a), was then amended to read, as it presently does:

9 If any item required to be shown on a federal tax return, including any gross income,
10 deduction, penalty, credit, or tax for any year of any taxpayer is changed or corrected by
11 the Commissioner of Internal Revenue or other officer of the United States or other
12 competent authority, . . . that taxpayer shall report each change or correction . . . within
13 six months after the date of each final federal determination For any individual . . .
14 changes or corrections need not be reported unless they increase the amount of tax
15 payable

16 The amended language was effective for federal determinations that became final on or
17 after January 1, 2000. (*Id.*) Thus, assuming for the sake of argument that the IRS assessments of
18 June 8, 1998, were final federal determinations, it appears that the pre-1999 language is effective for
19 purposes of the federal changes at issue in this appeal.

20 Prior to 1999, a taxpayer was required by R&TC section 18622 to report only changes in
21 “gross income or deductions for any year” After the amendments to the statute, a taxpayer is
22 required to report changes in “any item required to be shown on a federal tax return, including any gross
23 income, deduction, penalty, credit, or tax for any year” In addition, prior to 1999, both corporate
24 and individual taxpayers had to report federal changes only if the federal changes increased the amount
25 of tax payable at the state level. After the amendments, corporations must report all federal changes
26 (regardless of whether the federal changes increase the amount of tax payable at the state level) but
27 individuals still only have to report federal changes that increase the amount of tax payable at the state
28 level.

29 Regulation 19059, subdivision (e)—along with its predecessor Regulation 18586.3,
30 subdivision (e)⁵—contain the following definition of a “final determination”:

31 A final determination is an irrevocable determination or adjustment of a taxpayer’s
32 federal tax liability from which there exists no further right of appeal either

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34 ⁵ Former R&TC section 18586.3 was renumbered R&TC section 19059, operative January 1, 1994. Similarly, as noted
35 above, Regulation 18586.3 was renumbered in 1998 and is now Regulation 19059.

1 administrative or judicial.

2 Furthermore, Regulation 19059, subdivision (e)—along with its predecessor, Regulation 18586.3,
3 subdivision (e)—provide some examples of a final federal determination, including (i) a closing
4 agreement, (ii) a 90-day deficiency notice, and (ii) an assessment of a deficiency pursuant to a waiver
5 where a 90-day deficiency notice is not issued.

6 STAFF COMMENTS

7 As stated above, the FTB issued NPAs for the 1991 and 1993 tax years on
8 August 25, 1998. Because appellant's respective returns for 1991 and 1993 were filed with the FTB on
9 December 13, 1991 and December 15, 1993, the FTB's assessments for the tax years ending
10 March 31, 1991, and March 31, 1993, would be barred under the normal four-year statute of limitations
11 set forth in R&TC section 19057. However, the FTB's assessments would be timely if R&TC section
12 19059 or 19060 applies. Thus, it appears, then, that the only genuine dispute is whether R&TC section
13 18622 required appellant to report the 1991 and 1993 federal changes to the FTB, thus triggering the
14 application of R&TC section 19059 or 19060.

15 Here, the IRS changed appellant's claimed deductions for officer compensation for the
16 tax years 1991 and 1993. The IRS recorded its assessments to appellant's federal account on
17 June 8, 1998. Due to net operating loss carryovers/carryforwards at the federal level, the IRS
18 assessments did not impose additional federal taxes.

19 Staff notes that R&TC section 18622 (both the pre-1999 version and the current version)
20 does not state that additional tax must be due at the federal level before a federal change must be
21 reported to the FTB.⁶ Also, staff notes that a "final determination" is defined in Regulation 19059 as
22 "an irrevocable determination *or* adjustment of a taxpayer's federal tax liability from which there exists
23 no further right of appeal, either administrative or judicial." (Cal. Code Regs., tit. 18, § 19059, subd. (e)
24 (emphasis supplied).) Thus, a final federal determination does not necessarily have to include an
25 adjustment to a taxpayer's federal tax liability. Accordingly, at the oral hearing, appellant should be
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28 ⁶ Staff is of the opinion that the outcome in this appeal is not dependent upon whether the Board applies the pre-1999 version
of R&TC section 18622 or the current version of R&TC section 18622. At the oral hearing, the parties may wish to discuss
this issue. As noted above, the current language of R&TC section 18622 is effective for federal determinations that became
final on or after January 1, 2000. (Rev & Tax. Code, § 18622.)

