

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
BAY GAURDIAN COMPANY,) OTA NO. 18063341
)
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 APPELLANT.)
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TRANSCRIPT OF PROCEEDINGS

Sacramento, California

Wednesday, August 26, 2020

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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IN THE MATTER OF THE OF APPEAL,)
BAY GUARDIAN COMPANY,) OTA NO. 18063341
APPELLANT.)
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Transcript of Proceedings, taken at
400 R Street, Sacramento, California, 95811,
commencing at 10:45 a.m. and concluding
at 12:29 p.m. on Wednesday, August 26, 2020,
reported by Ernalyn M. Alonzo, Hearing Reporter,
in and for the State of California.

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APPEARANCES:

Panel Lead: ALJ TOMMY LEUNG

Panel Members: ALJ ALBERTO ROSAS
ALJ CHERYL AKIN

For the Appellant: BRUCE BRUGMANN
JEAN BRUGMANN
JOHN HARPER

For the Respondent: STATE OF CALIFORNIA
FRANCHISE TAX BOARD

D'ARCY DEWEY
BRADLEY KRAGEL

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-8 were received at page 7.)
(Department's Exhibits A-W were received at page 7.)

P R E S E N T A T I O N

	<u>PAGE</u>
By Mr. Harper	10
By Ms. Dewey	35

<u>APPELLANT'S WITNESSES TESTIMONY:</u>	<u>PAGE</u>
Sandra Lang	13

CLOSING STATEMENT

	<u>PAGE</u>
By Mr. Harper	52

1 Sacramento, California; Wednesday, August 26, 2020

2 10:45 a.m.

3

4 JUDGE LEUNG: Ms. Alonzo, we are ready to start
5 the record on OTA Hearing Number 18063341, Appeal of Bay
6 Guardian Company, taxable year 2012 or taxable year ending
7 April 30th of 2013.

8 It is approximately 10:45 a.m. in Sacramento. We
9 are conducting this hearing electronically. We have
10 parties online, parties on the phone, parties on audio
11 only, with Judges Akin and Rosas. I'm Judge Leung. We
12 will be making the decision on this case. We'll make this
13 decision as equal partners and equal participants.

14 For purposes of record, may I please have the
15 parties introduce themselves, starting with you,
16 Mr. Harper.

17 MR. HARPER: John Harper. I'm the CPA for the
18 Bay Guardian.

19 JUDGE LEUNG: Thank you, sir.

20 For the Franchise Tax Board.

21 MS. DEWEY: D'Arcy Dewey, I'm attorney for
22 respondent, Franchise Tax Board.

23 JUDGE LEUNG: Okay. Mr. Harper, will you,
24 Ms. Lang, Jean Brugmann, and Bruce Brugmann, please raise
25 your right hands.

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SANDRA LANG,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

JEAN BRUGMANN,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

BRUCE BRUGMANN,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

JUDGE LEUNG: Okay. Thank you.

Okay. Some things we need to get entered into the record. Enter into the record today the prehearing conference minutes for August 5th and July 2nd of 2020. Enter into the record the joint issue statements and joint facts statement, and the issue statement will be amended. It will be issues of whether the \$1,925,599 in deductions taken by Bay Guardian Company on the tax return for taxable years ended April 20 of 2013, was properly denied by Franchise Tax Board.

1 The deductions were taken by Bay Guardian either
2 as a bad debt or part of an NOL carry over or one of two
3 other statutory possibilities, either Sections 186 of
4 Internal Revenue Code or Section 24678 of Revenue and
5 Taxation Code.

6 Exhibits, Franchise Tax Board's Exhibits A
7 through W are admitted into the record.

8 (Department's Exhibits A-W were received in
9 in evidence by the administrative Law Judge.)

10 Bay Guardian Company's Exhibits 1 through 8 are
11 admitted into the record and admitted into evidence.

12 (Appellant's Exhibits 1-8 were received
13 in evidence by the Administrative Law Judge.)

14 As far as Franchise Tax Board's objections to the
15 cover letter, Ms. Dewey, what would you like to say about
16 that?

17 MS. DEWEY: As we stated in our -- we object to
18 the cover letter as an improper additional briefing under
19 OTA Regulation 30304. The additional briefing was not
20 requested in writing, was not served on FTB, and does not
21 state any facts, arguments, or other grounds for good
22 cause for the additional briefing.

23 JUDGE LEUNG: Mr. Harper?

24 MR. HARPER: I'm sorry. I couldn't understand
25 anything she said.

1 JUDGE LEUNG: Okay. Thank you. Ms. Dewey, I
2 think you need to get a little bit closer to the mic and
3 repeat your objections.

4 MS. DEWEY: Okay. So as stated in our grounds in
5 our memo of August 12th, the improper additional briefing
6 under OTA Regulation 30304, the additional briefing was
7 not requested in writing, was not served on the FTB, and
8 does not state new facts, argument, or other grounds for
9 good cause for additional briefing.

10 JUDGE LEUNG: Thank you.

11 Mr. Harper, did you get that?

12 MR. HARPER: Yes.

13 JUDGE LEUNG: And your response to that.

14 MR. HARPER: Well, it's without merit. When we
15 first talked, I asked you what information you had. You
16 know, we've given the Franchise Tax Board massive amounts
17 of documents. I did not know what the Court had. And you
18 told me basically you had nothing. And then you gave me
19 until August 5th to supply the Court with information. We
20 had not submitted a brief before that. This is -- or any
21 exhibits before that. You actually, specifically, told me
22 our exhibits would be numbered. FTB's exhibits are
23 alphabetical.

24 This is our original briefing based on your
25 instructions and, basically, you told me, "Give us what

1 you want in the file." That's what we've done.
2 There's -- you know, what doesn't she like? I mean, I --
3 we tried to do everything you told us to do, and we did
4 it, you know, we did it well before August 5th. It was
5 mailed by certified mail. We followed up with the OTA to
6 make sure they got it. And then we actually even e-mailed
7 it to the OTA to make sure you had it twice.

8 And then I was told by Susana in your office that
9 they would forward the e-mail to the Franchise Tax Board,
10 and they got it well before August 5th. So, you know,
11 again, we tried to do everything you told us we had time
12 to do, and we did it well before August 5th.

13 JUDGE LEUNG: Thank you.

14 Okay. What I'm going to do is we're going to
15 admit into the record, into evidence your Exhibits 1
16 through 8. As far as the cover letter is concerned, I so
17 understand what you did, Mr. Harper. We did not ask for
18 further briefing but, you know, I've worked in private
19 practice before also and it's very unusual for just to
20 slap together some exhibits and send it off. You have to
21 have some cover letter explaining things. So I get what
22 you did.

23 It is a bit lengthy for a cover letter. But
24 basically what you said in the cover letter is you're
25 basically summarizing your exhibits, which is, you know,

1 to me there's no harm no foul. What I can do is that
2 we'll get -- we'll look at it as correspondence as part of
3 the file, and we'll get it into the case that way. And
4 we'll put the exhibits as Exhibits 1 through 8.

5 And Franchise Tax Board, there's nothing in the
6 cover letter that does not appear either in their exhibits
7 or on your exhibits. So they're part of the record. So
8 I'm going to say if you really want a ruling, the
9 objection is overruled. The exhibits come in. The cover
10 letter is part correspondence, and its parts of file.
11 That will be my final ruling on this.

12 And with that, I think we are ready to start.
13 Both parties -- each party has 45 minutes for their
14 presentations.

15 Mr. Harper, you may begin at your convenience.
16 Thank you.

17

18 PRESENTATION

19 MR. HARPER: Okay. I would like to thank the
20 Court for giving us the opportunity to plead our case. We
21 are not lawyers, so we're apologizing in advance from any
22 deviations from normal protocol. Any errors in procedures
23 are due to our lack of experience and not due for lack of
24 respect for the Court. Please feel free to stop me or ask
25 questions at any point in time during my statement.

1 We're here on behalf of the Bay Guardian, a free
2 weekly alternative newspaper circulated in the San
3 Francisco Bay area since 1966. Note, it's a free paper
4 with its only source of income coming from advertising.
5 They were victims of a predatory pricing -- of predatory
6 pricing by a competitor and a future lawsuit followed.

