

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

January 18, 1984

Horace A. Backus
c/o J. H. Cohn & Co.
400 Park Ave.
New York, NY 10022

Dear Mr. Backus:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 690 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Hill M. Lalin
J. H. Cohn & Company
400 Park Avenue
New York, NY 10022
Taxing Bureau's Representative

STATE TAX COMMISSION

AFFIDAVIT OF MAILING

for Redetermination of Deficiencies or for Refunds :
of Personal Income Tax under Article 22 of the Tax :
Law for the Year 1979. :

State of New York }
County of Albany } ss.:

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 18th day of January, 1984, he served the within notice of Decision by certified mail upon R. Charles Backus, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

R. Charles Backus
c/o J. H. Cohn & Co.
400 Park Ave.
New York, NY 10022

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
18th day of January, 1984.

David Parbuck

Ernest P. Thompson
pursuant to Tax Law section 174

Authorized to administer oaths

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STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petitions :
of :
HORACE A. BACKUS : DECISION
and :
R. CHARLES BACKUS :
for Redetermination of Deficiencies or for :
Refunds of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1979. :

Petitioners, Horace A. Backus and R. Charles Backus, c/o J. H. Cohn & Co., Attn: Hill M. Lalin, 400 Park Avenue, New York, New York 10022, filed petitions for redetermination of deficiencies or for refunds of personal income tax under Article 22 of the Tax Law for the year 1979 (File Nos. 33566 and 33567).

A formal hearing was held before Julius E. Braun, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on June 23, 1982 at 9:15 A.M., with all briefs to be submitted by September 1, 1982. Petitioners appeared by J. H. Cohn & Company, C.P.A.'s (Hill M. Lalin, C.P.A.). The Audit Division appeared by Paul B. Coburn, Esq. (Alexander Weiss, Esq., of counsel).

ISSUE

Whether the Audit Division properly recomputed each petitioner's tax liability, premised upon the assertion that a portion of the amounts paid as compensation by R. Austin Backus, Inc. to each of the individual petitioners was excessive and constituted a constructive dividend.

FINDINGS OF FACT

1. On April 8, 1981, the Audit Division issued notices of deficiency asserting, for 1979, additional personal income tax due from petitioners,

R. Charles Backus and Horace A. Backus, in the amounts of \$1,844.00 and \$1,911.00, respectively, plus interest. A Statement of Personal Income Tax Audit Changes previously issued to each of the individual petitioners on October 15, 1980 provided, in explanation of these deficiencies, as follows:

"[t]he compensation paid to officers is excessive in 1978 and 1979. A reasonable amount of compensation of \$75000 is allowed and the excess is considered constructive dividends due to accruals. No additional tax is due for 1978. Additional tax due in 1979 is in maximum tax computation."

2. R. Austin Backus, Inc. (the "corporation") was incorporated under the laws of New York State on February 5, 1954 and commenced its principal business activity of cattle auctioneering as of the same date. Petitioners, R. Charles Backus and Horace A. Backus (herein individually referred to as "Charles" and "Horace", and collectively referred to as "the brothers"), together with their brother Everett Backus ("Everett") who is not a party to this proceeding, owned in equal amounts all of the outstanding stock of the corporation. Charles was the corporation's president, Everett was its secretary and Horace was its treasurer.

3. Charles and Horace are nationally recognized authorities on the breed of cattle known as Holstein-Fresian and, through the corporation, organized and conducted sales of this breed of cattle. The brothers have been involved with selling cattle since the mid-1940's, becoming involved initially through their father, who had been involved in the business (though not in corporate form) as a cattle sale manager, auctioneer and pedigree man for most of his life.

4. The two types of sales or "shows" conducted are "dispersal" sales and "consignment" sales, which may be described as follows:

a) dispersal sale - involves the sale at auction of a particular cow or herd of cattle for one farmer or breeder. The seller usually contacts

the brothers to arrange and conduct the sale, and the sale is usually conducted at the seller's farm.

b) consignment sale - where the brothers gather a herd or lot of cattle themselves from several sellers and/or breeders, and arrange and conduct a sale of these cattle on behalf of the various owners. They seek high quality cattle with good sale potential and must convince the sellers to sell and arrange for a site for the sale.

