OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **BAY GUARDIAN COMPANY**	) OTA Case No. 18063341

OPINION

Representing the Parties:

For Appellant:	John R. Harper, CPA, Kevin Harper, Jean Brugman, Bruce Brugman
For Respondent:	D'Arcy Dewey, Tax Counsel Bradley Kragle, Tax Counsel IV[1]
For Office of Tax Appeals:	Andrew Jacobson, Tax Counsel III

T. LEUNG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045,[2] Bay Guardian Company (appellant) appeals an action by respondent Franchise Tax Board proposing an assessment of $70,691 in additional tax, plus interest, for the taxable year ended (TYE) April 30, 2013.

Office of Tax Appeals Administrative Law Judges Cheryl L. Akin, Alberto T. Rosas, and Tommy Leung held an oral hearing for this matter on August 26, 2020.[3] At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUES

1. Whether appellant is entitled to deduct its settlement proceeds pursuant to Internal Revenue Code (IRC) section 186 or R&TC section 24678.

[1] Louis Ambrose, Tax Counsel IV, wrote respondent's Additional Brief and Second Additional Brief.

[2] All section references are to laws and regulations operative for the TYE April 30, 2013.

[3] The oral hearing was noticed for Sacramento and conducted electronically due to COVID-19.

2. Whether appellant has established that respondent erred in disallowing appellant's claimed bad debt deduction.
3. Whether appellant has established that it is entitled to claim an additional net operating loss (NOL) deduction for the TYE April 30, 2013.

FACTUAL FINDINGS

General Background

1. Appellant published the *Bay Guardian*, a free alternative weekly newspaper in the San Francisco Bay area from 1966 through May 2012. During the TYE April 30, 2013, appellant was an accrual method taxpayer with a fiscal year ending on April 30th. Appellant sold advertising space using an advertising rate card that accounted for publishing costs, plus a percentage charge that varied based on how often the customer purchased advertising. Appellant routinely offered discounts to weekly advertisers.
2. During the TYE April 30, 2013, appellant received final installment payments totaling $2,719,486[4] stemming from the settlement[5] of a lawsuit for predatory pricing under California's Unfair Practices Act (Bus. & Prof. Code, § 17043) against its competitors (*New Times* defendants).[6] Appellant received its first installment payment of $3,750,000 in 2010 and, during the TYE April 30, 2011, claimed a bad debt deduction of $1,037,000.
3. The court also ordered injunctive relief for appellant with respect to all equitable issues pursuant to Business and Professions Code section 17078, including an order prohibiting the *New Times* defendants from engaging in specified price cutting acts for a 10-year period beginning in 2008.
4. On its tax return for the TYE April 30, 2013, appellant reported an "other" loss of $1,670,213, which on an attached statement appellant explained consisted of the following: (1) "settlement net of fees" of $875,720; (2) "relief of debt" of $770,493; and (3) "honorarium" of $24,000. Appellant reported total deductions of $2,269,928, which

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[4] This amount included $1,842,725 in attorney's fees.

[5] The total settlement amount was $6.5 million; the jury verdict previously awarded appellant $16 million, with approximately $7 million for actual damages and the balance for partial treble damages.

[6] See *Bay Guardian Co. v. New Times Media LLC* (2010) 187 Cal.App.4th 438 (*New Times*); according to the trial court, the "damage period" was from October 2001 to approximately January 2008.

included a bad debt deduction of $1,925,599 and other deductions (business expenses) of $50,661. It is the $1,925,599 bad debt deduction that is the subject of this appeal.

5. After taking other deductions and making adjustments, appellant reported a net loss for state purposes of $64,019 and tax of $800. Because appellant reported a loss, no NOL carryovers or carrybacks were claimed. According to appellant's FTB Form 3805Q, *NOL Computation and NOL and Disaster Loss Limitations – Corporations*, and the Statement 10 attached to that form, appellant reported NOL carryovers from 2002 through 2012. Because appellant did not use any NOLs from 2002 through 2012, appellant's cumulated NOLs totaled the sum of $1,222,923.