1 prepared to further discuss its contention that final determinations were never issued because there was
2 no additional tax due at the federal level.

3 In addition, appellant should be prepared to discuss the fact that (i) the pre-1999 version
4 of R&TC section 18622 required corporate taxpayers (such as appellant) to report federal changes that
5 increased the amount of tax payable at the state level, and (ii) the current version of R&TC section
6 18622 requires corporate taxpayers to report all federal changes (regardless of whether the federal
7 changes increase the amount of tax payable at the state level).

8 After the close of briefing and the original distribution of this Hearing Summary,
9 appellant's representative submitted the following exhibits:

- 10 • A federal Form 870-AD (*Offer to Waive Restrictions on Assessment and Collection of Tax*
11 *Deficiency and to Accept Overassessment*), which is signed by Kent L. Fortin, appellant's chief
12 financial officer, and dated April 27, 1998.
- 13 • A federal Form 3610 (Audit Statement), which is dated April 16, 1998.
- 14 • An undated memo from Terry Milne, who is listed as the Appeals Team Case Leader for the
15 IRS. The memo is not on letterhead and is attached to an IRS fax cover sheet, dated
16 December 15, 2004. The memo states that the RARs for 1990 to 1993 were "considerably
17 reduced" but that "[d]ue to a mix-up at the IRS, apparently a final report was never issued
18 following the successful appeal concluded in April of 1999, and . . . the case has remained in IRS
19 limbo until just recently when collection efforts were erroneously started"

20 With regard to the first two documents, staff notes that the Form 3610 was previously
21 provided by respondent on page two of Exhibit C of its opening brief. The other document, the Form
22 870-AD, shows the same information shown in the Form 3610. Both documents show zero federal tax
23 due for 1991 and 1993. According to the Form 5278, which was previously in the record and briefed by
24 the parties, the elimination in federal tax in 1991 and 1993 was due to the application of federal net
25 operating losses generated in 1992 and applied to 1991 and 1993. (See FTB OB, Exhibit C, p. 5.) It
26 does not appear to be disputed that no such loss carry-back or carry-forward could be used for California
27 purposes.

28 With regard to the memo, the parties will want to discuss at the hearing how it should be

1 weighed in relation to the IRS transcripts and other documentation in the record. Prior to the submission
2 of the memo, the record and briefing already reflected that no federal tax was owed for 1991 and 1993,
3 and further that this result was due to changes made by the IRS Appeals Office, including the
4 application of federal loss carrybacks and carryforwards from 1992. This appears consistent with the
5 memo, except that the memo refers to the IRS Appeal being concluded in April of 1999 while the other
6 documents in the record suggest it was concluded in or around April of 1998. The parties will want to
7 discuss the statement in the memo that the Appeal was “concluded” in 1999 but “[d]ue to a mix-up at
8 the IRS, apparently a final report was never issued following the successful appeal concluded in April of
9 1999, and . . . the case has remained in IRS limbo until just recently when collection efforts were
10 erroneously started”

11 Staff has requested additional briefing from the parties to address the materials submitted
12 by appellant and questions raised by a Board Member’s office, and to provide an opportunity for the
13 parties to provide any additional evidence or argument that might assist the Board in determining
14 whether respondent erred in denying appellant’s refund claim. Each party’s response will be distributed
15 shortly after it is received, and the responses are due by November 7, 2013 (respondent) and November
16 14, 2013 (appellant).

