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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

9
10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **APPLIED COMPANIES¹**) Case No. 526527

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

17 Representing the Parties:

19 For Appellant: Mike Catalano³
20 For Franchise Tax Board: Eric R. Brown, Tax Counsel III

22 **QUESTIONS:** (1) Whether the Franchise Tax Board's (FTB or respondent) proposed assessments,
23 which are based on federal changes, are barred by the statute of limitations.
24 (2) Whether appellant has substantiated its employee compensation deductions for
25

26 ¹ Appellant appears to be headquartered in Los Angeles County, California.

27 ² This appeal was originally scheduled for hearing by the Board at the Culver City meeting on February 2, 2012. Appellant's
28 request for a postponement was granted and the matter was rescheduled to the April 24-26, 2012 oral hearing calendar.

³ Appellant was previously represented by Dennis Brager, Esq.

1 the 1991 and 1993 tax years.

2 HEARING SUMMARY

3 Background

4 Appellant filed timely federal and California returns for the taxable years ending
5 March 31, 1991, and March 31, 1993, reporting a minimum tax due of \$800 for each year. (FTB OB,
6 p 1.) Appellant filed its 1991 California return on December 13, 1991, and its 1993 California return on
7 December 15, 1993. (*Id.*) Later, the Internal Revenue Service (IRS) audited appellant. (*Id.*) During the
8 audit, the IRS disallowed deductions related to officer compensation on the basis that appellant's officer
9 compensation amounts were excessive. (*Id.*) The IRS disallowed \$450,000 of the claimed officer
10 compensation for 1991 and \$600,000 of the claimed officer compensation for 1993. (*Id.*)

11 In April 1998, the IRS issued a Revenue Agent's Report (RAR), wherein the IRS agreed
12 to reduce the previously disallowed officer compensation amounts by \$106,498 for 1991 and \$130,072
13 for 1993. Thus, after the issuance of the RAR, the disallowed officer compensation totaled \$343,502
14 (i.e., \$450,000 - \$106,498) for 1991 and \$469,928 for 1993 (i.e., \$600,000 - \$130,072). (*Id.* pp 1-2.)
15 Appellant did not report the IRS adjustments to the FTB. Later, on June 1, 1998, the FTB received a
16 copy of the RAR from the IRS. (*Id.* p 2.)

17 According to appellant's federal transcripts, the IRS issued assessments for the 1991 and
18 1993 tax years on June 8, 1998. (FTB OB, Exs. F & G.) Specifically, for 1991, appellant's federal
19 transcript shows the IRS issued an additional tax assessment (IRS Transaction Code 300) in the amount
20 of \$22,525 on June 8, 1998, and then simultaneously, on June 8, 1998, the IRS issued a credit
21 (IRS Transaction Code 309) of \$22,525. (*Id.*, Ex F., pp 4-5.) In its opening brief, the FTB states that
22 the credit was issued due to a net operating loss carryback from the 1992 tax year. (*Id.*, p. 4, fn. 6.) For
23 1993, appellant's federal transcript shows the IRS issued an additional tax assessment (IRS Transaction
24 Code 300) in the amount of \$0.00 on June 8, 1998. (*Id.*, Ex G, p 3.) In its opening brief, the FTB states
25 that there was no additional tax assessed at the federal level for the 1993 tax year due to a net operating
26 loss carryforward from the 1992 tax year. (*Id.*, p. 4, fn. 7.)

27 On August 25, 1998, the FTB issued Notices of Proposed Assessments (NPAs) based on
28 the federal changes above by adding \$343,502 to appellant's 1991 California taxable income and

1 \$469,928 to appellant's 1993 California taxable income. (FTB OB, Exs. D & E.) In its opening brief,
2 the FTB states that "due to differences between federal and state law," appellant could not utilize its net
3 operating loss carrybacks/carryforwards for state tax purposes. (*Id.*, p 5.) Appellant did not timely
4 protest the FTB's proposed assessments, and thus, the FTB's proposed assessments became final after
5 the expiration of the 60-day time periods. (*Id.* p 2.)

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

9 **Issue No. 1 Whether the FTB's proposed assessments, which are based on federal changes, are**
10 **barred by the statute of limitations.**

11 Contentions

12 Appellant

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

20 The FTB

21 The FTB notes that appellant cites to Regulation 18586.3 for the definition of a "final
22 determination." (FTB OB., p 4.) The FTB argues, however, that Regulation 18586.3 does not address
23 what constitutes a federal determination or adjustment that necessitates a reporting requirement. (*Id.*
24 p 5.) Specifically, the FTB contends that Regulation 18586.3 is simply the predecessor to Revenue and
25 Taxation Code (R&TC) section 19059 (and the regulation thereunder), which "has to do with the period
26 of limitation for proposing a deficiency assessment following federal changes that are properly reported
27

28 ⁴ The Appeals Division staff (staff) notes that this regulation was renumbered in 1998 and is now Regulation 19059.

1 within the six month period prescribed by section 18622.” (*Id.*)

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 Applicable Law

11 Statute of Limitations

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

15 *Current Law*

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

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

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

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

3 (a), stated:

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

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

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

26 Regulation 19059⁵ contains the following definition of a “final determination”:

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

1 A final determination is an irrevocable determination or adjustment of a taxpayer's
2 federal tax liability from which there exists no further right of appeal either
administrative or judicial.