7 The company was forced to reduce its practices
8 below cost to compete. The company was advised by its
9 attorneys to track this reduction by reporting revenue at
10 its regular price. This reduction would constitute
11 damages. The business was ultimately sold, and the
12 accounting records were deleted by the new ownership.
13 This has led to the challenges in substantiating the bad
14 debt.

15 We hope that common sense, review of the
16 financial statements, and the testimony of the controller
17 will convince the Court the validity of these amounts.
18 Now, before we go any further, again, I just want to note
19 that the IRS has never audited or had any questions with
20 the exact same numbers and the exact same tax returns and
21 the exact same years.

22 We also want to point -- bring to your attention
23 how we got here. The case dates back to 2014, and had
24 been transferred to the New York City Appeals Office of
25 the Franchise Tax Board. The result of the New York

1 hearing was never revealed, and the case was transferred
2 back to Sacramento. We wonder why the FTB would go to the
3 trouble to transfer a case from Sacramento to New York,
4 hear the appeal by two FTB appeal officers, exchange
5 correspondence, and then transfer the case back to
6 Sacramento without issuing a report.

7 We speculate the two appeals officers could not
8 agree, which means one of them agreed with our position.
9 Or secondly, someone higher up in the Franchise Tax Board
10 disagreed with their conclusion. The Bay Guardian has
11 admittedly followed poor accounting practices by
12 overstating revenue to calculate damages in a lawsuit.
13 Basically, the FTB wants the company to pay tax on income
14 it never received. It's as simple as that. It's as basic
15 as that. They want us to pay tax on money, cash that was
16 never received. Okay.

17 Beginning in 2004, Bay Guardian discovered its
18 main competitor, The San Francisco Weekly, had been
19 selling advertising space in its newspaper at a price that
20 was below the cost to produce the advertisement. The San
21 Francisco Weekly started this practice with the sole
22 purpose of driving the Bay Guardian out of business. This
23 practice is known as predatory pricing and is in violation
24 of the California Unfair Practices Act.

25 In order to prove the illegal acts of the San

1 Francisco Weekly and substantiate the amount of the
2 damages, the Bay Guardian was advised by its legal counsel
3 to account for revenue as follows.

4 You want to put a picture up on the screen for
5 everybody. We're trying to put -- it worked in practice.

6 Okay. This is just an example of an add using
7 \$100. So you record revenue at the regular rates, which
8 is \$100. You bill the customer at the lower rate, which
9 is the rate that the San Francisco Weekly was charging,
10 which was \$80. But then \$80 of accounts receivable and
11 then an additional accounts receivable for unbilled
12 discount, \$20. So we're reporting \$100 of revenue. We're
13 only billing for only \$80 of revenue.

14 The customer then pays it. We get \$80. We
15 remove \$80 from accounts receivable. The remaining \$20
16 stays in accounts receivable. This was in effect due to
17 the damages -- how we were recording the damages from the
18 predatory pricing practice.

19 We asked Sandra Lang who was the controller of
20 the Bay Guardian and is our Exhibit 1, you know, we just
21 wanted Sandy to look at it and confirm it because she was
22 involved.

23 So Sandy, would you mind just introducing
24 yourself and stating your role.

25 MS. LANG: Yeah. Good morning all, Judges, Your

1 Honors. My name is Sandra Lang. I was the controller for
2 the Bay Guardian during this period. And as John pointed
3 out, in preparing for the lawsuit was -- was adamant that
4 we needed somehow to prove that the Weekly or New Times
5 were selling below cost. Our lead attorney in preparing
6 for the lawsuit was -- was adamant we needed to somehow
7 prove the weekly or new times was selling below cost, and
8 additionally we needed to prove what our monetary damages
9 were.

10 So we came up with this way to account for sale.
11 So the -- as John pointed out, we'd sell the regular price
12 for the add was 100 bucks. We'd submit a bill to the
13 advertiser for \$80 based on the weekly cost -- or the
14 price of the weekly add which was proven either by a
15 contract or a bill from them or something. And then we
16 had a \$20 discount that we put in other accounts
17 receivable.

18 And it was -- it was basically to be able to go
19 into court. And when the Court asked us to prove your
20 damages or where are your damages, we could point to that
21 line on the balance sheet and say those were our monetary
22 balance -- damages.

23 MR. HARPER: Thank you, Sandy.

24 Sandy has written a very detailed --

25 JUDGE LEUNG: Mr. Harper. Mr. Harper, just one

1 minute.

2 Ms. Lang, is that the extent of your testimony?

3 MS. LANG: Unless you have questions, yes, sir.

4 JUDGE LEUNG: We might. Mr. Harper, hold on
5 before you continue.

6 Let me ask the Franchise Tax Board, do you have
7 any questions for Ms. Lang?

8 MR. KRAGEL: Judges, this is Brad Kragel with the
9 Franchise Tax Board. You know, I have just one question.

10 Ms. Lang, can you hear me?

11 MS. LANG: Yes, sir.

12 MR. KRAGEL: Can you confirm that the company no
13 longer has any records that would show the details of
14 these transactions as you describe them.

15 MS. LANG: That's correct, sir.

16 MR. KRAGEL: And can you just confirm for me what
17 happened to those records and the timeline on that.

18 MS. LANG: The San Francisco Bay Guardian was
19 sold to San Francisco New Print, to the ownership of the
20 Examiner, in 2014, I think. And we transferred all
21 records, all electronics, everything over to the Examiner
22 group and during -- at one point, they wiped the servers
23 clean. I'm not sure on who's authorization or why but
24 the -- I was not notified nor anybody else with the
25 Guardian -- former Guardian at that point, was notified.

1 So that's what happened.

2 MR. KRAGEL: Okay. Well, thank you for your
3 time.

4 No further, questions, Judges.

5 JUDGE LEUNG: Thank you, Franchise Tax Board.

6 Judge Akin, do you have any questions for
7 Ms. Lang?

8 JUDGE AKIN: Judge Akin speaking here. Yes, I do
9 have one question.

10 So Ms. Lang, can you explain to me when the
11 practice of reporting those discounts as accounts
12 receivable began and when it ended?

13 MS. LANG: Yeah. It began before we actually
14 filed the suit in 2004. Because we, you know, we were
15 discussing preparatory -- how to prove our or the points
16 of our lawsuits. So it began around 2003, and it
17 basically ended when the sale of the guardian came
18 through. Because once we started and both sides -- both
19 papers survived the lawsuit, but we never got our prices
20 back to where they should have been. Because once the
21 client was paying 80 bucks for a \$100 add, you know, we
22 just didn't go back to them and say, okay, case closed.
23 You have to pay more now.

24 JUDGE AKIN: Okay. Thank you, Ms. Lang.

25 Judge Akin speaking.

1 JUDGE LEUNG: Thank you, Judge Akin.

2 Judge Rosas, do you have any questions for the
3 witness?

4 JUDGE ROSAS: Good morning. This is Judge Rosas.
5 I just have an administrative procedural question. I just
6 want to confirm whether the witness was sworn in.

7 MS. LANG: Yeah. I -- I affirmed to tell the
8 truth and nothing but the truth.

9 JUDGE ROSAS: Okay. Thank you. That's the
10 extent of my questions.

11 JUDGE LEUNG: Ms. Lang, this is Judge Leung.
12 Now, I understand that your civil lawsuit attorneys
13 advised you to somehow provide some sort of mechanism to
14 create a record for these discounts in lost revenue. Did
15 they advise you as to how to file the tax returns too?

16 MS. LANG: No, sir.

17 JUDGE LEUNG: So that was no?

18 MS. LANG: That's correct. No, sir. They --
19 they did not advise on the tax return.

20 JUDGE LEUNG: So up until the time when you
21 started keeping track of the discounts, how -- how did you
22 report revenues from advertising?

23 MS. LANG: We reported them as accounts
24 receivable. And when they advertiser paid, we converted
25 from accounts receivable to cash.

1 JUDGE LEUNG: Was that the same method when you
2 were providing discounts, like, say, \$100, \$80 example?

3 MS. LANG: Yes, sir.

4 JUDGE LEUNG: So you reported the receivable as
5 100 bucks and -- even though you only knew you were going
6 to collect \$80.

7 MS. LANG: Well, I mean to the extent that --
8 yeah. Right then the advertiser was only going to pay us
9 \$80 or leave us to take the \$80 add from the Weekly. So
10 we wanted to keep the advertiser, you know, and -- that --
11 that's all.