17 **Issue No. 2: Whether appellant has substantiated its employee compensation deductions for the**
18 **tax years ending March 31, 1991, and March 31, 1993.**

19 Contentions

20 Appellant’s Appeal Letter

21 Appellant argues that the FTB’s assessments are incorrect and erroneous. (App. Ltr.,
22 p.2.) Specifically, appellant argues that its employee compensation deductions are “fully deductible for
23 the tax years in question” under R&TC section 24343 and “other applicable authority.” However,
24 appellant does not otherwise expand on this argument in its opening brief. (*Id.*)

25 FTB’s Opening Brief

26 The FTB argues that appellant has failed to demonstrate that the FTB erred by
27 disallowing portions of officer compensation for taxable years 1991 and 1993. (FTB OB., p 6.)
28 Specifically, the FTB states that appellant has provided “no factual or legal argument to support its

1 assertion” that the FTB erred. (*Id.*) Furthermore, the FTB asserts that appellant has the burden of proof
2 and appellant’s unsupported assertions are insufficient to carry its burden. (*Id.*, citing the *Appeal of*
3 *Frank J. and Barbara D. Burgett*, 83-SBE-127, June 21, 1983.)⁷

4 Appellant’s Reply Brief

5 Appellant asserts that whether amounts paid to an employee represent reasonable
6 compensation is a question that must be determined on the basis of all of the evidence, citing *Perlmutter*
7 *v. Commissioner* (1965) 44 T.C. 382, 401. (App. Reply Br., p. 5.) In addition, appellant asserts that the
8 Ninth Circuit applies the following five factors to determine whether compensation is reasonable:
9 (1) the taxpayer’s role in the company, (2) salaries paid by similar companies for like services, (3) the
10 company’s character and condition, (4) any conflicts of interest in which the company may be disguising
11 dividends as salary, and (5) the internal consistency of the compensation plan, citing *Elliotts Inc. v.*
12 *Commissioner (Elliotts)* (9th Cir. 1983) 716 F.2d 1241, 1243-1245. (*Id.*) Appellant contends that this
13 multi-factor analysis is performed through the lens of an “independent investor test,” with the relevant
14 inquiry being whether an inactive and independent investor would be willing to compensate the
15 employee as he or she was compensated, citing *Elliotts v. Commissioner, supra*, and *Multi-Pak Corp. v.*
16 *Commissioner (Multi-Pak)*, T.C. Memo 2010-139. (*Id.*) As for each of the five factors listed above,
17 appellant makes the following arguments:

18 (1) *Employee’s role in the company*—Appellant contends that its payments to Mr. Barney
19 Klinger, appellant’s sole shareholder, constitute reasonable compensation for the services rendered, as
20 Mr. Klinger was appellant’s Chairman of the Board, Chief Executive Officer, Chief Engineer, Senior
21 Marketing Executive, and Senior Sales Representative. (*Id.* p. 7.) Also, appellant states that
22 “Mr. Klinger personally guaranteed up to \$4,500,000 in personal guarantees for loans to [appellant] that
23 were critical to its Survival (sic)” and appellant cites to the Ninth Circuit’s unpublished decision in
24 *E.J. Harrison & Sons, Inc. v. Commissioner* (9th Cir. 2005) 138 Fed. Appx. 994 for the contention that,
25 when an individual guarantees loans for a company, then a greater amount of compensation may be
26 found to be reasonable. (*Id.*)

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28 ⁷ Board of Equalization cases are generally available for viewing on the Board’s website (www.boe.ca.gov).

1 (2) *Salaries paid by similar companies for like services*—As for this second factor, appellant
2 merely cites to the following website, without further analysis:

3 <http://observationsandnotes.blogspot.com/2009/04/stock-market-returns-by-year.html>.
4 (*Id.* p. 8.)

5 (3) *Company’s character and general economic condition*—Appellant contends that this
6 factor considers the size of a company—as indicated by gross revenues and net income—as well as the
7 general economic conditions, citing *Elliotts, supra*, at 1246. (*Id.*) As for appellant’s gross income and/or
8 net income, appellant asserts the following:

- 9 • Appellant asserts that it had gross revenues of approximately \$9,171,259 in 1991 and
10 \$7,510,989 in 1993.
- 11 • Appellant asserts that it had net income of \$320,935 in 1991 and \$828,789 in 1993.
- 12 • Appellant asserts that the average net income for the five-year period from 1990 to 1994 was
13 \$1,002,004.