3 (Cal. Code Regs., tit. 18, § 19059, subd. (e).) Regulation 19059 further provides that a closing
4 agreement is an example of a "final determination." (*Id.*, subd. (e)(1).)

5 STAFF COMMENTS

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

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

18 Appeal Division staff (staff) notes that R&TC section 18622 (both the pre-1999 version
19 and the current version) does not state that additional tax must be due at the federal level before a federal
20 change must be reported to the FTB.⁶ Also, staff notes that a "final determination" is defined in
21 Regulation 19059 as "an irrevocable determination *or* adjustment of a taxpayer's federal tax liability
22 from which there exists no further right of appeal, either administrative or judicial." (Cal. Code Regs.,
23 tit. 18, § 19059, subd. (e) (emphasis supplied).) Thus, a final federal determination does not necessarily
24 have to include an adjustment to a taxpayer's federal tax liability. Accordingly, at the oral hearing,
25 appellant should be prepared to further discuss its contention that final determinations were never issued
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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 because there was no additional tax due at the federal level.

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

7 Pursuant to Regulation 5523.6, appellant may wish to consider providing additional
8 evidence to Board Proceedings at least 14 days prior to the oral hearing.⁷

9 **Issue No. 2 Whether appellant has substantiated its employee compensation deductions for the**
10 **1991 and 1993 tax years.**

11 Contentions

12 Appellant

13 Appellant argues that the FTB's assessments are incorrect and erroneous. (App. Ltr.,
14 p.2.) Specifically, appellant argues that its employee compensation deductions are "fully deductible for
15 the tax years in question" under R&TC section 24343 and "other applicable authority." However,
16 appellant does not otherwise expand on this argument. (*Id.*)

17 The FTB

18 The FTB argues that appellant has failed to demonstrate the FTB erred by disallowing
19 portions of officer compensation for taxable years ending March 31, 1991, and March 31, 1993.
20 (FTB OB., p 6.) Specifically, the FTB states that appellant has provided "no factual or legal argument to
21 support its assertion" that the FTB erred. (*Id.*) Furthermore, the FTB asserts that appellant has the
22 burden of proof and appellant's unsupported assertions are insufficient to carry its burden. (*Id.*, citing
23 the *Appeal of Frank J. and Barbara D. Burgett*, 83-SBE-127, June 21, 1983.)⁸

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27 ⁷ Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of
28 Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

⁸ Board of Equalization cases are generally available for viewing on the Board's website (www.boe.ca.gov).

1 Applicable Law

2 Deductions—Employee Compensation

3 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a
4 deduction has the burden of proving by competent evidence that the he or she is entitled to that
5 deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*,
6 2001-SBE-001, May 31, 2001.) The Board has consistently held that an FTB determination which is
7 based on a final federal determination is presumed to be correct. (*Appeal of Frank J. and Barbara D.*
8 *Burgett, supra.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof.
9 (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

10 R&TC section 24343 incorporates IRC section 162. IRC section 162 provides that
11 deductions shall be allowed for all ordinary and necessary expenses paid or incurred in carrying on a
12 trade or business. Whether employee compensation is reasonable for tax deduction purposes is a
13 question of fact which must be decided on the basis of a review of all the facts in each particular case.
14 (See *Irby Construction Co. v. United States* (Ct. Cl. 1961) 290 F. 2d 824; *Heil Beauty Supplies v.*
15 *Commissioner* (8th Cir. 1952) 199 F. 2d 193; *Appeal of Southland Publishing Co., Inc.*, 64-SBE-010,
16 Jan. 7, 1964.) Factors that various courts have considered relevant to their inquiry as to the
17 reasonableness of compensation include (i) the type and extent of services rendered by the employee,
18 (ii) the prior earning capacity of the employee, (iii) the general economic conditions of the period,
19 (iv) the amounts paid by similar enterprises for services of a like character, and (v) a comparison of
20 shareholder distributions with salary payments made to shareholder-employees. (See *Irby Construction*
21 *Co. v. United States, supra*, at 826.)

22 STAFF COMMENTS

23 As noted above, the IRS disallowed employee compensation deductions totaling
24 \$343,502 for 1991 and \$469,928 for 1993. Based upon those federal changes, the FTB increased
25 appellant's California taxable income by \$343,502 for 1991 and \$469,928 for 1993. At the oral hearing,
26 appellant should be prepared to show that the FTB's assessments (i.e., in disallowing the amounts of
27 officer compensation as being excessive) are erroneous, such that appellant is entitled to a refund of the
28 amounts paid.

1 As indicated above, appellant argues that the compensation amounts are “fully deductible
2 for the tax years in question” under R&TC section 24343 and “other applicable authority.” Appellant,
3 however, did not otherwise expand on this argument in its opening brief. The Board has consistently
4 held that an FTB determination based on a final federal determination is presumed to be correct.
5 (*Appeal of Frank J. and Barbara D. Burgett, supra.*) Furthermore, the Board has held that a taxpayer’s
6 unsupported assertions are insufficient to carry a taxpayer’s burden of proof. (*Appeal of Aaron and
7 Eloise Magidow, supra.*) Accordingly, appellant may wish to consider providing additional evidence to
8 Board Proceedings at least 14 days prior to the oral hearing.

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12 Applied Companies_wjs

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