12 JUDGE LEUNG: Well, isn't unusual to overreport
13 income like that? I mean, you'll be paying tax on revenue
14 that you'll never receive from the advertiser.

15 MS. LANG: Again, I didn't know if the court was
16 going to order to pay us up. I mean, we -- you know, we
17 didn't know if the advertiser would eventually say, well
18 yeah, I guess I got an illegal discount here. I mean, but
19 paramount was proving that the behavior happening so that
20 when we went to the jury -- we went to the trial that we
21 could say, this is what they were doing; and secondarily,
22 proving the amount of our monetary damages.

23 And yes, we overpaid taxes. It was killing me
24 because we were not -- certainly not in any shape to spend
25 extra money. But we felt, the lawyers felt, and I felt,

1 and we all felt that we had to prove the monetary damages.
2 We had to prove somehow bring that to the forefront.

3 JUDGE LEUNG: Okay. Thank you, Ms. Lang. Thank
4 you for testifying today.

5 Mr. Harper, you may continue. Thank you.

6 MR. HARPER: All I want to mention is, you know,
7 Sandy has written a very lengthy and detailed memo which
8 is our Exhibit 1. And, you know, I encourage you to read
9 that. Again, I apologize. I can't tell you what to do
10 but, again, it's our Exhibit 1.

11 And thank you Sandy.

12 One thing that, you know, that's totally unusual
13 is over reporting income and paying taxes. But the Bay
14 Guardian, you know, I know Sandy mentioned her paying
15 taxes but, again, we're over reporting income. But the
16 Bay Guardian was losing so much money at that point, you
17 know, we -- you know, in these years we have a huge net
18 operating loss carry forward going back to 2003.

19 So, you know, even though we were over reporting
20 income, it never put us in a taxable situation. So that's
21 just a clarification, but we were definitely over
22 reporting income. And again like I say, Exhibit 1 is a
23 memo that Sandy put together for us.

24 So thank you.

25 Okay. Continuing. The company knew from the

1 beginning that these accounts receivable were made up of
2 unbilled discounts -- the accounts receivable were made up
3 of unbilled discounts would never be collected from the
4 actual customers. The collection, if any, would have to
5 come from a successful lawsuit against the San Francisco
6 Weekly. This finally happened in 2008 when the Bay
7 Guardian prevailed in its lawsuit with the Weekly.

8 However, due to an appeal by the San Francisco
9 Weekly in which the original judgment was affirmed, the
10 actual settlement did not occur until 2013 with a
11 settlement of \$2.7 million. This was paid to the lead
12 attorney's trust account and distributed first to attorney
13 fees of 1.8 million with the balance \$875,000 paid to the
14 Bay Guardian. This amount, along with other closing
15 activity, is reported on the Bay Guardian tax return as
16 other income.

17 We have a schedule here. It's Form 100, page 3,
18 line 10. It's Respondent's Exhibit A, page 3. You'll see
19 line 10 is \$1,670,000. And then we'll show you on
20 statement two, the bottom-line settlement of net fees
21 \$875,000. That's the net settlement after attorney fees.

22 We'd also like to point out that we have this
23 relief of debt item. I mean, that was a credit which was
24 unpaid, and that becomes income. I'd like to mention
25 also, you know, this -- you know the Franchise has a real

1 problem when we write-off an asset and take an expense.
2 They have no problem when we write-off a liability and
3 report it as income. During the course of the audit, they
4 didn't spend one second asking about this relief of debt
5 income. So just to highlight.

6 All right. Continuing. The company has already
7 recognized income of \$1.9 million by reporting the lawsuit
8 settlement as income. The company has reported income of
9 \$2.8 million. That's the \$875,00 they got and the
10 previously recorded \$1.9 million, which was the unbilled
11 accounts receivable. But the only cash they received was
12 \$875,000.

13 To remedy the over reporting of income and remove
14 the accounts receivable from the balance sheet, the
15 company took a bad debt deduction of \$1.9 million. By
16 doing so, the company ended up correctly reporting income
17 on the actual cash received of \$875,000. The FTB position
18 has the company reporting income in the amount of
19 \$2.8 million, even though only \$875,000 was received.

20 The position of the FTB has a dissolved
21 corporation ending up with a balance sheet asset of \$1.9
22 million which, is worthless and uncollectible. The
23 dissolved corporation's balance should basically be zero
24 assets and zero liabilities and equity. The FTB insist on
25 only doing one side of the accounting entry.

1 I have asked the FTB at every step of the way --
2 the field audit, the appeals off -- to look at both sides
3 of the accounting entry. The debits and credits have to
4 balance. The issue has been completely ignored. They
5 refuse to acknowledge that the debits and credits have to
6 balance.

7 The reporting of income and the related accounts
8 receivable was done on the advice of the Bay Guardian's
9 attorneys to document damage due to predatory pricing.
10 The company knew from the start of this practice, that
11 they would never collect from their customers. If they
12 ever collected it, it would be from the San Francisco
13 Weekly and only through a lawsuit.

14 Based on this fact, the company should not have
15 been reporting unbilled discounts as income and effect
16 over stating income. I call your attention to the
17 Respondent's Brief, page 14, which discusses generally
18 accepted accounting principles. And I agree completely
19 with the Respondent's conclusion that the income is not
20 accruable. The Bay Guardian should never have recorded as
21 income the total non-discounted advertising revenue.

22 However, the Respondent does not follow through
23 with what this means; that the company never recorded the
24 revenue and accounts receivable; the income would be
25 reduced by the accrued income; and the operating carry

1 forward increased the reduced income. And you not only
2 have a net operating loss, your net operating loss carry
3 forwards increase. Basically, over-stated income of
4 \$1.9 million, which means we've understated our net
5 operating loss carry forward by \$1.9 million. Had we not
6 over reported the income, our net operating loss carry
7 forward would be \$1.9 million higher.

8 The whole point of putting a balance sheet in the
9 corporate return is to prevent taxpayers from doing
10 exactly what the FTB is trying to do. The FTB is
11 crediting expenses which raises income with no
12 corresponding debit. They would end up creating a balance
13 sheet that's out of balance. I call your attention to
14 Respondent's Brief page 11, first paragraph.

15 Respondent notes that as displayed in Table 1
16 above -- we'll show you Table 1 -- the net income amount
17 reported on the income statement for tax years '06
18 through '11 are not consistent with the net reported
19 income reported on Schedule N, one of Appellant's
20 corporate tax return. This disparity in reporting calls
21 the creditability of the income statements into question.
22 I just want to emphasis that statement.

23 This disparity in reporting calls the credibility
24 of the income statements into question. This worksheet is
25 prepared from financial statements that the client -- that

1 Bay Guardian submitted before we make our journal entries.
2 We get raw information. We make journal entries, and then
3 we send those journal entries to the client, and they book
4 the income.

5 For each return, our journal entries are done
6 before we prepare the tax return. We've always reconciled
7 book income to tax income. We've always reconciled retain
8 earnings to the balance sheet. The financial statements
9 that we receive, which are part of Respondent's Brief,
10 Exhibit B, are prior to adjusting entries with tax
11 adjustments noted in pencil.

12 The only adjustment each year is for
13 depreciation. And we do not ask the client to redo their
14 financial statements after recording our journal entries.
15 They post these journal entries that we make before they
16 close the books for the year. Table 1, which is -- it
17 points everything, you know, disparage our work. Table 1
18 is Respondent's Brief, page 7, is completely wrong and
19 cast a very disparaging light over the validity over the
20 Bay Guardian financial statements. They go to great
21 lengths to prove that our book income and tax return
22 income does not reconcile.

23 With very little effort, the FTB could have been
24 able to figure out that each year was off by our
25 depreciation adjusting entry. For example, year-end

1 4/30/07, the difference is \$80,117, which is the adjusting
2 entry we made for depreciation. You can see Respondent's
3 Brief, Exhibit G, page 2, line 20. And that's exactly
4 what's on that line. Page 2, line 20, is depreciation
5 expense of \$80,117. The most disturbing item in Table 1
6 is year-end 4/30/2000 -- 2009. Excuse me. And that's
7 highlighted.

8 This shows income of \$276,000 and a difference of
9 \$600,000. If you look at the financial statements, which
10 is Respondent's Exhibit B, page 24, we have a book loss of
11 \$280,000. So they're showing income of -- again, it's
12 highlighted in green. It's profit loss, you know. Excuse
13 me. They're showing income of \$276,000, and we actually
14 have a loss of \$280,000. That's a difference of \$557,000.