6. On the Schedule L Balance Sheet for the TYE April 30, 2013, appellant reported a trade notes and accounts receivable of $1,892,835 at the beginning of the taxable year and $414,373 at the end of the taxable year.

7. Respondent examined appellant's tax returns for the TYE April 30, 2011, the TYE April 30,2012, and the TYE April 30, 2013. The Internal Revenue Service (IRS) did not audit appellant's tax return for the TYE April 30, 2013. In letters dated September 10, 2014, October 17, 2014, and December 31, 2014, respondent requested that appellant provide additional information concerning its claimed bad debt deduction of $1,925,599, including:

   a. a written explanation of the bad debt expenses,
   b. a detailed schedule or the general ledger for the bad debt expense account,
   c. a schedule of debtors who defaulted on their debts,
   d. documentation in support of the debts' worthlessness and the accounting method used to record the bad debt expense,
   e. a schedule of overreported accounts receivable by year beginning in the first year of such overreporting,
   f. a year-by-year break down of the accounts receivable booked at the higher advertising rate detailing the total accounts receivable, accrued discounts, and net accounts receivable,
   g. documents for a sample advertiser to show the account receivable for the advertiser and the amount actually paid by the advertiser,

h. additional information concerning appellant's customers including actual accounts receivable journal entries and invoices, checks and cash receipts journal entries, its accounts receivable trade subsidiary ledger and its other assets ledger, and

i. a schedule of overreported accounts receivable by year showing the discounts provided.

8. Appellant explained that for purposes of showing damages for its lawsuit, beginning in 2005[7] and ending in 2013, it reported on its tax return advertising revenue based on the customary advertising rate, while it contracted with advertisers and charged them at the discounted advertising rate used by the *New Times* defendants; the bad debt deduction of $1,925,599 represented the difference between these two computations. Appellant's controller explained that its attorney in the *New Times* litigation had recommended that appellant offer to customers advertising space at rates equivalent to those of the *New Times* defendants beginning in 2005 as long as they provided a copy of a *New Times* sales contract.

9. Appellant's controller asserted that:

a. the majority of its local clients provided such agreements, which show that they were purchasing advertising space from the *New Times* defendants at below cost prices,

b. appellant changed its bookkeeping at this time,

c. appellant recorded the advertising revenue at the higher, customary price, while "the difference as a result of the matching offer was booked as a discount," which was recorded on appellant's balance sheet as "Other Assets,"

d. after receiving the settlement funds, appellant wrote off the "Other Assets" as bad debts, and

e. this "discounting" occurred through the final settlement payment in 2013.

Appellant's controller further stated that "the sales were recorded at the higher usual and customary rate and [appellant] paid all appropriate taxes based on the higher sales rate." Appellant also asserted that in June 2012, its electronic records

[7] Appellant also asserts it began this practice in 2001, which corresponds with the *New Times* court's finding that the damage period started in 2001.

were transferred as part of the sale of the newspaper assets to San Francisco Print Media Company, which destroyed all of appellant's records about 18 months following the sale.

10. Appellant provided respondent an email dated October 30, 2014, from one of appellant's shareholders to another shareholder. Appellant's shareholder asserted that appellant lacked a year-by-year breakdown of accounts receivable booked at the higher rate and cancelled checks paid by advertisers. Appellant also provided copies of the following documents: (A) balance sheets for the TYE April 30, 2005, through the TYE April 30, 2013; (B) income statements for fiscal years 2006 through 2012; (C) account detail for Virgin Megastore prepared for the *New Times* litigation reporting discounts totaling $75,373.15 for the period January 12, 2000, through October 8, 2003; (D) account detail for Tongue and Groove prepared for the *New Times* litigation reporting discounts totaling $4,718.33 from March 22, 2000, through October 26, 2005; and (F) appellant's exhibits from the *New Times* litigation showing 6,880 discounted advertisements from 1999 through 2007.