5. The brothers became fully involved in the business of organizing and conducting the shows on their own in or about 1953, when their father suffered a stroke. Although their duties overlap to an extent, Charles is most specifically involved in the sales as the auctioneer, while Horace "reads the breeds", a two-step process which involves highlighting each cow's pedigree and attempting to enthuse buyers to bid on the cow by highlighting the benefits to be derived from owning it. In 1954, the brothers conducted a national convention sale (among the largest type of shows in the industry), and have conducted several such sales since 1954. They had the highest average herd dispersal sales in 1979 in the states of New York, Pennsylvania, Ohio, Virginia, Massachusetts, New Jersey and Connecticut, and in 1979 held a special sale at the M.G.M. Hotel in Las Vegas, Nevada, which was one of the largest cattle sales in the history of the industry.

6. Over the years, the brothers have developed a very well-known and favorable reputation in the industry as the result of their performances in arranging and conducting sales. They have handled many of the largest sales nationwide, have been elected as delegates from New York to the national breeders convention, and have developed numerous friendships, business contacts and a vast background of experience in the industry.

7. In organizing and conducting either type of sale, the brothers prepare a catalog of the cattle to be sold, including photos of the cows and a description of their pedigrees. They advertise the sale in breed journals and in local and national agricultural publications, and take care of all the details surrounding the sale. In consignment sales, they also assemble the herd after convincing the owners to sell. In both types of sales they make sure the cattle are properly groomed and cared for and that all local health regulations and interstate transport regulations (where applicable) are met. After the sales, they account for all funds involved, handle collections of funds due, provide for the care and transport of the cattle to their new owners, handle transfer certificates and secure necessary insurance. They also mediate in buyer/seller disputes. The corporation has no investment interest in the cattle sold and acts only as the sales or auction agent.

8. Payment for arranging and conducting auctions is made on a commission (percentage of gross sale) basis. In dispersal sales, the commission amount is paid to the corporation immediately after the sale out of proceeds received on the sale by the seller or breeder. In consignment sales, all monies exchanged between buyers and sellers are held in escrow by the corporation until transfer of the animal(s), with the commission amount deducted by the corporation from the consignor's receipts. Commissions received appear on the corporation's tax reports in gross receipts. In consignment sales, the corporation tries to collect and account for all funds within three weeks, although this is not always possible.

9. Consignment sale commissions range from twelve (12) to fifteen (15) percent and are either set by the national breeder's association or the particular state, or are arrived at after negotiation between the brothers and the consignors.

Dispersal sale commissions are arrived at by negotiation between the brothers and the seller or breeder, and the brothers try to consistently set commissions on such sales at ten (10) percent. Consignment sales merit higher commission rates because the overhead expense of such sales is higher.

10. The corporation's office is located in Mexico, New York, and it employs two persons there on a full-time basis to perform clerical work and to help with the pedigrees and catalogs. Other persons who perform work for the corporation are hired "by the sale" as needed.

11. Expenses of the corporation and compensation of its officers are paid out of the commissions earned. Compensation paid to officers in 1979 totalled \$372,123.00, with \$187,312.00 paid to Horace and \$184,811.00 paid to Charles. No compensation was paid to Everett, nor were any dividends declared or distributed to the corporation's three shareholders in 1979 or in any other year of its existence. Everett attends meetings of the corporation, including those at which officers' compensation is discussed and approved, but he is otherwise uninvolved with the corporation, since it is a business in which he has no personal interest and which, by the nature of its services, would require him to travel away from home extensively. Everett has never questioned his non-receipt of compensation or dividends from the corporation. Everett actively operates the business of a corporation which publishes weekly newspapers in Oswego County, New York. Everett, Charles and Horace are the sole shareholders of the publishing corporation, with the latter two brothers uninvolved with its operation.

12. Compensation paid to the brothers in 1979 totalled approximately four (4) percent of the corporation's total gross sales volume. This amount of compensation (\$372,123.00) also equalled the amount remaining from gross profit

after payment of the corporation's expenses. The brothers assert that they hope to receive about two (2) percent each of gross sales as compensation and feel that such an amount represents just compensation for the services they perform.