15 I do not understand how anyone doing an audit
16 could write down a variance that large and not question at
17 all as to what was going on. It's kind of like, does
18 anybody review this work. So the FTB has called into
19 questionable -- into question the credibility of the
20 income statement. We would certainly question -- would
21 certainly question the credibility of the FTB audit staff.
22 This is very, very poor work.

23 My next section is on this 186 issue. So I'm not
24 sure if we're supposed to pursue that now, or we're going
25 to talk about this California Section 24678.

1 JUDGE LEUNG: Mr. Harper, you can talk about both
2 right now.

3 MR. HARPER: Okay. The IRC Section 186 relates
4 to allowance of deduction of compensatory amount which is
5 included in gross income is received or accrued during the
6 taxable year for compensatory injury. Section 186(b) (3)
7 states, "Injury sustained in business or the property by
8 reason of any conducts forbidden in the antitrust laws for
9 which a civil action may be brought."

10 We believe the IRC Section 186 (b) (3) clearly
11 relates to our factual situation. We would like to call
12 your attention to the Respondent's Brief, page 16,
13 paragraph 3, I'm quoting this. "The judgment against New
14 Times was awarded for unfair competition in violation of
15 California Business and Professions Code Section 17043,
16 which is not antitrust statute. It included actual damage
17 for loss profits and credible damages. The facts giving
18 rise to this suit, namely New Times' unfair pricing
19 tactics to increase its market share." That's the end of
20 the quote.

21 I think the Respondent is acknowledging that
22 Section 186(b) (3) applies. We would like to call your
23 attention -- now this is a jury sheet, the sum -- the
24 verdict sheet. We've highlighted Item 3 where the jury
25 found by a vote of 11 to 1 that the intent of selling

1 advertising below cost was to injure competitor or destroy
2 competition.

3 I'd like to point out Item 4. By a vote of 11 to
4 1, they found that selling advertising below cost caused
5 harm to the plaintiff. Next, you could see -- next would
6 be Item 7 and 10 where the jury by a vote of 10 to 2 and
7 11 to 1, respectively, found that the intent was to injure
8 a competitor or destroy competition. Okay.

9 So we -- our position, you know, we believe we
10 know taxpayer has overstated income. And to remedy this
11 over statement, we took a bad debt deduction. And we
12 should be allowed -- an alternative to the bad debt
13 deduction is we've overstated income, which means our net
14 operating loss carry forward is understated.

15 So it's the bad debt or the net operating loss.
16 It's one or the other. And it has, you know -- well, and
17 then in addition to that, we think we've overstated income
18 to the extent of the damages, the \$875,000 which -- which
19 that was pointed out. I never even -- I completely missed
20 that issue. Everybody in the Franchise Tax Board missed
21 that issue, and it was only, you know, a memo from Claudia
22 Lopez of your office that pointed that out to me. So --
23 and everybody else.

24 We believe our position is absolutely correct and
25 this has been substantiated by independent testimony from

1 Sandra Lang the results of our very successful -- very
2 successful lawsuit for attorneys -- but successful
3 lawsuit, the proper use of double entry accounting --
4 which, again, the Franchise Tax Board refuses to do or
5 acknowledge -- and the fact that this issue has never been
6 rose -- questioned by the IRS.

7 I'd be happy to answer any questions, but that's
8 kind of where we're at. Thank you.

9 JUDGE LEUNG: Does the Franchise Tax Board have
10 any questions for Mr. Harper?

11 MR. KRAGEL: Just a couple of questions, Judges
12 and Mr. Harper. Can you hear me okay, Mr. Harper?

13 MR. HARPER: Yes.

14 MR. KRAGEL: You would agree that the records or
15 the source records showing the discounts, you were
16 unable -- or your client was unable to prove -- or produce
17 that, correct, because they were destroyed?

18 MR. HARPER: That's true. In your exhibit, it's
19 Exhibit W, there's -- there's basically three of these
20 source records for bad debt. Now these, you know, these
21 were paper copies that were used in the lawsuit. And
22 that's why these still exist. But not all of them. The
23 Bay Guardian, they actually used a separate accounting
24 system, and it was tracked in a separate account.

25 They used the software -- a specific newspaper

1 software program called Smart Publishers, and this program
2 tracked sales. But again, when all these records were
3 turned over to -- when the business was sold, you know,
4 the accounting records were deleted. So no, we fully
5 acknowledge we do not have a list that builds up to
6 \$1.9 million. We've said that from the very beginning.

7 MR. KRAGEL: Thank you. And just one other
8 question. When did you find out that your client was
9 reporting the discount amount at accounts receivable?

10 MR. HARPER: Okay. Well first off, I found out
11 at the end. I would have told them not to do it. So
12 again, you know, I found out when the lawsuit was settled,
13 and they received the money. You know, I was not involved
14 in that decision as to how to report it.

15 MR. KRAGEL: Thank you, Mr. Harper. No further
16 questions.

17 JUDGE LEUNG: This is Judge Leung. Thank you,
18 Mr. Kragel.

19 Judge Akin, do you have any questions for
20 Mr. Harper?

21 JUDGE AKIN: Judge Akin speaking. No questions
22 at this time.

23 JUDGE LEUNG: Judge Rosas?

24 JUDGE ROSAS: This is Judge Rosas. I do not have
25 any questions. Thank you.

1 JUDGE LEUNG: Mr. Harper, this is Judge Leung. I
2 have a couple of questions for you. Where to begin?
3 Okay. There's a January 2018 letter from you to the
4 Franchise Tax Board. I believe that's Exhibit T, as in
5 Tommy. And it talks about, you know financial statements.
6 It also mentions that in 2008, Bay Guardian transferred
7 about one-and-a-half-million dollars from their accounts
8 receivable account to other assets. What was going on
9 there? What was that all about?

10 MR. HARPER: Sandy, you're still on the phone,
11 aren't you?

12 MS. LANG: Yes, sir.

13 MR. HARPER: Because again, this is where --
14 remember for the longest time everything was included as a
15 one-line item in accounts receivable. And then you
16 started separately stating the unbilled discounts as a
17 separate line item.

18 Judge Leung, would it be okay if Sandy responded
19 to that because I think it was done just to, you know,
20 reclassify. So, you know, a user of the financial
21 statements would be able to see what was actual -- what we
22 thought collectible receivables versus what was the
23 unbilled receivables. So that --

24 JUDGE LEUNG: Okay. This is Judge Leung. It's
25 Okay, Ms. Lang. You're just reminded that you're still

1 under oath. So go ahead. Thank you.

2 MS. LANG: Yeah, I'm still under oath. And,
3 yeah, basically we were in -- as we approached the trial,
4 we decided, again, to -- to highlight that amount as -- as
5 different accounts receivable. Accounts receivable that
6 we were not expecting to actually receive one.

7 JUDGE LEUNG: Okay. This is Judge Leung again.
8 Okay. So this question is going to be for you,
9 Mr. Harper, if, not, then to Ms. Lang. We noticed that
10 following the lawsuit and the -- the collection action and
11 the settlement of the collection action, the lawsuit
12 was -- you won about \$16 million in damages. And after,
13 you had to fight the bank to get the money. You finally
14 came down to about six-and-a-half-million dollars in
15 damages. We noticed the first installment payment
16 happened sometime in December 2010, about \$3.75 million.

17 So my question to you, Mr. Harper, why wasn't the
18 bad debt on that operating loss used for the year ending
19 April 30th of 2011 return to -- to, you know, report that
20 over reporting of income in that year, as opposed to
21 the -- the term for the taxable year ending April 30 of
22 2013?

23 MR. HARPER: Can I grab that return?

24 JUDGE LEUNG: Absolutely. And one of, you know,
25 the basic things is that my question is -- is that first

1 of all, you wouldn't have had lost the or had the
2 underlining records destroyed by your buyers of Bay
3 Guardian back in 2010 or 2011. And clearly you would have
4 been able to, you know, book that or reverse those entries
5 a lot earlier and given you the NOLs, you know, on a 2010
6 return opposed to 2012 return.

7 MR. HARPER: Okay. I'm going to grab the file
8 okay. It's not far. And it's your 4/30/10 or 4/30/11?
9 I'll grab them both.