11. Appellant provided respondent with an email dated December 18, 2014, from appellant's controller to one of appellant's shareholders, which stated that appellant's old accounting records had been destroyed but that the "changes on the tax returns accurately reflect the year to year changes."[8]

12. The $1,925,599 did not represent "bona fide" debt.

13. In a position letter to appellant dated April 1, 2015, respondent stated that, as a result of its audit, it had revised appellant's reported income for the TYE April 30, 2011, from -$118,131 to $11,664, an increase of $129,795, but that appellant owed no additional tax for this taxable year. Respondent also stated that it allowed appellant an NOL deduction of $11,664, which reduced appellant's taxable income for the TYE April 30, 2011, to $0, resulting in a revised NOL carryover amount of $887,257. Respondent stated that appellant did not owe any additional tax for the TYE April 30, 2012.

14. In a position letter dated April 27, 2015, respondent informed appellant that it was denying appellant's claimed bad debt deduction of $1,925,599 for the TYE

[8] The attachments to this e-mail are not in the record.

April 30, 2013.[9] Respondent noted that it had requested that appellant provide a breakdown for all taxable years from 1999 through 2012, in which it listed the accounts receivable booked at the higher customary rate and the discounts that resulted in the bad debt expense, but that appellant had failed to provide the requested documentation.

15. On June 3, 2015, respondent issued a Notice of Proposed Assessment (NPA) for the TYE April 30, 2013, proposing to disallow appellant's claimed bad debt expense deduction of $1,925,599, and increase appellant's income from the *New Times* litigation by $1,041 and gain from the sale of its business assets by $86,038. This increased appellant's reported net income from -$64,019 to $1,948,659, an increase of $2,012,678. After allowing appellant an NOL carryover of $1,138,946, the NPA revised appellant's taxable net income to $809,713 and proposed additional tax of $70,779.

16. Appellant protested respondent's disallowance of the bad debt deduction, while conceding the remaining adjustments.[10]

17. During the protest, respondent requested that appellant show that it had previously reported taxable income of $1,925,599. In a letter to respondent dated February 21, 2017, appellant stated that, "[t]he only place for a credit of $1,925,599 is on the income statement, which is exactly where it was posted from 2004 thru 2010. Remember, the debts [*sic*] have to equal the credits to generate a debt (accounts receivable) of $1,925,599 there has to be credits (income) of 1,925,599." Appellant submitted the following additional documentation: (A) account detail for the UPS Store prepared for the *New Times* litigation reporting discounts totaling $1,366.36 from November 12, 2003, through August 31, 2005; and (B) comparative balance sheets for calendar years ending December 31, 2004, through December 31, 2008.

18. Respondent asserts that it compared appellant's returns for taxable years 2006 through 2012, (as well as respondent's analysis of appellant's 2004 and 2005 returns) and found that appellant had failed to substantiate accruals for contingent litigation gains (unbilled

[9] Respondent also determined that appellant understated its (1) settlement payments from the *New Times* litigation net of attorney's fees by $129,795 and $1,041 for the TYE April 30, 2011, and the TYE April 30, 2013, respectively, and (2) gains from the sale of its business assets by $86,038 for the TYE April 30, 2013. These items are not at issue in the current appeal.

[10] On appeal, appellant only addresses respondent's disallowance of its reported bad debt expense deduction of $1,925,599. Therefore, we will not discuss the other two adjustments reflected in the NPA.

discounts). As a result, respondent concluded that appellant was not entitled to a bad debt deduction of $1,925,599 for the TYE April 30, 2013.

19. On May 31, 2018, respondent issued a Notice of Action (NOA) affirming the disallowance of appellant's $1,925,599 claimed bad debt expense deduction. The NOA increased the allowed NOL carryover from $1,138,946 to $1,139,934, an increase of $988,[11] revised appellant's taxable net income to $808,725 and reduced the proposed assessment of additional tax to $70,691. The NOA stated that for the TYE April 30, 2013, appellant's NOL carryover had been reduced to $0.

Additional Briefing Request

20. On April 10, 2019, the Office of Tax Appeals (OTA) requested additional briefing from appellant to explain under what authority it could have alternatively reported its bad debt deduction as an NOL carryover.