13. The amount of officers' compensation for 1979 was finally set at a December, 1979 meeting of the corporation's three shareholders. The brothers are not compensated at regularly specified intervals, but rather "take it as it comes" in lump sums from time to time during the year. They base these amounts taken on about two percent (each) of gross sales at the time, as they "...can pretty much figure out how much it's going to be." Commissions earned on a sale are generally not withdrawn until risks of bad debts on collections and other contingencies are resolved. The brothers note that although they have an idea of how much four percent of gross sales will amount to, it is difficult to predict the risks and outcome of contingencies until the sale and collections are mostly completed. By December, most of these items of income and expense can be ascertained and the final figures, including risks, can be determined with reasonable accuracy. Cash must often be left in the corporation at year's end to cover unresolved contingencies. In 1979, a "great deal" of ultimate officers' compensation was paid out during the year rather than as a year-end lump sum.

14. The brothers devote their full-time attention to the corporation's business. In 1979, Horace spent 159 days and 117 nights and Charles spent 210 days and 139 nights away from home on business.

15. All commissions earned are received and recorded by the corporation, and compensation paid by the corporation to the brothers is reflected on the brothers' personal income tax returns. In addition to such compensation, the

brothers, on occasion, work at a sale individually rather than on behalf of the corporation. The compensation received in such instances is paid directly to the brothers and not to the corporation, appears only on their personal returns and is not included as income received by the corporation.

16. In the case of a major sale, much of the preliminary work may occur in the year or years prior to the sale, and thus income received may fluctuate from year to year. Accordingly, hours worked in a given year may not tie in directly to income earned in that year.

17. The corporation's name and assets (consisting of an old truck, a tent and some public address equipment) were sold subsequent to the year at issue herein for \$30,000.00 to a new corporation, Backus Associates, Inc., formed by three individuals not related to the Backus brothers. The brothers continue to work for the new corporation but only to conduct sales, with no pre-sale or post-sale responsibility for advertising, cataloging, collections, accounting, etc. Horace reads the breeds and Charles acts as auctioneer, with their compensation for only these services set at one (1) percent (each) of the new corporation's gross sales.

18. Compensation paid by the corporation to the brothers during a five-year period for which figures were supplied at the hearing was as follows:

<u>Year</u>	<u>Total Compensation</u>	<u>Paid to Charles</u>	<u>Paid to Horace</u>	<u>Corporation's Gross Sales</u>	<u>Corporation's Gross Profit</u>
1980	\$199,102.00	\$112,401.00	\$ 86,701.00	(not specified)	\$ 484,154.00
1979*	372,123.00	184,111.00	187,312.00	\$10,542,750.00	2,921,339.00
1978	178,645.00	85,823.00	92,822.00	4,749,357.00	1,872,230.00
1977	94,858.00	50,929.00	43,929.00	2,575,450.00	1,450,489.00
1976	145,768.00	72,745.00	73,023.00	(not specified)	1,788,119.00

* The large increase in gross sales in 1979 is attributable to the special sale held at the M.G.M. Hotel in Las Vegas in that year (see Finding of Fact "5").

Four (4) percent of the corporation's gross sales for 1979, 1978 and 1977 equals \$421,710.00, \$189,974.00 and \$103,018.00, respectively.

19. Petitioners assert that the brothers' record of performance, influence in the industry, experience, reputation, contacts and the time spent establishing these were the reasons that their services were in demand. They assert that the compensation paid was based on the brothers' expertise and efforts and was reasonable in light of the services rendered. They note that compensation paid was not only for work at the actual sales, but also reflected pre-sale and post-sale efforts and responsibilities, and further that the brothers devoted all their working time to the corporation's business. They note that the value of the cattle is dictated by the buyers and sellers and that commission rates are either set as standards or, more commonly, are arrived at through negotiations between the sellers or consignors and the brothers. Finally, they note that the brothers withdrew amounts of money from the corporation during the year as the risks of non-payment and other contingencies were reduced, that they hoped for and considered as fair compensation a payment to each brother of approximately two (2) percent of gross sales, and that actual compensation paid in 1977, 1978 and 1979 amounted to slightly less than two (2) percent each (see Finding of Fact "18"). No salary comparison to others in the industry was offered because figures to make such comparison are not available. Petitioners also note no basis has been established to support the \$75,000.00 figure asserted as reasonable compensation by the Audit Division.