10 JUDGE LEUNG: This is Judge Leung. So I believe
11 the first installment was paid out around Christmas time
12 in 2010. So it would be the tax year ending April 30th of
13 2011.

14 MR. HARPER: On that tax return, we -- we showed
15 we have revenue of \$7,273,000. We reported as returns and
16 allowance or bad debts \$1,037,000. So on that return we
17 basically wrote off \$1,037,000 of bad debts. And we had
18 \$2,571,000 of legal fees. I know you didn't ask that.

19 JUDGE LEUNG: Correct. I didn't ask that yet.
20 But sticking with the \$1,037,000 in bad debt you wrote
21 off, is any part of that part of \$1,925,599 that you are
22 asking to deduct for the 2012 tax year?

23 MR. HARPER: Well, no. It wouldn't -- it
24 wouldn't be. I mean, I'd have to ask -- you know, we'd
25 have to go back and ask Sandy. This came from, you know,

1 the records we were given. All right. Let's see. You
2 know, again, we'd have to go back to the source records.
3 I don't have an answer. The information prepared shows
4 bad debts of \$1,037,000. Sandy I'm sure you don't recall
5 any -- anything about what that is going back, you know,
6 nine years.

7 MS. LANG: I barely recall 2014.

8 MR. HARPER: Yeah.

9 MS. LANG: I mean, I barely recall 2019 at this
10 point. But I'm fairly certain that when we started
11 getting money from the new times after expenses, we
12 recorded it as revenue but took a bad debt deduction
13 because of all the damages we had.

14 MR. HARPER: To answer your question, you know,
15 in total we've taken bad debts of \$1,037,000 plus
16 \$1,900,000, so close to \$3 million of bad debts. And
17 we've reported revenue of that amount.

18 JUDGE LEUNG: Okay. Then that's the end of my
19 questions. Mr. Harper, do you have anything else to add
20 to your presentation before I go to the Franchise Tax
21 Board?

22 MR. HARPER: Unless, Bruce and Jean is there
23 anything you want to add? Hopefully, they're still there.
24 Let just ask one question.

25 Sandra, she's at work and, you know, I told her

1 we'd try to get her in and out of this as soon as
2 possible. So can we let Sandy go, or do you want us to
3 keep her?

4 JUDGE LEUNG: I think the Franchise Tax Board has
5 already questioned her, and the Judges have already
6 questioned her.

7 Franchise Tax Board, you have no further
8 questions of Ms. Lang, do you?

9 MR. KRAGEL: Judge, this is Brad Kragel. No we
10 do not, Judge.

11 JUDGE LEUNG: Okay. This is Judge Leung.
12 Mr. Harper -- Ms. Lang, thank you for your service.
13 You're free to go about your day's affairs as you were.
14 So you can still listen in if you want to, but that's up
15 to you.

16 MS. LANG: Thank you very much, Your Honor. I
17 will leave this conversation. However, if I am needed in
18 the future, John knows how to get a hold of me. And thank
19 you for your time.

20 JUDGE LEUNG: Thank you.

21 MR. HARPER: Thank you, Sandy.

22 JUDGE LEUNG: Thank you, Ms. Lang.

23 MS. LANG: Bye-bye.

24 JUDGE LEUNG: Okay. I think we're ready for the
25 Franchise Tax Board's presentation.

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PRESENTATION

MS. DEWEY: All right. Good morning, members of the panel. I'm D'Arcy Dewey, and I'm here with co-counsel, Bradley Kragel, representing Respondent, Franchise Tax Board.

The issues in this matter, as agreed by the parties and were slightly by the Judge, but I'll state them as I have drafted here, are whether Appellant has shown that Respondent erred in disallowing an increase net operating loss deduction for tax year 2012; whether Appellant has shown that Respondent has erred in disallowing upon bad debt deduction for tax year 2012; and whether Appellant has shown that its entitled to a deduction under Internal Revenue Code Section 186.

Appellant reported \$1.9 million bad debt deduction on its 2012 tax returns. Appellant claimed that the deduction arose out of a highly unusual accounting practice, whereby, Appellant sold advertising space at a discount but booked the income at the undiscounted price. Respondent determined that Appellant --

JUDGE LEUNG: Ms. Dewey, this is Judge Leung. Could you please hold on for one minute? You're sort of breaking up a little bit. So maybe angle yourself a little bit closer to the mic, so you're not breaking up.

MS. DEWEY: I apologize.

1 So starting again to some agree. Appellant
2 reported a \$1.9 million bad debt deduction on its to 2012
3 tax return. The Appellant claimed that the deduction
4 arose out of a highly unusual accounting practice,
5 whereby, Appellant sold advertising space at a discount,
6 but booked the income at the undiscounted price.
7 Respondent determined that Appellant failed to
8 substantiate that it was entitled to a bad debt deduction
9 and alternately, an increased net operating loss
10 deduction.

11 Upon the OTA's request during briefing,
12 Respondent also determined that Appellant was not entitled
13 to a deduction for injury from an antitrust suit. The
14 evidence supported -- supports Respondent's conclusions.
15 This case is about substantiation. Taxpayers have the
16 burden to show that they are entitled to a deduction,
17 whether for net operating losses or for bad debt.
18 Taxpayers must keep records substantiating the income and
19 deductions reported on their tax returns.

20 Respondent's determinations are presumed correct.
21 To prevail, Appellant must be able to point to a deduction
22 statute and demonstrate the credible evidence that it met
23 their requirements of the statute. Appellant's
24 unsupported statement are not sufficient. Appellant
25 argues that it overstated income in prior tax years in an

1 effort to prove damages in a lawsuit that it initiated in
2 the 2004 tax year.

3 The facts of the case are this. Appellant was a
4 newspaper company organized as a C corporation. It used
5 the accrual method of accounting and had a tax year end of
6 April 30th. In October 2004, Appellant brought suit for
7 unfair business practicing against its competitor, which I
8 refer to as New Times here. In May 2008, Appellant
9 prevailed and was awarded damages for lost profits
10 partially troubled. In August 2010, the award was
11 generally affirmed on appeal.

12 In December 2010, Appellant entered into a
13 settlement agreement for the award due to competing
14 creditor claims against New Times. Appellant received
15 settlement payments in tax years 2010 and 2012, which it
16 offset in those years but with the legal expenses. The
17 payments and the legal expenses were adjusted by the FTB
18 and are not contested.

19 Appellant claimed that sometime during 2004 and
20 2005 or maybe 2003, its attorneys advised to track add
21 discounts in order to prove damages in the New Times suit.
22 On this advice, Appellant began booking add sales into
23 revenue at undiscounted prices, even though it did not
24 expect payment from customers on the discounted portion.

25 Appellant asserts that the unbilled discounts

1 were recognized in taxable income, and this practice
2 continued either tax year 2008 or tax year 2012. The
3 record is inconsistent regarding the applicable dates.
4 According to Appellant, it's 2012 bad debt deduction was a
5 write-off of its accrued unbilled discount. I'm going to
6 pause and make sure that everybody can hear me at this
7 time.

8 JUDGE LEUNG: This is Judge Leung. You're still
9 breaking up in some portions. We can barely get you most
10 of the time. So stick by what you were doing very
11 beginning. What you were doing worked very well. Towards
12 the end you were sort of breaking up some more.

13 MS. DEWEY: Yeah. I think I tend to lean back a
14 little bit. So I'll try to stay closer, or I can
15 alternatively call in from here. Can I continue? Can you
16 hear me now?

17 JUDGE LEUNG: This is Judge Leung. Yes, we can
18 here you now.

19 MS. DEWEY: Okay. I'll just try to keep leaning
20 in. So continuing.

21 In support of its claims, Appellant provided
22 financial statements, sample of customer accounts and
23 estimates of the unbilled discounts accrued between tax
24 years 2004 and 2008. Based on the documentation provided,
25 Respondent could not verify the nature of Appellant's

1 deduction. Respondent determined that Appellant was not
2 entitled to a bad debt deduction and declined to allow an
3 increased net operating loss deduction.

4 Respondent made additional adjustments not at
5 issue in this, appeal, and issued a Notice of Action which
6 assessed additional tax of \$70,000. Turning to the first
7 issue, or sub-issue, California provides a deduction for
8 net operating loss carry overs in partial conformity with
9 Internal Revenue Code Section 172. Respondent may
10 redetermined taxable income in closed tax years in order
11 to recalculate the correct net operating loss carry over
12 to the year of the deduction.

