

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18011260
)
SKU TRADING, INC.) Date Issued: January 29, 2019
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)
_____)

OPINION

Representing the Parties:

For Appellant: Jane Kim, CPA
For FTB: Ciro Immordino, Tax Counsel IV
David Gemmingen, Tax Counsel IV

Office of Tax Appeals: Mai C. Tran, Tax Counsel IV

KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, SKU Trading, Inc. (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing an assessment of \$142,208 in tax, plus applicable interest, for the 2007 tax year. OTA Administrative Law Judges Andrew J. Kwee, Douglas Bramhall, and Linda C. Cheng heard this appeal on October 22, 2018, in Van Nuys, California. At the conclusion of the oral hearing, the record was closed, and this matter was submitted for decision.

ISSUE

Has appellant shown error in FTB’s proposed assessment, which is based on a mandatory conversion from the “cash” to “accrual” method of accounting during the 2007 tax year?

FACTUAL FINDINGS

1. Appellant, a “C corporation” within the meaning of Internal Revenue Code (IRC) section 1361(a)(2) (hereinafter C corporation), was incorporated in California in 2002. Appellant operates as a merchant and wholesaler of apparel under the dba (i.e., trade name) “CO Textile” and “MI Trim.”

2. Appellant filed state and federal tax returns for 2007, each dated May 5, 2008, reporting gross receipts of \$10,138,838. On both returns, appellant reported that it used the cash basis method of accounting to compute taxable income.
3. For the prior tax year, 2006, appellant filed state and federal tax returns, each dated May 5, 2007, reporting gross receipts of \$8,586,018. On both returns, appellant reported that it used the cash basis method of accounting to compute taxable income.
4. Dongeun Shin, CPA, Accountancy Corporation, prepared the 2006 and 2007 tax returns for appellant.
5. Both parties agree that, at least since 2004,¹ appellant has been reporting to FTB that it used the cash basis method of accounting. Appellant reported in this manner by checking the box for “cash” in response to the question asking the taxpayer to report which accounting method was used to compute taxable income.
6. Upon audit, FTB determined that appellant was required to compute its taxable income using the accrual method. Subsequently, on October 30, 2009, FTB issued a Notice of Proposed Assessment (NPA) for \$152,207.18 in additional tax, plus interest, based on a mandatory conversion from the “cash” to “accrual” method of accounting.
7. Appellant timely protested the NPA, contending that it correctly computed its income using the accrual method. In support, appellant alleged that the prior tax returns contained a “check mark error” because appellant’s prior tax preparer had mistakenly checked the wrong box (i.e., the box to report on the cash basis) on all of appellant’s tax returns since 2003.
8. On September 15, 2010, appellant filed an amended tax return for 2007, claiming an Enterprise Zone Credit of \$22,656, which was partially offset by a reported increase to net income of \$32,296. On the amended tax return, appellant again reported that it used the cash basis method of accounting. The return was signed under penalty of perjury by an officer for appellant, and by a different tax preparer from the one who prepared the original return.
9. FTB issued a Notice of Action (NOA) on July 27, 2012, reducing the proposed additional tax from \$152,207.18 to \$142,208, due to an error by FTB. Although appellant only

¹ Appellant contends it checked the “cash” box on all returns filed since 2003. FTB contends that appellant checked the “cash” box on all returns filed with FTB since 2004. Only state and federal returns for 2006 and 2007 are a part of the evidentiary record.

claimed a \$22,656 tax credit, FTB erroneously allowed a credit of \$32,656, which is a \$10,000 difference in appellant's favor.

10. Appellant appealed to OTA's predecessor, the Board of Equalization (board) on August 27, 2012.²

DISCUSSION

For the tax year at issue, absent a statutory exception, the law provides that C corporations shall not compute income under the cash method of accounting. (R&TC, § 24654; Int.Rev. Code, § 448(a)(1).) Statutory exceptions exist for farming businesses, qualified personal service corporations, and small businesses with gross receipts of not more than \$5,000,000 for all taxable years beginning after December 31, 1985. (R&TC, § 24654; Int.Rev. Code, § 448(b).) Additionally, if it is necessary to use an inventory, then the taxpayer generally must use the accrual method. (Int.Rev. Code, § 471; Treas. Reg. § 1.446-1(c)(2)(i); *A & A Tool & Supply Co. v. Commissioner* (1950) 182 F.2d 300, 302.) IRC section 481(a) provides for adjustments to income in the event there is a change in accounting method during the taxable year.