14 In addition, appellant states that “while there was an appreciable difference between the average [net
15 income] and the net income in 1991, the fact that Mr. Klinger guaranteed \$4,500,000 in corporate loans
16 and had taken much less salary in the previous years more than compensates to make this factor weigh
17 strongly in [appellant’s] favor.” (*Id.*)

18 (4) *Conflicts of interest in which the company may be disguising dividends as salary*—
19 Appellant asserts that (i) the Ninth Circuit determines reasonableness of compensation, in part, by
20 applying an “independent investor test,” and (ii) under an “independent investor test,” a company’s
21 annual return of equity (hereinafter sometimes “ROE”) is calculated by determining the net income after
22 taxes and dividing this by total shareholders’ equity. (Citing *Multi-Pak, supra.*) (*Id.*) As for the facts of
23 this appeal, appellant asserts that its ROE amounts for the tax years ending March 31, 1991, and
24 March 31, 1993, were 7 percent and 14 percent, respectively, which appellant asserts is well above the
25 2.9 percent that the court in *Multi-Pak* based a determination of reasonable compensation on. (*Id.* p. 9.)
26 Accordingly, appellant asserts that an independent investor would have been “very satisfied” with the
27 ROE amounts yielded by appellant during the years in question.

28 ///

1 (5) *Internal consistency of the company's compensation plan*—Appellant asserts that this
2 factor prevents a company from paying year-end bonuses in an attempt to disguise dividends as
3 deductible compensation, citing *Multi-Pak, supra. (Id. p. 9.)* Appellant asserts that the following
4 factors show that appellant was not attempting to disguise dividends as deductible compensation:

- 5 • Appellant contends that Mr. Klinger's salary payments in 1991 and 1993 are based (in part) on
6 the fact that Mr. Klinger took reduced salaries in previous years to allow appellant to meet its
7 working capital needs.
- 8 • Appellant asserts that Mr. Klinger's salary payments in 1991 and 1993 reflect the value of the
9 personal loan guarantees provided by Mr. Klinger to the company.
- 10 • Appellant asserts that “[w]ith healthy rates of return in 1991 of 7% and 1993 of 14% an
11 independent investor would have been satisfied and would have been willing to pay Mr. Klinger
12 \$1,078,503 and \$1,275,159 in those respective years.”⁸
- 13 • Appellant asserts that Mr. Klinger's salary payments in 1991 and 1993 are reasonable, given
14 Mr. Klinger's essential role in the company.
- 15 • Appellant asserts that Mr. Klinger's salary payments in 1991 and 1993 are consistent with
16 industry standards and the condition of the company was “very good.”

17 Exhibits

18 Along with its reply brief, appellant provides the following exhibits:

- 19 • Declaration of Mr. Barney Klinger, who states, among other things, that (i) he personally
20 guaranteed loans for the company, and (ii) he worked 60+ hours a week.
- 21 • Declaration of Ronald Winkler, a past employee, who states, among other things, that
22 (i) Mr. Klinger was involved in the daily operation of the business, and (ii) Mr. Klinger played a
23 “pivotal role” in the business.
- 24 • Board Minutes dated August 30, 1991, setting compensation for Mr. Klinger.
- 25 • Special Minutes dated August 28, 1992, setting compensation for Mr. Klinger.
- 26 • A line of credit and/or loan documents, showing that Mr. Klinger guaranteed the lines of credit

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28 ⁸ Staff notes that appellant's 1991 and 1993 California returns state that Mr. Klinger received compensation of \$1,025,953 in 1991 and \$1,213,591 in 1993.

1 and/or loans for appellant.