13 So if Appellant overstated the income in prior
14 years, that would bear on the correct computation of the
15 net operating loss. According to Appellant, the unbilled
16 discounts were actually accrued damages expected from the
17 New Times suit. In other words, they were contingent
18 litigation gains. Generally, litigation gains are not
19 reportable for tax purposes until final disposition of the
20 suit; for example, settlement.

21 Any income accruals reported before the 2010
22 settlement in this case would have been improperly
23 overstated income that we could correct with a
24 recalculation of the net operating loss in 2012. For
25 Appellant to prevail on its claim to an increased net

1 operating loss, however, it must prove that it actually
2 accrued hand-billed discounts in taxable income and prove
3 the amount of the gains accrued for each taxable year so
4 that we can compute in the 2012 net operating loss
5 correctly.

6 Appellant has not met its burden of proof.
7 Appellant provided income statements. The 2012 statement
8 show only that its bad debt deduction consisted of
9 \$1.7 million from expense account labeled "Bad Debts" and
10 \$200,000 in advertising revenue. Nothing in the
11 statements refers specifically to advertising discounts.

12 The income statements for tax years 2006, 2009,
13 2010 and 2011 also report expenses similarly labeled "Bad
14 Debt" which Appellant excluded from income. In view of
15 this, it's possible that if Appellant did accrue
16 hand-billed discounts, then it also already excluded them
17 on its tax return. We simply don't have enough
18 information to know.

19 Appellant provided balance sheets. The balance
20 sheets are similarly unhelpful. Appellant states, for
21 example, that in 2008 it moved the accrued discounts on
22 its balance sheet from accounts receivable to other assets
23 and then ceased accruing discounts. Based on Appellant's
24 representations, we should be able to tie the \$1.9 million
25 deducted to the \$2.3 million moved to the other asset

1 account. We cannot. At the end of tax year 2011,
2 Appellant's other asset account was \$1.6 million, which
3 also cannot be tied to the bad debt line. The balance
4 sheets are inconsistent with Appellant's statement.

5 The customer record provided by Appellant
6 demonstrate only that Appellant was in the practice of
7 providing discounted add sales. They did not demonstrate
8 how Appellant reported the income from these sales for tax
9 return purposes for financial return -- financial acting
10 purposes. In fact, many years covered by the customer
11 records predate Appellant's alleged implementation of the
12 accounting practice at issue here.

13 Appellant's officers estimated that it accrued
14 approximately \$2.3 million of discounts in income between
15 tax year 2004 and 2008. The estimate does not match the
16 bad debt deduction and does not tie to the financial
17 statements or tax return. Appellant's controller, Sandy
18 Lang, asserts that she used the accounting practice from,
19 according to her statement today, 2003 through possibly
20 2014. Respondent could not verify Ms. Lang's statements
21 as they're not supported by documentation.

22 The accounting practice described by Appellant is
23 highly unusual. Generally accepted accounting practices
24 provide that contingent gains are not accruable. They are
25 too contingent to accurately reflect income. And this is

1 in imparity with the tax rules. The result of this
2 practice as discussed is to report income earlier than
3 necessary exposing the taxpayers to a real risk of
4 increased tax spent.

5 Given that Respondent would expect Appellant to
6 exercise a high degree of care maintaining contemporaneous
7 documentation to ensure that the company was able to prove
8 its position. Furthermore, Appellant had trouble pinning
9 down the dates applicable to this matter. Inconsistent
10 statements in the record refer to dates ranging between
11 1999 and 2013. Appellant argues that principles of double
12 entry accounting alone are sufficient to prove the
13 accrual. Appellant is mistaken.

14 Deduction are granted for the underlying economic
15 activity tracked on the financial statements. The
16 taxpayer must be able to prove the nature of the economic
17 activity represented by its financials and demonstrate
18 that it is deductible. The records simply does not
19 adequately substantiate Appellant's claims. Therefore,
20 Appellant has not shown that it should receive an increase
21 net operating loss deduction.

22 Turning to the second issue or sub-issue,
23 California provides a deduction for bad debts in
24 conformity with Internal Revenue Code Section 166. To
25 prevail, Appellant must show that it had a bona fide debt

1 which became worthless during the taxable year. A bona
2 fide debt arises from a creditor -- a debtor creditor
3 relationship based on a valid and enforceable obligation
4 to pay a fixed or determinable sum of money.

5 A debtor creditor relationship arises with the
6 parties' intent at the time of the lending that the lender
7 will correct -- collect, and the borrower will repay an
8 amount due. According to Appellant, it never intended to
9 collect the unbilled discounts from its customers, and
10 Appellant did not provide records showing otherwise.
11 Therefore, Appellant did not claim a bona fide debt with
12 its customers. Appellant claimed they expected payment in
13 the form of damages from New Times. New Times, clearly,
14 did not intend to indebt itself to Appellant.

15 However, in some limited circumstances, a debt
16 can be created by operation of law. As more fully
17 explained in Respondent's opening brief, Respondent could
18 not find precedent treating the underlying activity in New
19 Times' lawsuit as giving rise to debt by operation of law.
20 Secondarily, even if a creditor debtor relationship were
21 established with New Times, the debt would have been
22 income fixed and determinable at settlement, after which
23 it was fully paid and never became worthless. Therefore,
24 Appellant fails to even allege facts that it would qualify
25 for a bad debt deduction.

1 Turning to our third issue regarding Section 186.
2 I'd like to correct statements of law in Respondent's
3 Briefing. Respondent proceeded on the assumption that
4 California conforms to Internal Revenue Code Section 186
5 for purposes of the corporate tax. Upon further review,
6 Respondent's position is that California does not conform
7 to this section. California instead has a stand-alone
8 provision relating to awards from antitrust suits.

9 Revenue and Tax Code Section 24678 provides a
10 limitation on the taxation of an amount of damages
11 received or accrued as a result of an award and/or
12 settlement of a civil action brought under Section 4 of
13 the Clayton Act. The amount must be for injuries to the
14 corporation's business or property sustained as a result
15 of violation of the antitrust law.

16 If applicable, the tax imposed is limited to the
17 amount the corporation would have been liable for if it
18 had reported the damage award and income ratably on a
19 monthly basis for the duration of the period in which the
20 injury was sustained. California's provision applies only
21 to damages that result from a claim brought under
22 Section 4 of the Clayton Act.

23 Appellant prevailed on its action against New
24 Times for violations of California Business and
25 Professions Code Section 17043. Appellant did not bring a

1 claim under Section 4 of the Clayton Act. Therefore,
2 California's tax limitation is not applicable.

3 In summary, the taxpayers did not meet their
4 burden to prove that they're entitled to an increased net
5 operating loss. The taxpayers failed to allege facts
6 qualifying them for bad debt deduction. And finally,
7 California does not conform to Internal Revenue Code
8 Section 186 for corporate tax purposes. And California's
9 stand-alone provision relating to antitrust damages is not
10 applicable.

11 For the reasons discussed here, Respondent
12 respectfully request that your panel affirm Respondent's
13 Notice of Action. I'm happy to open up for any questions.

14 JUDGE LEUNG: This is Judge Leung. Mr. Harper,
15 do you have any questions for Ms. Dewey?

16 MR. HARPER: Every step of the way, you know, why
17 won't they make -- give us journal entries. I know that's
18 not their job, but they just sit back and say, you know,
19 we don't care what the other half of the entry is. I mean
20 that seems -- you know, the whole bases of the whole
21 country is double entry accounting, and the Franchise Tax
22 Board doesn't seem to be -- go by those rules. So, you
23 know, what's the other half of your entries? I
24 acknowledge that we should never have accrued income.
25 What's the other side of that entry?

1 MS. DEWEY: This is D'Arcy Dewey for Respondent.
2 In response to your question I'll refer you to our
3 argument stating that the deduction is for the underlying
4 economic activity. So the Appellant's burden of proof is
5 to show what that underlying economic activity was that
6 would give rise to a deduction.

7 MR. HARPER: So you didn't answer my question
8 either. That's, you know, at least you opened your mouth
9 and said something. Nobody else would ever say anything.
10 You know, debits and credits are supposed to balance.