FTB's proposed assessment is presumed correct once FTB shows a reasonable and rational basis for the determination. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)³ Unsupported assertions are not sufficient to satisfy an appellant's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) The failure to produce evidence that is within a party's control gives rise to a presumption that such evidence is unfavorable to the party's case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

Here, appellant reported on its 2007 return that it used the cash basis method of accounting. Nevertheless, both parties agree appellant was required to report under the accrual method because appellant earned more than \$5 million in gross receipts during 2006 and 2007. FTB calculated the adjustments to income that would be required if appellant changed from a

² R&TC section 20 provides that, unless the context requires otherwise, on and after January 1, 2018, the term "board," with respect to an appeal, means OTA.

³ Precedential opinions of the board may be cited as precedential authority to the Office of Tax Appeals unless a panel removes, in whole or in part, the precedential status of the opinion. The board's precedential opinions are viewable on its website: <www.boe.ca.gov/legal/legalopcont.htm>.

cash to accrual accounting method during 2007, and appellant does not dispute the accuracy of these calculations. Therefore, FTB has established a rational and reasonable basis for its proposed assessment, and appellant has the burden of proving its contention that no adjustments to income are warranted because appellant did, in fact, report under the accrual method.

We find that appellant's documentation is insufficient to establish that it was reporting under the accrual method. Appellant's documentation consisted of various versions of accounting reports. For example, appellant submitted three versions of a "general ledger," which are each several pages long and list summaries for various accounts.⁴ Appellant also provided several versions, respectively, of "sales by customer detail," which list or summarize various sales transactions, profit and loss detail sheets, and income statements. These documents are inconclusive for purposes of proving that appellant reported on the accrual basis. These documents could have been generated from appellant's records regardless of whether appellant reported on a cash or accrual basis. Appellant did not draw a connection establishing how the above documents, or the figures contained therein, prove that appellant reported on an accrual basis instead of a cash basis when computing taxable income on its 2007 tax return. Furthermore, appellant provided no original source documentation, such as sales receipts, statements, invoices, or other source documentation, to verify that taxable income as reported on its 2007 tax return was computed using the accrual basis.

Finally, we also consider the fact that after receiving the proposed assessment at issue in this appeal – that is, during the pendency of appellant's protest of FTB's determination that appellant used the cash basis method of accounting to compute taxable income – appellant filed an *amended* 2007 return, signed by both a corporate officer and a different tax preparer, under penalty of perjury, reporting that it used the *cash basis* method of accounting for these purposes. Appellant similarly reported that it used the cash basis on its originally filed 2007 tax return, which was signed by both appellant's president, and its return preparer, a CPA, under penalty of perjury. None of appellant's employees or officers testified at the hearing, and at no point during the appeal has appellant provided a declaration or statement under penalty of perjury stating that it did not use the cash basis, to contradict the statements in its original and amended return for

⁴The documents submitted included internal differences. For example, the account "104 Cash in bank" in the third "general ledger" contains nine entries, including \$159,879.82 in payroll disbursements. The same account in the second general ledger contains 18 entries, including \$0 in payroll disbursements. A number of such internal inconsistencies exist between the various versions of appellant's documentation and are unexplained by appellant.

2007 that it did use the cash basis. In summary, appellant has not provided us with any documentation to which we can look to confirm that appellant did report under the accrual method at the time it filed its original and amended 2007 returns. Therefore, we find that appellant failed to meet its burden of proof in establishing that it reported on the accrual basis, or that FTB’s proposed assessment was otherwise overstated.

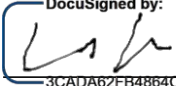
Appellant alternatively contends that we can conclude that it reported on an accrual basis as evidenced by the fact that it reported beginning and ending balances for accounts receivable and accounts payable on its Schedule L of the 2007 and 2006 tax returns, as well as beginning and ending balances for its inventories on Schedule A of the returns. However, both cash basis and accrual basis taxpayers may have account receivables, inventory, and account payables. The fact that this information is reported on Schedule L does not prove that appellant calculated its taxable income on an accrual basis. Therefore, we do not find this argument persuasive.

HOLDING

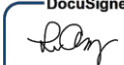
Appellant failed to meet its burden of proof to establish that it reported its taxable income for the 2007 tax year on an accrual basis, or that FTB’s proposed assessment was otherwise in error.

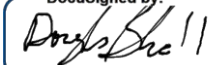
DISPOSITION

FTB’s proposed assessment is sustained.

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Andrew J. Kwee
Administrative Law Judge

We concur:

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Linda C. Cheng
Administrative Law Judge

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Douglas Bramhall
Administrative Law Judge