2 FTB's Corrected Reply Brief

3 The FTB asserts that its assessment, which is based on a federal audit, is presumed
4 correct and appellant has the burden of proving error, citing the *Appeal of Frank J. and Barbara D.*
5 *Burgett, supra*. (FTB Corrected Reply Brief, p. 2.) The FTB also asserts that appellant expressly agreed
6 to the IRS assessments for the tax years ending March 31, 1991 and March 31, 1993, via a "settlement"
7 with the IRS in April of 1998 which, the FTB asserts, contradicts appellant's argument on appeal that
8 the IRS assessments for those tax year are incorrect. (*Id.*)

9 The FTB quotes at length from the auditor's narrative set forth on Form 886-A, in which
10 the IRS alleged various factors in support of the federal assessments, including (i) the company
11 apparently never paid any dividends, (ii) there was never any arm's length bargaining between
12 Mr. Klinger and the Board of Directors, as Mr. Klinger was the sole shareholder and was effectively in
13 control of the Board, (iii) Mr. Klinger received large amounts of compensation, even when the company
14 was not making a profit, (iv) Mr. Klinger's compensation agreement was contrary to the best interests of
15 the company, in that the agreement (allegedly) allowed Mr. Klinger to receive more compensation when
16 the company took on more debt, (v) Mr. Klinger had a habit of personally borrowing funds from the
17 company and using the company as his "private bank" without review or oversight, and (vi) there was a
18 disparity between Mr. Klinger's compensation and that of appellant's other officers, as Mr. Klinger was
19 the only employee to earn over \$125,000 from 1988 through 1993. (FTB Corr. Reply Br., pp. 13 – 20.)

20 Next, in relation to the five factors set forth in *Elliot's, supra*, the FTB makes the
21 following arguments:

22 (1) *Employee's role in the company*—The FTB asserts that the IRS agent who audited
23 appellant conceded this point in his Form 886-A(which the FTB describes as its RAR). Accordingly,
24 the FTB argues that this factor is not a consideration on which the IRS's determination was ultimately
25 based. (*Id.*, pp. 20 - 21.)

26 (2) *Salaries paid by similar companies for like services*—The FTB asserts that the IRS agent
27 who audited appellant conceded this point in his Form 886-A. Accordingly, the FTB argues that this
28 factor is not a consideration on which the IRS's determination was ultimately based. (*Id.*)

1 (3) *Company's character and condition*—The FTB asserts that appellant does not meet this
2 third factor for the following reasons: First, the FTB asserts that the net income amounts cited by
3 appellant in its reply brief for 1991 and 1993, of \$320,935 and \$828,729, respectively, do not match the
4 net income amounts cited by the IRS agent in the Form 886-A. (*Id.*, p. 21.) Specifically, the FTB
5 asserts that the IRS agent expressly stated that appellant had a net loss in 1991 of \$217,000, and a net
6 income in 1993 of approximately \$1,000. (*Id.*) Also, the FTB asserts that the IRS agent expressly stated
7 that the amounts contained in the Form 886-A were from appellant's federal tax returns. (*Id.*) The FTB
8 asserts that, if appellant disputes that the amounts cited by the IRS agent in the Form 886-A are correct,
9 then appellant should produce copies of its federal returns for the Board's consideration. (*Id.*) Along
10 with its reply brief, the FTB provided a copy of the IRS agent's Form 886-A, which lists appellant's
11 income amounts (in millions) as follows:

(in millions)	1988	1989	1990	1991	1992	1993
Gross Receipts	7.6	8.4	17.3	14.5	9.7	10.8
Net income ⁹	(.4)	(.7)	(.977)	(.217)	(2.85)	.001
Mr. Klinger's compensation	.180	.184	.618	1.194	1.025	1.219

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18 Second, the FTB asserts that if the 1991 and 1993 net income amounts cited by appellant in its reply
19 brief are intended to reflect appellant's California net income amounts for 1991 and 1993 rather than
20 appellant's federal net income amounts for 1991 and 1993, then the FTB notes that the amounts cited by
21 appellant in its reply brief do not match the amounts previously reported in appellant's California
22 returns. Specifically, the FTB states that appellant reported a California net loss (before state
23 adjustments) of \$217,762 for the tax year ending March 31, 1991 and a California net income (before
24 state adjustments) of \$481,006 for the tax year ending March 31, 1993.¹⁰ (*Id.*, pp. 21-22.) Third, the
25 FTB notes that the IRS agent specifically stated that in light of the company's poor financial condition,
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27 ⁹ The parentheses represent net loss amounts. For example, "(.4)" represents a net loss of \$400,000.