11 JUDGE LEUNG: Okay. Thank you, Mr. Harper. This
12 Judge Leung again.

13 Judge Akin, any questions for the Franchise Tax
14 Board.

15 JUDGE AKIN: Just -- Judge Akin speaking. I
16 think I have just one question. And that is just
17 understanding a little better why it is that FTB is
18 maintaining that they would not be entitled to an
19 increased net operating loss carry forward. Is it you're
20 saying it's a substantiation issue? Could you explain
21 that a little more for me, Franchise Tax Board.

22 MS. DEWEY: Yes. This is D'Arcy Dewey for
23 Respondent. In response to your question, that's correct.
24 The FTB's position is that the Respondent -- I'm sorry --
25 the Appellant failed to substantiate that they actually

1 overstated income in the past years. They stated they
2 implemented an accounting practice, but we have no
3 evidence of that other than unsupported statements by
4 Appellant.

5 JUDGE AKIN: Judge Akin speaking. And just one
6 follow-up question to that. Looking at their financial
7 statements, you do see that they said in 2008, I think it
8 was, they began reporting it in other assets. You do see
9 the increase and then the decrease of those amounts. Is
10 it your position that that doesn't substantiate that those
11 increases in the other assets were actually reported as
12 income during those years?

13 Let -- if it helps, I could direct you to -- it's
14 actually your Exhibit V, Franchise Tax Board Exhibit V for
15 Victor. And I'll get you a Page Number. One moment. So
16 examples would be page 6 of 44, which would be their
17 balance sheet for the tax year ending April 30th, 2010.

18 And let me back you up to the one before that.
19 So the page before it, page 6 of Exhibit V. So if you
20 look at page -- I'm sorry, page 5. If you look at page 5
21 of Exhibit V, you can see their other asset balance is
22 \$2,215,474 for the tax year ending April 30th, 2010.

23 I'm just waiting to give you a chance to find
24 that.

25 MS. DEWEY: Yes, I'm there with you. Yeah.

1 JUDGE AKIN: Okay. And then if you flip to the
2 next page, so page 6 of Exhibit V, the same line, the
3 other assets, you see it increases to -- excuse me. It
4 decreases that year to \$1,246,484. And I think that's the
5 year that they're saying they received the first payment.
6 So they booked a bad debt expense. But if you then flip
7 to the next page, which should be page 7, I think you see
8 it go back to \$1,606,000.

9 MS. DEWEY: Correct.

10 JUDGE AKIN: So I guess my question is
11 specifically in those years that you're seeing the
12 increase, so the increase from tax year ending
13 April 30th, 2011, to the tax year ending April 30th, 2012,
14 you see that increase of -- it's approximately \$400,000.

15 Is it your position that you don't know, I guess,
16 that that was reported as revenue in that year?

17 MS. DEWEY: Right. It is our position that
18 it's -- we're not certain that was reported as revenue.
19 It may have been excluded as revenue in some other
20 fashion. But primarily our position is that we don't know
21 what those numbers represent on the balance sheet. What
22 is the underlying activity giving rise to this line?

23 JUDGE AKIN: Okay. Judge Akin speaking. Thank
24 you. That helps.

25 JUDGE LEUNG: This is Judge Leung Judge.

1 Judge Rosas, any questions for the Franchise Tax Board?

2 JUDGE ROSAS: This is Judge Rosas. Bear with me
3 as I take a look at my notes here. I do not have any
4 questions. Thank you.

5 JUDGE LEUNG: Thank you, Judge Rosas. This is
6 Judge Leung.

7 Ms. Dewey, I got a couple of questions for you.
8 First, I'm going to apologize for treating you as a
9 witness a minute ago. I did a little misstep there. My
10 questions to you -- a couple of questions. Let me get one
11 out of the way that's more procedural than anything else.

12 The taxpayer raised the question of why this case
13 was sent back to New York and came back to Sacramento with
14 no apparent outcome from New York. Can you explain what
15 happened there?

16 MS. DEWEY: Yes, Judge Leung. I -- I did look
17 for the rationale in the record. It's not clear to me
18 what happened. But the FTB does frequently move accounts
19 due to workload, due to people leaving the FTB. So it's
20 not surprising when something does get transferred on
21 occasion.

22 JUDGE LEUNG: Okay. This is Judge Leung again,
23 my second question is you argue that there's not enough
24 substantiation. So what exactly were you looking for?
25 Were you looking for the actual invoices or contracts?

1 What were you looking for to substantiate these amounts?

2 MS. DEWEY: Right. So I think ideally what we
3 would look for -- what ideally would prove this would be
4 the actual invoice showing how the customers were billed;
5 as that ties to how the journal entries reflect that
6 billing and reflect the booking into accounts receivable
7 and other assets on the balance sheet. So we just need to
8 be able to follow the invoices and the accounting
9 practices through -- to the tax return all the way
10 through.

11 JUDGE LEUNG: This is Judge Leung again. Wasn't
12 the judgment and the trial record for the underlying Bay
13 Guardian lawsuit, was there enough information there for
14 you to -- I mean, they had to prove their damages to the
15 court and to the jury. So was there enough exhibits there
16 for you to look through to figure out what was going on?

17 MS. DEWEY: No. This is D'Arcy Dewey for the
18 Respondent. Our position is that we didn't have enough
19 information based on the judgment and the Appellant's
20 documents received. The case was about whether or not --
21 was about damages in unfair business practices. So it
22 looked to us like they had considered many different
23 factors, which are not relevant here; such as competition
24 in the market. And it wasn't clear what the foundation of
25 the experts were based on; what documents they had their

1 expert witnesses were based on.

2 JUDGE LEUNG: Okay. This is Judge Leung again.
3 As I guess my final question is regarding the difference
4 Revenue and Tax Code Section 24678 and Internal Revenue
5 Code Section 186(b)(3). Other than your assertion that
6 the California section only applies for damages arising
7 from a federal lawsuit under the federal antitrust laws,
8 what other differences are there between the California
9 section and the federal section?

10 MS. DEWEY: So this is D'Arcy Dewey for
11 Respondent again. To be clear I believe your question is
12 what are the differences between IRC Section 186 and
13 California Provision Section 24678; is that correct?

14 Okay. So --

15 JUDGE LEUNG: This is Judge Leung. Yes, that's
16 correct.

17 MS. DEWEY: Sorry. I just saw you nod. I
18 apologize. So they apply a different -- a different
19 mechanism in order to come to kind of similar results.
20 186 allow the deduction for settle -- for awards from an
21 antitrust suit. And California applies a limitation. So
22 there's slightly different mechanism there. And the 186
23 section is kind of complicated with respect to how you
24 apply that. And I think California is a little simpler,
25 but it also has some complications to it.

1 The standards are also different. The
2 applicability is also slightly different. For example,
3 Internal Revenue Code Section 186 applies -- let me just
4 check my notes for just a second.

5 Basically, it applies to a suit that could be
6 taken under Section 4 of the Clayton Act. So we look at
7 whether or not the taxpayer's claim under Business and
8 Professions Code Section 17043 could have been taken as a
9 claim under Section 4 of the Clayton Act, and the FTB
10 concluded that it could not.

11 For purposes of the Californian statute, the
12 claim actually must be brought under Section 4 of the
13 Clayton Act. So it's a little bit more clear cut. We
14 don't have to do the analogy of 17043 to another antitrust
15 suit, basically. The 186 was more fully described in our
16 additional briefing.

17 JUDGE LEUNG: Okay. Thank you.

18 Mr. Harper, you have 15 minutes left to do your
19 closing statements.

20

21 CLOSING STATEMENT

22 MR. HARPER: First, Judge, I just would want to
23 respond to one of the questions you asked about the
24 Franchise Tax Board's having access to the court records,
25 which the Respondent answered no. I call your attention

1 to my Exhibit 4, which is correspondence between me and an
2 appeals officer in New York where we talk about, you
3 know -- again, it's the third paragraph where we're
4 talking about the only document signed by a judge is an
5 original judgment for \$15 million.

6 These two events occurred in 2010. And I state,
7 I know you have access to these documents as Steve Parada.
8 He was the second FTB officer at the hearing, made
9 reference to the case during our hearing. So she's
10 incorrect saying that they never looked at or never had
11 access to it, because he certainly looked it up. And
12 he's -- he was one of the appeals officers in New York,
13 again, we never heard from.

