OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18042649
L. HSU	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: L. Hsu

For Respondent: Christopher T. Casselman, Tax Counsel IV

For Office of Tax Appeals: Neha Garner, Tax Counsel III

R.TAY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 19045, L. Hsu (appellant) appeals an action by Franchise Tax Board (respondent) reducing appellant's aggregate net operating loss (NOL) carryover to the 2011 tax year to a total of $1,217,622.

Appellant waived the right to an oral hearing; therefore, we decide this matter based on the written record.

ISSUE

Whether appellant has demonstrated error in respondent's reduction of appellant's 2008, 2009, and 2010 NOL carryover to 2011.

FACTUAL FINDINGS

1. Grandpark, Inc. (Grandpark), taxed as an S corporation for U.S. federal and California income tax purposes, was incorporated in California on June 13, 2006, and is in the business of real estate development.
2. In 2006, appellant was one of two shareholders of Grandpark. During that year, he contributed $759,500 to Grandpark, which created stock basis by that amount.

3. Grandpark issued checks during 2006, three of which are relevant to this appeal. On June 21, 2006, Grandpark issued two checks to Shatto Villas, LLC (Shatto) for a total amount of $1.25 million.[1] On December 5, 2006, Grandpark issued a third check in the amount of $490,000, and appellant received that amount in his bank account.
4. In 2010, appellant owned 77.56 percent of Grandpark's shares and 40 percent of Shatto. Shatto was not a shareholder of Grandpark.
5. On his amended 2010 California resident income tax return, appellant reported a flow-through non-passive loss of $4,008,696 from his ownership in Grandpark that was incurred during that tax year. On that same return, appellant reported an NOL of $3,724,605 from 2010, $393,762 from 2009, and $157,080 from 2008, for a total claimed NOL carryover to 2011 of $4,275,447.
6. Respondent examined appellant's 2010 tax return. On June 28, 2016, respondent issued a Notice of Proposed Adjusted Carryover Amount (NPACA), which reduced appellant's total NOL carryover to 2011 from $4,275,447 to $834,356. Appellant protested the proposed adjustments to his NOL carryovers.
7. At protest, respondent upwardly revised appellant's total NOL carryover to $1,217,622 (from its original determination of $834,356) and issued a Notice of Action – Revision on October 18, 2017. Specifically, respondent reduced appellant's total claimed NOL carryover of $4,275,447 by the following: (1) $387,140 of debt repayment income attributable to Grandpark's conversion of its loans to appellant to capital contributions in 2010; (2) $945,605 of suspended losses (losses in excess of basis) based on respondent's re-computation of appellant's stock basis in Grandpark in 2010; (3) $1,568,000 of losses subject to the at-risk limitation; and (4) fully eliminating appellant's 2008 NOL carryover of $157,080 because of respondent's finding that appellant had unreported distributions in 2006 that should have reduced his stock basis in Grandpark to zero from 2006 through 2008, thus preventing appellant from generating a 2008 NOL. Appellant filed this timely appeal.

[1] Appellant represented that the purpose of these payments was for real estate development.

DISCUSSION

Respondent's determination is presumed correct and taxpayers have the burden of proving it to be wrong. (*Appeal of Wright Capital Holdings, LLC*, 2019-OTA-219P; *Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Taxpayers bear the burden of proving that they are entitled to claimed losses. (*Welch v. Helvering* (1933) 290 U.S. 111.) Taxpayers attempting to deduct NOLs bear the burden of establishing both the existence of the NOLs and the amount of any NOL that may be carried over. (*Deutsch v. Commissioner*, T.C. Memo. 2012-318, citing *U.S. v Olympic Radio & Television, Inc.* (1955) 349 U.S. 232.) Unsupported assertions are not sufficient to satisfy taxpayers' burden of proof. (*Appeal of Wright Capital Holdings, LLC*, *supra*.) It is well established that taxpayers' failure to introduce evidence that is within their control gives rise to the presumption that the evidence, if provided, would be unfavorable to their position. (*Appeal of Morosky*, 2019-OTA-312P.)