21. In its additional brief, appellant did not provide any additional legal or accounting authority and simply repeated its argument that respondent was recognizing appellant's settlement income twice by denying the bad debt deduction while accepting appellant's reported income of $875,720 from its settlement proceeds.[12]

DISCUSSION

Issue 1: Whether appellant is entitled to deduct its settlement proceeds pursuant to either IRC section 186 or R&TC section 24678.

IRC section 61(a)(2), as incorporated by R&TC section 24271, defines gross income to include gross income derived from business. IRC section 186(a), as incorporated by R&TC section 17201(a), allows individuals to deduct from gross income amounts received or accrued during the taxable year for a compensable injury. As relevant to this appeal, the term "compensable injury" means an injury "sustained in business, or to property, by reason of any conduct forbidden in the antitrust laws for which a *civil action may* be brought under section 4 of the [Clayton Act]." (IRC, § 186(b)(3), emphasis added.) The term "compensatory amount"

[11] Respondent increased the NOL deduction for the TYE April 30, 2013, based on an NOL carryback of $988 from the TYE April 30, 2014.

[12] In a second additional brief, appellant provided copies of the following documents: (A) Verdict Form dated March 5, 2008, from appellant's *New Times* litigation; and (B) an article describing appellant's efforts to collect its judgment against the *New Times* defendants.

means the amount that the taxpayer received or accrued during the taxable year as damages resulting from "an award in, or in settlement of, a *civil action* for recovery for a compensable injury, reduced by any amounts paid or incurred in the taxable year in securing such award or settlement." (IRC, § 186(c), emphasis added.)

Section 4 of the Clayton Act, as codified at United States Code, title 15, section 15, provides in relevant part that any person whose business or property was injured by "anything forbidden in the antitrust laws" may file an action in any United States district court "and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." Section 3 of the Robinson-Patman Act, as codified at 15 U.S.C. section 13a, provides in relevant part that it is unlawful for any person engaged in commerce to knowingly discriminate against a purchaser's competitors by granting the purchaser any discount, rebate, allowance, or advertising service charge, or to contract to sell goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor. However, the U.S. Supreme Court has held that only a criminal action can be brought for a violation of section 3 of the Robinson-Patman Act. (*Nashville Milk Co. v. Carnation Co.* (1958) 355 U.S. 373, 382.) However, for Corporation Tax Law purposes, California does not conform to IRC section 186,[13] but has its own stand-alone provision. (See R&TC, § 24678.) This California analog to IRC section 186 for corporations restricts the deduction to only damages awarded following a lawsuit filed under the Clayton Act, and then only for those damages that would have been included in income if the injury had not occurred (i.e., actual damages). (See R&TC, § 24678.) Because appellant's predatory pricing lawsuit was brought under California law (Bus. & Prof. Code, § 17043), and not the Clayton Act, R&TC section 24678 is not applicable.

<u>Issue 2: Whether appellant has established that respondent erred in disallowing appellant's claimed bad debt deduction</u>.

Income tax deductions are a matter of legislative grace and a taxpayer has the burden of proving its entitlement thereto. (See *INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code

[13] See R&TC, § 24341.

Regs., tit. 18, § 30219(c).) There is a presumption of correctness as to respondent's denial of deductions. (*Appeal of Janke* (80-SBE-059) 1980 WL 4988.)

A business bad debt deduction against ordinary income is allowed in the year the obligation becomes partially or totally worthless. (IRC, § 166(a); R&TC, § 24348; *Redman v. Commissioner* (1st Cir. 1946) 155 F.2d 319.) A bad debt must be a bona fide debt that "arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable amount of money." (Treas. Reg. § 1.166-1(c); see also *Adelson v. United States* (Fed. Cir. 1984) 737 F.2d 1569, 1571.) A taxpayer claiming a bad debt deduction has the burden of proof to establish a deductible bad debt loss. (*Appeal of Credo Developers, Inc.* (84-SBE-028) 1984 WL 16108.) The determination of whether a particular debt is a bona fide debt for tax purposes depends on the facts and circumstances of each case. (*Segel v. Commissioner* (1987) 89 T.C. 816, 827.) The lack of formal debt instruments and agreements as to security, time for repayment, and obligation to pay interest is significant evidence that the transaction did not give rise to a bona fide debt. (*Kean v. Commissioner* (1988) 91 T.C. 575, 595-596.) A bad debt must be accounted for in the year in which it becomes worthless. (IRC, § 166(a)(1).) No deduction may be allowed for a particular year if a bad debt became worthless before or after that year. (*Redman v. Commissioner, supra*; *Appeal of Kune* (84-SBE-106) 1984 WL 16186.) The standard for the determination of worthlessness is an objective test of actual worthlessness, a time which is fixed by an identifiable event or events that furnish a reasonable basis for a taxpayer to abandon any hope of future recovery. (*Appeal of Southwestern Development Company* (85-SBE-104) 1985 WL 15875.)