14 Also her statement, you know, the concept --
15 because that's why I asked, why are we going to New York
16 for this appeal conference? I called and they said, well,
17 due to workloads, we're transferring it to an area that
18 does have as high of a workload. Which all make sense,
19 but why would you then hear the case, trade
20 correspondence, two people hear the case and exchange
21 correspondence, and then not issue a report.

22 You know, as you're trying to even out workloads,
23 all the work was done in New York. All they had to do was
24 write a report, you know. I still question -- I hear her
25 answer, and it's evening out workloads but all the work

1 was done. All they had to do was write a report. So
2 somebody didn't like what they were going to say. I'm
3 sorry. That's the way I feel. Okay.

4 Now, the only way to generate account receivable,
5 which is debit on a balance sheet, is through a credit.
6 And the only place to put a large credit is revenue, which
7 is an income statement item. There's no other -- so
8 accounts receivable came from somewhere. Because it's on
9 the balance sheet and it's been there consistently.
10 Judge Akin pointed out how it goes up and down, you know.
11 It came through revenue.

12 The whole purpose of a financial statement is to
13 summarize thousands of transactions. Again, the
14 Respondent says, you know, they wanted to look at
15 invoices. Not once did they ever ask to look at a single
16 invoice. Everything, you know, they look at bank
17 statements. Bank statements are the key to any audit.
18 Cash is the only thing you can't make up or pretend
19 doesn't exist or pretend it does exist. You get a bank
20 statement, and you're pretty much done with your audit.

21 I try not to ramble 'cause I -- but again, you
22 got to understand. This is a small business, you know,
23 and they don't have a huge accounting staff. So you know,
24 you ask for this stuff, you know, the financial statements
25 they're very accurate. And we review them. We go through

1 them. And again, we show -- we've shown you where the
2 Franchise Tax Board has taken liberty with basically
3 trying to disparage our balance sheets, where they're as
4 much at fault for the work they did.

5 Finally, on this Section 24678, I'm looking right
6 at it. And it says to me, forbidding in the antitrust --
7 then the tax attributable to the inclusion of that amount
8 in gross income for the taxable year shall not be greater
9 than the aggregate of increases in taxes, which would have
10 resulted if that amount included had been included in
11 gross income in equal installments for each month.

12 So we're talking about \$875,000 of income. You
13 do a quick calculation. Well, just say nine years that's
14 what -- 100 months? I'm trying to break this \$875,000
15 into months because that's what it says.

16 This is \$8,000 a month or \$96,000 a year. So
17 we've got net operating losses going back to 2003 for the
18 smallest amount. I mean, it's \$153,000, \$390,050,
19 \$320,000, \$104,272. So if you calculated a tax
20 attributing this income back to those years, the tax would
21 be zero. So I think, you know, first off, I think its
22 excluded under 186, the federal provisions. And then if
23 you did the calculation, it would be excluded under the
24 California provision.

25 And I'm looking right at it, the tax attributable

1 to the inclusion of that amount in gross income for the
2 year shall not be greater than what the tax would have
3 been had it been resulted in each month. So that -- I
4 don't know.

5 So I think even looking at the California
6 provision, the tax result is zero. So -- pardon me.
7 Excuse me. Again, you know, I just fall back to our
8 conclusions, you know. You know, we've got testimony of
9 Sandra Lang. She's totally independent of the Bay
10 Guardian. We tell you exactly what we do, and we get the
11 standard comment from the Franchise Tax Board,
12 unsubstantiated comment. I've heard that so many times,
13 you know, in response to my explanation of what we did.

14 This is a small business, you know. I would ask
15 the big question is, you know, where's the money? You
16 know, this is a business. They're basically saying
17 there's \$1.9 million somewhere. And this is a business
18 that works on -- this was a business that worked strictly
19 on credit cards and checks. And that means the funds had
20 to go through a bank. And the Franchise Tax Board through
21 their audit had every bank statement for the year they
22 were looking at, the year before, and year after, and
23 there's no record of anything, you know, there because it
24 was never received.

25 We booked something in error. We reversed it to

1 correct that error. They did this -- they took this very
2 unusual plan, based on attorney's advice, which turned out
3 to be very good advice, as it was one of the key elements
4 in winning their lawsuit. There are situations where
5 records don't exist. Houses burn down, deeds are gone.
6 You can get a deed. Construction records are gone.
7 They're out of business. There are situations, and this
8 is one of them.

9 We told you exactly what they did or how this
10 stuff was -- the software program that generated it, we
11 gave you three examples which are in the Respondent's
12 exhibits. And again, those survive because they were
13 actual hard copies used it in trial, and we have that for
14 hundreds of people.

15 The last thing, this double entry accounting
16 system is crucial, and I keep going back to it. If the
17 Franchise Tax Board would just look at it, which they
18 refuse. They have to have -- the debits and credits have
19 to balance. How can you end up with a dissolved
20 corporation with a \$1.9 million worthless asset on its
21 balance sheet? I think we've absolutely sustained our
22 claim.

23 We've acknowledged that we don't have a list of
24 those bad debits. As an alternative we've certainly shown
25 that we overstated income, and if not through the

1 financial statements through Sandy's testimony -- and she
2 was right there doing it every day for all those years,
3 and nobody -- you know, nobody made her do it. She was
4 doing it based on sound advice from attorneys.

5 I really don't know what else I can add. Thank
6 you.

7 JUDGE LEUNG: Thank you, Mr. Harper. This is
8 Judge Leung.

9 Any final questions from judges? Judge Akin?

10 JUDGE AKIN: Judge Akin speaking. No further
11 questions from me.

12 JUDGE LEUNG: Thank you. Judge Rosas?

13 JUDGE ROSAS: This is Judge Rosas. Mr. Harper, I
14 just have one question. You made reference to documents
15 that are no longer available. You made reference to the
16 court documents that were available, which were provided
17 in this matter. Question, did you attempt to go to the
18 courthouse to obtain copies of the court records and court
19 files in the underlying matter?

20 MR. HARPER: I'm sorry. You asked me if I went
21 to get the records?

22 JUDGE ROSAS: Correct. I'm trying to figure out
23 for purposes of this appeal if an effort was made to
24 obtain court records of the underlying case.

25 MR. HARPER: I did not.

1 JUDGE ROSAS: Do you know if anyone else for
2 purposes of this appeal made an effort to obtain such
3 records?

4 MR. HARPER: Now, I'm not sure. When you say
5 purpose of this appeal, as I told you earlier, I know the
6 Franchise Tax Board, this Steve Parada, he looked at them.
7 And he was, you know, he's in Sacramento. He made
8 reference to the documents in our hearing with the
9 New York City Franchise Tax Board. They had two people.
10 One was in New York City, and Steve Parada was either in
11 Sacramento or Rancho Cordova.

12 Which, again, I didn't understand. You transfer
13 a case to New York, and then it's heard by somebody in
14 Sacramento.

15 JUDGE ROSAS: Mr. Harper, I understand your
16 frustration, and I understand you're referencing matters
17 that took place in the underlying audit. But to get to
18 the heart of my question, I'm trying to figure out for
19 purposes of this current appeal before the California
20 Office of Tax Appeals, was an effort made to obtain
21 records that were filed in the underlying lawsuit?

22 MR. HARPER: No.

23 JUDGE ROSAS: Thank you, Mr. Harper. That
24 answers my question.

25 JUDGE LEUNG: Thank you, Judge Rosas. This is

1 Judge Leung. As I mentioned earlier, the judges are going
2 to take a brief break for about no more than five minutes.
3 Please do not go away. Do not disconnect. Stay on the
4 line. We'll be right back. Thank you.

5 (There was a pause in the proceedings.)

6 JUDGE LEUNG: This is Judge Leung. We're back on
7 the record.

8 Mr. Harper, any other final words, maybe one or
9 two sentences, before we wrap up.

10 MR. HARPER: No, I'm fine.

11 JUDGE LEUNG: Thank you.

12 This is Judge Leung again, we decide that there's
13 no additional briefing needed at this point. We are
14 closing the record. Thank you everybody for attending
15 this hearing.

16 We will endeavor to get our decisions out within
17 100 days after making our decision. And again, thank you
18 very much. And the next hearing is scheduled for
19 1:00 p.m., and OTA will now be going on a brief recess.

20 Thank you.

21 (Proceedings adjourned at 12:29 p.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 29th day of September, 2020.

ERNALYN M. ALONZO
HEARING REPORTER