California generally conforms to the federal tax treatment of S corporations and their shareholders. (R&TC, §§ 17087.5, 23800.) Shareholders are required to treat the S corporation's income and deductions as if "realized directly from the source from which realized by the corporation, or incurred in the same manner by the corporation." (Internal Revenue Code (IRC), § 1366(b).)

The tax liability of an S corporation's shareholder is computed by taking into account the shareholder's pro rata share of the S corporation's items of income, loss, deduction, or credit the separate treatment of which could affect the shareholder's tax liability and nonseparately computed income or loss. (IRC, § 1366(a)(1).) Therefore, any flow-through losses are determined by the percentage of the outstanding shares owned by the shareholder. According to the Schedule K-1 issued to appellant by Grandpark for the 2010 tax year, appellant owned 77.56 percent of the outstanding shares of Grandpark. Based on this percentage, Grandpark allocated a flow-through loss of $4,008,696 to appellant. As stated above, appellant's flow-through loss was deductible only to the extent of his basis in Grandpark, and then only to the amount for which he was at-risk.

The IRC places certain limitations on pass-through loss deductions that shareholders may claim on their tax returns. As relevant here, IRC section 1366(d)(1) limits shareholders from claiming losses and deductions in excess of their basis in stock and debt in the S corporation. Additionally, the at-risk provisions further limit the deductibility of any such losses. (See IRC,

§ 465.) Any amounts not allowed in the current year may be carried forward indefinitely until the shareholders transfer all of their stock in the S corporation. (IRC, § 1366(d)(2); Treas. Reg. § 1.1366-2(a)(6).)

Respondent examined appellant's 2010 tax year and determined that appellant overstated his NOL carryovers as reported on his 2010 California income tax return because he used an inflated basis and did not properly calculate his at-risk limitation. Based on the documents and information provided at audit and protest, respondent reduced appellant's NOL carryover, as set forth in the Notice of Action – Revision dated October 18, 2017. Appellant appealed respondent's determination, but on appeal, appellant does not dispute the bulk of respondent's proposed reductions. Specifically, appellant provides no arguments to dispute the following reductions to his 2010 NOL carryover: (1) the $387,140 of debt repayment income attributable to Grandpark's conversion of its loans to appellant to capital contributions in 2010; (2) the $945,605 of suspended losses (losses in excess of basis); and (3) the $1,568,000 of losses subject to the at-risk limitation. As such, we sustain this portion of respondent's adjustments to appellant's 2010 NOL carryover.[2]

Appellant's only argument on appeal is that respondent erred in its elimination of his 2008 NOL carryover of $157,080.[3] Appellant argues that he contributed $759,500 to Grandpark in 2006 and therefore he had a stock basis (including at-risk basis) of at least that amount in 2006. Respondent does not dispute that the $759,500 created stock basis. However, respondent's position is that appellant received two unreported distributions from Grandpark in 2006: (1) $1.25 million on June 22, 2006; and (2) $490,000 on December 5, 2006. Respondent asserts that even if appellant had stock basis in Grandpark of about $759,500 at some point in 2006, these distributions, totaling $1.74 million, would have fully reduced that basis to zero by the end of 2006. Respondent further argues that appellant's zero basis would have continued through 2008, and consequently, he would not have generated an NOL for the 2008 tax year. Thus, respondent eliminated the entirety of appellant's 2008 NOL carryover of $157,080.

[2] Based on our review of the record, it appears these conceded adjustments relate solely to appellant's 2010 NOL. It also does not appear respondent made any adjustments to appellant's 2009 NOL. Therefore, our discussion that follows relates solely to the disputed adjustments respondent made to disallow in full appellant's 2008 NOL.

[3] Appellant also argues that the 2010 NOLs of T. and M. Hsu (his parents, who are not parties to this appeal) should be adjusted. However, we do not have jurisdiction over their 2010 tax year, and therefore do not discuss this argument further.