Here, appellant has not established its right to claim a bad debt deduction of $1,925,599 for the TYE April 30, 2013. Appellant asserts that the claimed bad debts of $1,925,599 represent sales of advertising space that were reported on its prior returns as having been sold at the customary rate rather than the actual discount rate from 2004 (or as early as 1999) to 2013. However, the record shows that there were no bona fide debts. Appellant states that it recognized the income beginning in 2004 and that "the only way the accounts receivable was generated was by reporting income." Appellant also argues that its tax reporting "resulted in an overstatement of income by $1,925,599." An email dated October 30, 2014, from one shareholder to another, indicates that appellant did not actually charge most customers for the advertisements at market price, but in fact charged only the discounted rate.[14]

Appellant's advertising customers contracted to purchase advertising space at the discounted rate. As appellant admits, these customers had no obligation to pay any amounts above and beyond the discounted rate. While appellant engaged in forensic accounting to account for its lost profits in preparation for litigation, there were no actual receivables as its advertisers were not obligated to pay the customary advertising rate; thus, appellant did not incur any bona fide debt with respect to the unbilled difference between the customary price of the advertisements and the discounted price which would qualify it for a bad debt deduction under IRC section 166. Therefore, appellant failed to satisfy its burden of showing that any debt existed. (See Treas. Reg. 1.166-1(c); *Appeal of Credo Developers, Inc.*, *supra*.)

Even though the IRS has never questioned appellant's tax returns for the TYE April 30, 2013, or for any of the years before, respondent is not affected by the IRS's failure to question appellant's reporting and may come to different conclusions about appellant's claimed deductions. Moreover, respondent and OTA are not bound to adopt the conclusion reached by the IRS in any particular case, even when the determination results from a detailed audit. (*Appeal of Bertrand* (85-SBE-071) 1985 WL 15852; *Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.)

Therefore, appellant has failed to show error in respondent's disallowance of its bad debt deduction.[15]

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[14] The email states: "The Bay Guardian discounted 6,889 [*sic*] ads in the period from1999 to 2007 . . . This represents a portion of the discounting that occurred and is approximately 75% of the Bay Guardian clients from 1999 - 2007. The discounting continued from 2007 to May 2012 when the paper was sold. *Once a client got on the discount rate, it was almost impossible to get them back to the rate card price*." (Emphasis added.)

[15] Appellant also argues that the $1,925,599 may represent an accrual of its damages or the settlement award in the *New Times* litigation. Even if appellant could prove, by a preponderance of the evidence, that the $1,925,599 was a bona fide debt owed to it by the *New Times* defendants, it cannot deduct amounts attributed to discounts given to its advertisers outside of the damage period. Because appellant was protected from these improper practices going forward and had received a damage award for its prior damages, there was no need for appellant to continue its practice of reporting discounts as revenue following the damage award and injunction in May of 2008. Moreover, under this theory, appellant has failed to show how much of the $1,925,599 was attributable to nondeductible partial treble damages, rather than compensatory damages.

Issue 3: Whether appellant has established that it is entitled to claim an additional NOL deduction for the TYE April 30, 2013.