28 ¹⁰ Staff notes that appellant's amended California return for the tax year ending March 31, 1993, reports a California net
income (before state adjustments) of only \$11,078. (FTB Corrected Reply Br., Ex. C, p. 1.)

1 Mr. Klinger's annual salary increases were not "ordinary or necessary" but were "obscene and
2 unconscionable." (*Id.*, at pp. 4 & 22 & Ex. A, p. 15.) Fourth, the FTB reiterates its contention that
3 appellant expressly agreed to the IRS assessments for the tax years ending March 31, 1991 and
4 March 31, 1993. (*Id.*, pp. 4 & 22.)

5 (4) *Conflicts of interest in which the company may be disguising dividends as salary*—The
6 FTB contends that appellant's argument regarding return of equity does not demonstrate that a conflict
7 of interest did not exist, in that appellant's argument fails to honestly discuss the fact that, as the sole
8 shareholder of the company, Mr. Klinger could do whatever he wanted, regardless of whether his actions
9 were in the best interests of the company. (*Id.*, p. 22-23.) In fact, the FTB notes that the IRS agent
10 found, among other things, that Mr. Klinger's compensation arrangement was contrary to the best
11 interests of the company, as the arrangement allegedly allowed Mr. Klinger to receive more
12 compensation when the company took on more debt. (*Id.*, pp. 4-5 & 23.) In addition, the FTB notes
13 that the IRS agent asserted that Mr. Klinger had a habit of personally borrowing funds from the
14 company and using the company as his "private bank" without review or oversight. (*Id.*, pp. 4-5.)

15 (5) *Internal consistency of the company's compensation plan*—The FTB argues that
16 appellant's compensation plan was not internally consistent. (*Id.*, pp. 23-24.) For example, the FTB
17 asserts that the IRS agent found that appellant did not issue a Form W-2 nor a Form 1099 for the
18 \$450,000 bonus that Mr. Klinger received for 1991. (*Id.*) Furthermore, the FTB contends that the
19 disparity between Mr. Klinger's compensation and that of appellant's other officers could not be more
20 stark, as the IRS agent noted that Mr. Klinger was the only employee to earn over \$125,000 from 1988
21 through 1993. (*Id.*) In addition, the FTB asserts that the IRS agent found that Mr. Klinger's
22 compensation of \$1,025,000 for the tax year ending March 31, 1992 (which, however, is not a year at
23 issue) was in excess of 36 percent of appellant's entire payroll for that year.

24 Applicable Law

25 Deductions—Employee Compensation

26 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a
27 deduction has the burden of proving by competent evidence that he or she is entitled to that deduction.
28 (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*,

1 2001-SBE-001, May 31, 2001.) The Board has consistently held that an FTB determination which is
2 based on a final federal determination is presumed to be correct. (*Appeal of Frank J. and Barbara D.*
3 *Burgett, supra.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof.
4 (*Appeal of Aaron and Eloise Magidow, 82-SBE-274, Nov. 17, 1982.*)

5 R&TC section 24343 incorporates IRC section 162. IRC section 162 provides that
6 deductions shall be allowed for all ordinary and necessary expenses paid or incurred in carrying on a
7 trade or business. Whether employee compensation is reasonable for tax deduction purposes is a
8 question of fact which must be decided on the basis of a review of all of the facts in each particular case.
9 (*See Irby Construction Co. v. United States (Ct. Cl. 1961) 290 F. 2d 824; Heil Beauty Supplies v.*
10 *Commissioner (8th Cir. 1952) 199 F. 2d 193; Appeal of Southland Publishing Co., Inc., 64-SBE-010,*
11 *Jan. 7, 1964.*) The Ninth Circuit Court of Appeals has listed five factors for determining reasonable
12 compensation: (1) the employee's role in the company, (2) the salaries paid by similar companies for
13 like services, (3) the company's character and condition, (4) conflicts of interest in which the company
14 may be disguising dividends as salary, and (5) internal consistency of the company's compensation plan.
15 (*Elliot v. Commissioner, supra; Multi-Pak Corp. v. Commissioner, supra.*) No one factor is decisive.
16 (*Id.*)