Appellant disagrees, countering that he did not receive $1.74 million of unreported distributions from Grandpark. Although he admits he received proceeds of $490,000 from Grandpark, he contends it was a loan, not a distribution that reduced his stock basis. We next analyze the two transactions separately.

With respect to the first transaction at issue—the two checks totaling $1.25 million that Grandpark issued to Shatto—respondent alleges that appellant ultimately received the $1.25 million from Grandpark as a distribution that was passed through Shatto and HJL Associates in a scheme to avoid taxation. Respondent appears to believe that since appellant has an ownership interest in both Grandpark and Shatto, and since HJL Associates is a sole proprietorship purportedly owned by appellant's sister, appellant used the three entities to funnel money to himself tax-free. Respondent also points to the fact that just two days after Grandpark paid Shatto, appellant made a deposit into his personal account in the same amount as Grandpark's payment to Shatto, which allegedly shows that all the transactions were part of a single plan to ultimately distribute the $1.25 million to appellant.

However, we find that respondent's assertion that appellant received a distribution of $1.25 million to be unsupported by the evidence in the record and based on conjecture regarding the timing of withdrawals and deposits, and the relationship between appellant, Shatto, and HJL Associates. In fact, respondent provides no concrete evidence to show that appellant actually received the $1.25 million that Grandpark first paid to Shatto. We acknowledge that the timing of appellant's deposit of $1.25 million on June 22, 2006, suggests he received that amount from Grandpark. However, there is no proof in the record that shows appellant's deposit was actually from Grandpark. To the contrary, the checks and bank statements simply show that the flow of funds ends with HJL Associates, and not with appellant. We thus find appellant met his burden of proof to rebut respondent's determination on this issue, and respondent has not provided any other evidence to show that Grandpark made a distribution to appellant through Shatto and HJL Associates. Thus, we conclude that appellant did not receive $1.25 million as a distribution from Grandpark in 2006.

As for the $490,000 amount that respondent also determined to be an unreported distribution, Grandpark issued a check to appellant in the amount of $490,000 in 2006, and appellant admitted that he received that amount. Appellant, however, asserts that the $490,000 was a shareholder loan from Grandpark. To establish that there was a bona fide loan from

Grandpark to appellant, appellant must show that he had an unconditional obligation to repay the funds and Grandpark had an unconditional intention to secure repayment. (*Baird v. Commissioner,* T.C. Memo. 1982-220.) We find that appellant has failed to provide any evidence of a loan, including a loan agreement, collateral, or repayment or interest charged with regard to the $490,000 amount. Appellant further asserts that the amount was "one of some loan/cash flow transactions" between appellant and Grandpark; however, appellant does not provide any explanation for why this cash flow transaction is not a distribution. Therefore, appellant has not shown respondent erroneously determined that the $490,000 was an unreported distribution to appellant in 2006.

In sum, we find that appellant's unreported distribution of $490,000 offsets his capital contribution of $759,500, and that, contrary to respondent's finding, appellant had at-risk basis in Grandpark at the end of 2006 and continued to have at-risk basis by the end of 2008 of at least $157,080. Consequently, based on the record before us, appellant was entitled to a 2008 NOL carryover of $157,080 to 2011.

HOLDING

Appellant has not shown that respondent erred in its reduction of his 2010 NOL carryover to 2011 with respect to (1) $387,140 of debt repayment income attributable to Grandpark's conversion of its loans to appellant to capital contributions; (2) the $945,605 of suspended losses (losses in excess of basis); and (3) the $1,568,000 of losses subject to the at-risk limitation. Appellant, however, has shown that respondent erred in its finding that appellant received a $1.25 million unreported distribution in 2006, and thus, consistent with our discussion above, appellant is entitled to his entire 2008 NOL carryover of $157,080.

DISPOSITION

Appellant is entitled to carry forward his entire 2008 NOL of $157,080 to 2011. In all other respects, respondent's action is sustained.

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Richard Tay
Administrative Law Judge

We concur:

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Kenneth Gast
Administrative Law Judge

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Teresa A. Stanley
Administrative Law Judge

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