R&TC sections 24416.20 and 24416.21 incorporated into California law with many modifications IRC section 172. An NOL is defined in general as the excess of allowed deductions over gross income. (IRC, § 172(c).) IRC section 172(a) allowed a deduction for the taxable year for an amount equal to the aggregate of (1) the NOL carryovers to such year; plus (2) the NOL carrybacks to such year. During 2013, the IRC generally allowed an NOL for any taxable year to be (1) carried back to each of the two taxable years preceding the taxable year of such loss, and (2) then carried forward to each of the 20 taxable years following the taxable year of the loss. (IRC, § 172(b)(1)(A).)

From 1999 through 2012, the period for which appellant claims to have generated NOL carryovers, California placed many restrictions on businesses that claimed NOL deductions. In general, R&TC section 24416.20 modified IRC section 172(b)(2) by reducing the NOL that could be carried over to any subsequent years from 100 percent to 50 percent for 1999 or any prior taxable year, 55 percent for 2000 and 2001, and 60 percent for 2002 and 2003, before reverting to 100 percent for 2004 and afterwards. With limited exceptions, California did not allow NOL deductions for the 2008, 2009, 2010, and 2011 taxable years. (R&TC, § 24416.21(a).) R&TC section 24416(e) modified IRC section 172(b)(1)(A) by reducing the carryover period for these taxable years from 20 years to five years from 1987 through 1999, and 10 years from 2000 through 2007. California then generally extended the NOL carryover period by 4 years for losses incurred in taxable years beginning before 2008, 3 years for losses incurred in 2008, 2 years for losses incurred in 2009 and 1 year for losses incurred in 2010, before conforming once again to the 20-year carryover period under IRC section 172(b)(1)(A). (R&TC, § 24416.21(b).)

To claim an NOL deduction, a taxpayer must: (1) compute the NOL for any preceding or succeeding taxable year from which an NOL may be carried over or carried back to such taxable year, (2) compute the NOL carryovers to such taxable year from such preceding taxable years and the NOL carrybacks to such taxable year from such succeeding taxable years, and (3) add such NOL carryovers and carrybacks to determine the NOL deduction for such taxable year. (Treas. Reg. § 1.172-1(b).) "In determining the amount of any [NOL] carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year." (Treas. Reg. § 1.172-1(e)(1).) "Every taxpayer claiming [an NOL] deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the [NOL] deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the [NOL] deduction." (Treas. Reg. § 1.172-1(c).)

Deductions are a matter of legislative grace, and the taxpayer bears the burden to establish entitlement to an NOL deduction. (*See New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 450; *Appeal of Telles* (86-SBE-061) 1986 WL 22792.) "A taxpayer claiming an NOL deduction bears the burden of establishing both the existence of the NOL and the amount of any NOL that may be carried over to the subject years." (*Scharringhausen v. Commissioner*, T.C. Memo. 2012-350; see also Cal. Code Regs., tit.18, § 30219(a).)

Appellant contends that disallowing a bad debt deduction, an NOL, or a write-off of accounts payable in the amount of $1,925,599 results in a worthless asset on its balance sheet. Appellant asserts that if it uses proper double entry accounting, the balance sheet of the dissolved corporation will show total assets and liabilities of zero, and the same income will only be recognized once.[16] Appellant argues that, even if it is not entitled to claim a bad debt deduction of $1,925,599, it may still claim an equivalent NOL deduction based on its prior reporting of overstated income from its recorded sale of newspaper advertising at full price that was recognized for tax purposes in prior tax years. Appellant asserts that it could have filed tax returns between 2004 and 2013 by "reducing the accounts receivable and increasing the companies' Net Operating Loss Carry Forward . . . , remembering that the accounts receivable in question arose by reporting income in prior years." Appellant states that it "should never have overstated its income and recorded accounts receivable during the period contested in [its] lawsuit." Accordingly, these NOLs were not previously reported by appellant and were wholly or largely generated prior to the TYE April 30, 2013, and would need to be carried over to the TYE April 30, 2013.