20. The Audit Division asserts, by contrast, that cattle selling prices have risen steadily throughout the decade of the 1970's and that such price increases rather than any extra effort or ability put forth by the brothers caused much of the increased revenue received by the corporation. The Audit

Division notes that the corporation has never paid any dividends, and that a pattern has occurred over the years whereby corporate deductions for expenses and officers' compensation have reduced corporate tax liability to zero or to a negligible amount. The Audit Division maintains that compensation is determined with reference only to reducing corporate tax liability to zero, that compensation received by the brothers is subject to the maximum tax "ceiling" on earned income and that a portion of such compensation received is actually dividend income which is not a deductible item to the corporation and would (in the year at issue) be subject to higher personal income tax rates. Finally, the Audit Division asserts that the brothers are not entitled to all of the corporation's earnings (after expenses) as compensation simply because their work was responsible for generating all of such earnings.

CONCLUSIONS OF LAW

A. That section 162 of the Internal Revenue Code permits a deduction for ordinary and necessary business expenses, specifically including "a reasonable allowance for salaries or other compensation for personal services actually rendered". That "...[t]he test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments for services." (Treas. Reg. sec. 1.162-7). Where payments made ostensibly as salaries or compensation are in fact unreasonable in amount (or are made other than in payment for services rendered), all or a portion of such payments may be considered constructive dividends not deductible by the corporation (see generally Treas. Reg. sec. 1.162-7, 8).

B. That the question of reasonableness of salary or compensation paid is a factual one, to be determined upon an examination of all the facts and circumstances presented. No one factor is decisive, and consideration should be

accorded several factors including, but not limited to, the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of the salaries paid with the gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer to all employees; and, in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years. (See generally Mahaska Bottling Co. v. Comm., 21 TCM 1530; Good Chevrolet v. Comm., 36 TCM 1157.) Closely-held corporations are subject to closer scrutiny with respect to salaries and other compensation paid to officer/shareholders (see Good Chevrolet, supra, citing Charles Schneider and Co. v. C.I.R., 500 F.2d 148 (1974)). Finally, the burden of proving that salaries and other compensation paid were reasonable rests with the taxpayer (see Tax Law section 689(e); see also Geiger & Peters, Inc. v. Commissioner, 27 TC 911; Charles McCandless Tile Service v. U.S., 422 F.2d 1336).

C. That all of the income earned by the corporation resulted from the personal services rendered by the brothers. They devoted essentially all of their working time to the corporation's business. The corporation owned few assets, including basically only an old truck, a tent and some public address equipment, and capital was not a material income-producing factor. The significant income-producing factor for the corporation was the experience, reputation, contacts, knowledge and proven abilities of the brothers. The brothers have spent their entire lives working with and learning about Holstein-Fresian cattle and their services as a result were in high demand.

D. That the brothers were hardworking, astute businessmen and the success of the corporation appears due solely to their abilities and effort. The brothers hoped to receive about two percent each of the corporation's gross sales as compensation for their services. In fact, their combined compensation for 1979 totalled slightly less than four percent of gross sales, as was also the case in both 1978 and 1977 (see Finding of Fact "18"). The 1979 total compensation paid was more than double that paid in 1978. However, gross sales more than doubled in 1979 due to the special M.G.M. sale (see Findings of Fact "5" and "18"), which had absorbed a great deal of the brothers' time and energy in the preceeding year.

E. That the salaries paid by the corporation to the brothers were reasonable in light of all the facts and circumstances and were paid entirely for services rendered. Accordingly, said salaries were properly deducted by the corporation and no part thereof constituted a constructive dividend to petitioners.

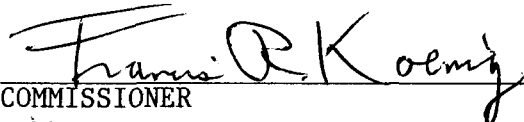
F. That the petitions of Horace A. Backus and R. Charles Backus are granted and the notices of deficiency issued to each of the brothers on April 8, 1981 are cancelled.

DATED: Albany, New York

JAN 18 1984

STATE TAX COMMISSION


PRESIDENT


COMMISSIONER


COMMISSIONER