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Income--Salaries--Division of Profits (Am-Plus Storage Battery Co. v. Commissioner, etc., IV U.S. Daily, Sept. 23, 1929 at 1752 (7th Cir.))

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The very words "long term contract" suggest a practical inability ordinarily to determine in any one taxable period the net profit or loss realized on such an agreement. Provisions for just such a situation are found in the Federal Regulations where long term contracts are defined to mean building, installation or construction contracts covering a period in excess of one year.[1] The case under consideration is within the spirit if not within the letter of the present law [2] and was so deemed to be under the act in force at that time.[3] "The mere diminution of loss is not gain, profit or income." [4] Recoupment of losses by plaintiff does not come within the purview of gain derived from capital, from labor or from both combined, including profit gained through sale or conversion of capital assets.[5] The interest recovered does constitute income within the meaning of the income tax law; not so with the principal. A dissenting opinion in the case was founded upon the theory that a year is necessarily the unit for determination of income for tax purposes.[6]

A. K. B.

INCOME—SALARIES—DIVISION OF PROFITS.—Plaintiff is an Illinois corporation with a capital stock of $10,000 invested by two of its directors, each of whom had subscribed for 49% of the corporate stock. These directors were also president and treasurer and vice-president and secretary respectively and were to receive a yearly salary of $5,000 plus 10% commission of all the business done by the corporation. As officers they devoted all their time and effort to the affairs of the corporation but waived payment of their commissions for the years 1919 and 1920, the profits being small. However, in the year 1921 the gross business of the corporation was $123,748.78. Each of the officers was allowed and received his salary of $5,000 and also a commission of $12,374.88, making the total payment to the two officers, $34,749.76. The Commissioner determined that of this sum $9,813.27 had been excessively allowed the officers as salaries and commissions and assessed a deficiency against the corporation for deducting this amount from its income tax return for 1921. The petitioner now seeks a redetermination of the Commissioner's holding. *Held,* when officers' compensation absorbs practically all of the profits under normal conditions and effects a partial

[1] Regulations 74, Art. 334 (1928).
[2] *Supra* Note 1.
[3] Regulations 33, Art. 121, based upon Treasury Decision 2161, promulgated Feb. 19, 1915, construing the Act of 1913.
[4] Bowers v. Kerbdaugh-Empire Co., 271 U. S. 170, 175, 46 Sup. Ct. Rep. 449, 451, 70 L. ed. 886 (1926).
[5] Marshall v. Commissioner, 10 B. T. A. 1140 (1928).
[6] Per Northcutt, *J.*

distribution of profits and especially in view of the fact that the compensation is in the same proportion as the stock ownership, such compensation is unreasonable. Am-Plus Storage Battery Co. v. Commissioner, etc., (C. C. A. 7th) IV U. S. Daily, Sept. 23, 1929 at 1752.

A corporation may deduct as necessary expenses, a reasonable allowance for salaries for personal services actually rendered.[1] While salaries voted by directors are presumptively valid, they are not conclusive as regards the corporation's liability for income and excess profits tax.[2] The fixing of salaries is completely within the discretion of the Board of Directors, although the Government may inquire as to whether the amount paid was salary or something else.[3] If the compensation is unreasonable and is a division of profits in the guise of salary then it is not deductible and is subject to taxation.[4] The final determination as to whether or not a salary is unreasonable is a question of fact to be determined from the evidence.[5] The burden is on the petitioner to prove that the compensation is reasonable. Where salaries are in excess of the usual value of the services the deduction of such salary from income is properly disallowed.[6] Even where the excess payment to the directors is not in direct proportion to the stockholding of such directors, it is not deductible.[7]

E. S.

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[1] H. L. Trimyer & Co., Inc. v. Noel, Collector, etc., 28 F. 2d 781 (E. D., Va., 1928); Rev. Act. of 1918, Sec. 234 (A) (1), 40 Stat. 1077; Reg. 45, 1920 Edition states: "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact purely payments for services." This is a question of fact to be determined by the evidence in each case. U. S. v. Knitting Mills, 273 Fed. 657 (C. C. A. 3d, 1921); Becker Bros. v. U. S., 7 F. 2d 3 (C. C. A. 2d, 1925).

[2] U. S. v. Knitting Mills; Becker Bros. v. U. S.; all *supra* Note 1; T. D. 2303, Cum. Bull., December 1921, p. 219.

[3] *Supra* Note 2.

[4] U. S. v. Knitting Mills, Becker Bros. v. U. S.; all *supra* Note 1.

[5] Brown v. Commissioner, etc., 22 F. (2d) 797 (C. C. A. 5th, 1927); Brown v. Commissioner, etc., 27 F. (2d) 91 (C. C. A. 3d, 1928).

[6] *Re*: Schaeffler Mercantile Co., 2 B. T. A. 480 (1925); *Re*: De Brown Auto Sales Co., 2 B. T. A. 896 (1925); *Re*: Maxwell Brothers Grocery Co., 2 B. T. A. 980 (1925); *Re*: Wood & Bishop Co., 4 B. T. A. 271 (1926).

[7] *Re*: Gustafson Manufacturing Company, 1 B. T. A. 508 (1925).