[16] Appellant asserts that if its claimed deduction of $1,925,599 is disallowed, its income has been overstated by an identical amount. Appellant argues that it received a settlement installment payment of $2,719,486 in the TYE April 30, 2013, from which it subtracted legal fees of $1,842,725, resulting in a duplicate income of $875,720 that has already been reported in prior years. As discussed *infra*, appellant has failed to prove, by a preponderance of the evidence, that it overreported its income in prior years. Appellant received its first settlement installment payment of $3,750,000 during the TYE April 30, 2011. As noted below, appellant already took a bad debt deduction of $1,037,000 for the TYE April 30, 2011, which suggests that appellant might have already reduced its income at that time.

Appellant indicates that it discounted 6,880 advertisements (which it says represents about 75 percent of its clients) between 1999 and 2007, which is supported by an exhibit used during the *New Times* litigation. While appellant has established that it provided discounts to its customers, appellant has failed to provide detailed accounting records which would establish that these discounts were recognized as revenue on its prior tax returns, and if so recognized, the amount of "discount" revenue recognized in each of the prior tax years such that the additional NOL available to be carried over to appellant's TYE April 30, 2013, can be computed with any degree of certainty. Appellant asserts that its accounting records were destroyed following the sale of its newspaper business in May 2012, and in lieu thereof, appellant provided income statements, balance sheets, and customer sales data that were prepared for the *New Times* litigation to document its NOLs. However, appellant's internal accounting is relevant only to the extent that it ties into its returns; here, appellant has failed to tie its internal accounting records to its reporting of revenues on its tax returns for the applicable prior taxable years. Once again, appellant's burden in this appeal is not to balance its books, but to prove, by a preponderance of the evidence, that it overstated its income on its returns for prior taxable years.

Appellant also has not been clear or consistent in delineating the period during which it purportedly overstated its taxable income by reporting the customary price of advertising space as revenue, rather than the discounted price that it actually charged. In its opening brief, appellant asserts that it began to record and report overstated income in 2004 but does not state when the accruals stopped. In correspondence with respondent, appellant claims that it accrued these unbilled discounts between 2004 and 2008; according to appellant's controller, this period was from 2005 through 2013; according to one of appellant's shareholders, this period was between 1999 and May 2012. However, the *New Times* court awarded damages to appellant for the period covering October 2001 through approximately January 2008, and yet the record does not include any tax returns for the TYE April 30, 2000, to the TYE April 30, 2007. Thus, based on this paucity of evidence, we have no means of determining whether appellant overreported its income for these periods. Accordingly, the account detail for Virgin Megastore for the period January 12, 2000, through October 8, 2003, the account detail for the UPS Store for the period November 12, 2003, through August 31, 2005, and the account detail for Tongue and Groove for the period March 22, 2000, through October 19, 2005, which total approximately $82,000, do not establish that appellant overstated its taxable income by $1,925,599. The only document showing NOL carryforwards is the statement attached to appellant's FTB Form 3805Q, which, as discussed below, is incomplete and has been changed by respondent's audits of the TYE April 30, 2011, and the TYE April 30, 2013. We therefore find that appellant has failed to establish, by a preponderance of the evidence, that it had any additional NOL carryforwards from the TYE April 30, 2000, through the TYE April 30, 2007.

In addition, appellant's prior years' tax reporting does not show how appellant accumulated the claimed additional NOL carryovers of $1,925,599. For the TYE April 30, 2007, appellant claimed an NOL carryover deduction of $36,605, which negated net income of $36,605, resulting in a net income for tax purposes of $0. During the TYE April 30, 2008, through the TYE April 30, 2012, as reflected in part on appellant's Statement 10 attachment to its TYE April 30, 2013 FTB Form 3805Q showing NOL carryovers from 2002 through 2011, appellant reported only net losses for state tax purposes and was not able to claim any NOLs. However, respondent revised appellant's return on audit for the TYE April 30, 2011 (the year when appellant received its installment payment of $3,750,000 from the *New Times* lawsuit), by increasing its taxable income from -$118,131 to $11,664, and allowing appellant an NOL deduction of $11,664, which reduced appellant's taxable income for the TYE April 30, 2011, to $0; at the hearing, appellant testified that its tax return for this period also included a bad debt deduction of $1,037,000, which respondent allowed.[17] While the NOA for the TYE April 30, 2013, disallowed the bad debt deduction of $1,925,599, it allowed appellant an NOL carryover of $1,139,934, resulting in a revised taxable net income of $808,725. Again, without sufficient documentation, we cannot determine whether the TYE April 30, 2011 $1,037,000 bad debt deduction and the TYE April 30, 2013 NOL deduction of $1,139,934 includes some or all of the same customer discounts for which appellant is now seeking an additional NOL deduction of $1,925,599; clearly, if they do, then allowing appellant a further $1,925,599 deduction would convert the claimed double taxation event into a double deduction.

