

Appeal of Del Kern Cattle Company

Appellant, an accrual basis taxpayer, is a California corporation engaged in cattle feeding and farming. It commenced operations on March 1, 1966, and selected a fiscal year ending the last day of February. The **three officers** and directors each own one-third of the corporation's stock.

"In computing its net **income** for the **income** year ended February 28, 1967, appellant claimed 'a deduction for officers' salaries in the amount of \$100,000. During the course of an audit respondent found that the closing entries to appellant's books for that year reflected a **\$144,290.54** credit to retained earnings. The books did not reflect a charge to officers' salaries for the same year. However, in March or April of the following fiscal year an entry was made debiting retained earnings and crediting officers' salaries for \$100,000. This amount was not actually paid until May 12, 1967, two and one-half months after the close of the fiscal year. The total amount was deducted on appellant's franchise tax return for the income year ended February 28, 1967. **Respondent** disallowed the deduction for officers' salaries and this appeal followed. The deductibility of this amount is the sole issue for determination.

Since appellant was a commencing corporation in 1966, the net income from its first year of operation, the income year ended February 28, 1967, was used as the measure of the franchise tax for both the taxable years ended **February** 28, 1967, and February 29, 1968. The disallowance of this deduction resulted in proposed assessments for both those taxable years. The deduction was allowed for the following income year and resulted in an overpayment.

Appellant's major contention is that the salaries were informally authorized by the board of directors during the income year in question and were properly accrued for that year. Appellant especially emphasizes the fact that it is a closely held corporation and often operates in an informal manner. In support of this position, appellant's accountant, Mr. Mott, testified that he met

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with appellant's directors sometime in February 1967, after they were aware of the corporation's approximate earnings for the year. He also testified that it was his opinion that the corporation should **distribute** substantially all **the** anticipated earnings of \$140,000 to the officers in the form of salaries. The directors disagreed and suggested that no **more** than \$100,000 be paid. Mr. Mott stated that he left the meeting with the impression that payment was to be at least \$100,000 although he admitted that no specific sum had been determined. However, no corporate minutes or other written records were offered to substantiate, any transactions which allegedly occurred at this meeting. Nor were any book entries ever made at or near the date of this meeting reflecting any corporate liability to the officers for salary in any amount.

'With reference to the absence of any book entries, Mr. Mott testified that appellant's bookkeeper, who normally closed the books monthly, was instructed not to enter any amount as officers' salary because the exact figure had not been agreed to **as of** the close of the year. He explained that, rather than enter a minimum amount which would subsequently have to be adjusted, no entry was made until the exact amount was determined by the directors in April or May of 1967. The \$100,000 was paid May 12, 1967, when the president received \$40,000 and the vice president and treasurer each received \$30,000.

As an alternative argument, appellant relies on a **theory of** ratification' after the close 'of the year. Specifically, appellant urges that the directors ratified the salaries by accepting payment in May 1967, and also ratified charging the salaries against income for the year ended February 28, 1967, by accepting the financial statements for that year at a board meeting held on May 27, 1957.

Respondent, on the other hand, maintains that the salaries were neither fixed in amount nor authorized by the board of directors prior to the end of the income year in question and, therefore, they were not deductible.

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It is **also respondent's** position that, although the directors may formally ratify a previous informal authorization, the action is ineffective where the subsequent formal resolution does not mention any previous informal authorization.

In support of its position, respondent places heavy reliance upon the corporate minutes. The minutes indicate that at a directors' meeting on May 7, 1966, the directors resolved that in line with past practice no salaries would be paid to the officers and directors. The minutes of a directors' meeting held **May 6, 1967**, state that the policy of management in paying salaries to officers in amounts comparable to those paid executives performing similar functions in the cattle industry **was** to be continued for the fiscal year 1967. However, there was apparently another set of minutes for the same meeting which made no mention of officers' salaries. There was no conclusive testimony as to which set of minutes reflected the actual transactions which occurred at the May 6 meeting. In any event, the minutes of a special directors' meeting held just three weeks later on May 27, 1967, specifically resolved that in line **with' past** practices officers' salaries should be deferred for another year.

Appellant attempted to minimize the absence of an 'authorization to pay salaries in the minutes, by claiming that the minutes were totally inaccurate and unreliable. Of this we have no doubt and agree with appellant. Nevertheless, the fact remains that the record contains no minutes or other written memoranda which authorize either the payment or accrual of officers' salaries in a specific or ascertainable amount for the income year in question. Nor were there any minutes or other documents in the succeeding year ratifying a previous informal authorization as appellant suggests.

Section 24343 of the Revenue and Taxation Code, which allows the deduction of all ordinary and necessary business expenses incurred during the income year, specifically includes a reasonable allowance for salaries for personal services. The reasonableness of the

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compensation is not in question. However, as indicated, respondent maintains that the officers' salary in question was not incurred in the income year ended February 28, 1967, and may not be deducted for that year.

Under the accrual system of accounting, an expense accrues when all the events have occurred for which liability is determined and the liability has become fixed even though payment is not yet due. (Desco Corp. v. United States, 55 F.2d 411.) Salary expenses are not incurred unless and until a legal obligation to pay them arises. They do not accrue within a given period unless all of the events which fix the amount and determine the liability of the taxpayer to pay occur within that period. (Desco Corp. v. United States, supra.) Before a liability for officers' salaries becomes fixed, there must occur corporate action authorizing the payment of an ascertainable amount of compensation. The corporate authorization need not be formal and may consist of an informal agreement or understanding among the directors that a defined or ascertainable amount will be paid. (John T. Savage, T.C. Memo, June 18, 1970.) Here, however, there is evidence of neither corporate authorization nor a definite or ascertainable amount. (Bauer Bros. Co. v. Commissioner, 46 F.2d 874; Southland Coal Co., 16 B.T.A. 50; Bray & Kates Co., 3 B.T.A. 1316; cf. W. H. Harris Grocery Co., 3 B.T.A. 216.)

As appellant urges in its second contention, formal authorization or ratification by the board of directors may confirm an informal authorization of the previous year, particularly in the case of a closely held corporation. However, it must be proved. An informal authorization must not be tentative. It must have finality and relate to some definite amount and the substantiating evidence must be clear cut. (See, e.g., Indiana Rubber & Insulated Wire Co., 20 B.T.A. 1201; Southern Tire & Rubber Co., 18 B.T.A. 210.) Here even if the testimony of appellant's witnesses is taken at face value, we cannot conclude that a specific and ascertainable amount of officers' salaries was authorized either formally or informally during the income year 1967. Furthermore, appellant failed to establish that any ratification occurred during the succeeding year.