17 STAFF COMMENTS

18 As noted above, appellant and the FTB focus their arguments on the five factors set forth
19 in *Elliot, supra*. As for the first two factors (i.e., the employee's role in the company, and the salaries
20 paid by similar companies for like services), the FTB appears to concede those factors on appeal.
21 Accordingly, the Board may want to focus its analysis on the remaining three factors, which are set forth
22 below:

23 Company's character and condition

24 This factor focuses on the company's size and economic condition, as a basis for
25 determining whether any deductions for compensation are reasonable.

26 As noted above, evidence provided on appeal shows that Mr. Barney Klinger, received
27 compensation of \$1,194,210 for the tax year ending March 31, 1991, and at least \$1,219,000 for the tax
28 year ending March 31, 1993. Here, as part of appellant's effort to show that the deductions for

1 compensation were reasonable, appellant asserts that (i) it had net income of \$320,935 for the tax year
2 ending March 31, 1991, and \$828,789 for the tax year ending March 31, 1993, and (ii) Mr. Klinger
3 guaranteed various loans for the company.

4 Staff notes, however, that the IRS agent's Form 886-A states that appellant had a federal
5 net loss of \$217,000 for the tax year ending March 31, 1991, and a federal net income of only \$1,000 for
6 the tax year ending March 31, 1993, and the Form 886-A states that these amounts were taken directly
7 from appellant's 1991 and 1993 federal returns. In addition, staff notes that appellant's California return
8 for the tax year ending March 31, 1991, reported a net loss (before state adjustments) of \$217,762 and
9 appellant's amended California return for the tax year ending March 31, 1993, reported a net income
10 (before state adjustments) of only \$11,078.

11 Accordingly, at the oral hearing, appellant should provide evidence and/or argument,
12 substantiating that appellant had net income of \$320,935 for the tax year ending March 31, 1991, and
13 \$828,789 for the tax year ending March 31, 1993, as appellant alleges. Staff notes that the IRS agent's
14 Form 886-A specifically cited appellant's poor financial condition as a reason for disallowing
15 appellant's deductions for officer compensation for the tax years ending March 31, 1991, and
16 March 31, 1993.

17 **Conflicts of interest in which the company may be disguising dividends as salary**

18 As noted above, appellant asserts that its return of investor equity (ROE) amounts
19 demonstrate that a conflict of interest did not exist, as an independent investor would have been "very
20 satisfied" with the ROE amounts yielded by appellant during the years in question. At the oral hearing,
21 appellant should be prepared to substantiate the ROE amounts set forth in its reply brief. Specifically,
22 appellant asserts that its ROE amounts for the tax years ending March 31, 1991, and March 31, 1993,
23 were 7 percent and 14 percent, respectively, which appellant asserts is well above the 2.9 percent that
24 the court in *Multi-Pak, supra*, based a determination of reasonable compensation on.

25 Next, as noted above, the IRS agent specifically found that Mr. Klinger's compensation
26 agreement was contrary to the best interests of the company, in that the agreement (allegedly) allowed
27 Mr. Klinger to receive more compensation, when the company's took on more debt. Also, the IRS agent
28 alleged that Mr. Klinger had a tendency to personally borrow funds from the company, without any

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oversight.

Internal consistency of the company’s compensation plan

As noted above, evidence provided on appeal shows that Mr. Barney Klinger received compensation of \$1,194,210 for the tax year ending March 31, 1991, and at least \$1,219,000 for the tax year ending March 31, 1993. As indicated above, the FTB contends that there was a disparity between Mr. Klinger’s compensation and that of appellant’s other officers, as the IRS agent noted that Mr. Klinger was the only employee to earn over \$125,000 from 1988 through 1993. Appellant should be prepared to discuss this issue at the oral hearing.

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