[17] Appellant reported "other deductions" on Schedules L of its returns during these years, including a large and disproportionate deduction of $2,826,238 for the TYE April 30, 2011, for which the attached schedule was not provided to us and whose purpose appellant has not explained. We note that appellant used the other deductions line for the TYE April 30, 2013, to report a deduction of $1,670,213, which included its settlement amounts (after expenses and fees) of $875,720. Thus, appellant has used this line for deductions related to its litigation with *New Times* and affiliates in other taxable years. Because appellant entered into the Settlement Agreement in December 2010, and received its initial settlement payment not long thereafter, it appears that appellant might have already taken substantial deductions related to its purported overreporting during the TYE April 30, 2011.

It is well established that taxpayers who claim deductions must keep sufficient records to substantiate the claimed deductions. (*Sparkman v. Commissioner* (9th Cir. 2007) 509 F.3d 1149, 1159.) A taxpayer's inability to produce records does not relieve the taxpayer of their burden of proof. (*Villarreal v. Commissioner*, T.C. Memo. 1998-420.) When a taxpayer's records have been lost or destroyed through circumstances beyond its control, it is entitled to substantiate the deductions by reconstructing the expenditures through other credible evidence. (*Priestly v. Commissioner*, T.C. Memo. 2003-267.)

Here, the record shows that respondent offered appellant numerous opportunities to substantiate its $1,925,599 deduction through documentation such as invoices, which it failed to do. During the oral hearing, appellant's witness testified that appellant did not attempt to search through any of the *New Times* litigation files the court might have possessed to obtain such substantiation. Appellant's argument that it had to balance its books with the $1,925,599 deduction does not suffice; without providing the requested documentation, neither respondent nor OTA can reconcile the extraordinary manner appellant chose to report its income with the amount of income on which it was lawfully subjected to tax; even appellant indicated during the hearing that it was uncertain why there was a $1,037,000 bad debt deduction for the TYE April 30, 2011.[18] The lack of substantiation and the high degree of uncertainty prevents appellant from satisfying its burden of proof.

In addition, respondent requires that a taxpayer wishing to carry over an NOL from a year in which it has a net loss for state tax purposes to a future year in which it recognizes net income must file an FTB Form 3805Q.[19] Appellant has not provided copies of these forms for any taxable year, except for the TYE April 30, 2013.

Appellant has thus failed to satisfy its burden of providing adequate records to support its NOL deduction. (*New Colonial Ice Co. v. Helvering, supra*, 292 U.S. at p. 450; *Scharringhausen v. Commissioner, supra*, T.C. Memo. 2012-350.) Hence, appellant has failed to show that it is entitled to claim an NOL deduction of $1,925,599 for the TYE April 30, 2013.

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[18] Appellant's comparative balance sheets for calendar years ending December 31, 2004, through December 31, 2008, also do not support appellant's tax reporting, because they are for different periods than the returns.

[19] See 2008 Corporation Income Tax Booklet, pp. 12-13; 2008 Instructions for Form 3805Q, p. 1.

HOLDINGS

1. Appellant is not entitled to deduct its settlement proceeds pursuant to IRC section 186 or R&TC section 24678.
2. Appellant has not established that respondent erred in disallowing appellant's claimed bad debt deduction.
3. Appellant has failed to establish that it is entitled to claim an additional NOL deduction for the TYE April 30, 2013.

DISPOSITION

Respondent's action is sustained.

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

DocuSigned by:
Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

DocuSigned by:
Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

Date Issued: 12/2/2020