

Appeal of Faria Dairy, Inc.

The sole issue in this appeal is whether respondent properly denied appellant a business expense deduction for the purchase of bull semen in the amount of **\$80,580.**

Appellant, Faria Dairy, Inc. (**Faria**), operates a dairy farm, and owns all the stock of its subsidiary, Golden State Breeders, Inc. (Golden State). The latter keeps bulls for the production of semen to impregnate cows.

Subsequent to filing its 1980 corporate franchise tax return with a balance due of \$5,678, **appellant** filed an amended return reflecting an **overpayment** of \$7,615. According to appellant, the overpayment was a result of its failure to properly **take a** business expense deduction as provided in section 24343, for the purchase of bull semen. The amended return was treated as a claim for refund, which respondent denied. This timely appeal followed.

For the income years ended September 30, 1978, through 1983, **appellant** incurred the following breeding fees:

<u>Income Year</u> <u>Ended</u>	<u>Breeding Fees</u>
9/30/78	\$9,826
9/30/79	\$5,179
9/30/80	\$4,420 (85,000 [amended]) ^{2/}
9/30/81	\$5,455
9/30/82	-0-
9/30/83	-0-

Appellant argues that payments for its purchases of bull **semen** were incorrectly listed as loans on **its** books. When appellant learned of the error, it was corrected to properly reflect the purchase of bull semen. According to appellant, Golden State was continually short of cash and had incurred substantial losses for several years. As a consequence, between January 1, 1980, and September 30, 1980, several cash transfers were **made from** Faria to Golden State. The accountant for both

2/ Appellant's amended corporate return **for** income year 1980 increases the breeding fee \$80,580 for a total breeding fee of \$85,000.

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Golden State and Faria originally recorded these transfers as loans. The "loans" were carried as such on the records of both companies until the summer of 1983. At that **time** the accountant prepared a number of financial statements which were required because both companies **were** trying to obtain refinancing. While examining the financial statements of the companies, Faria's president, Yr. Frank Faria, noted the discrepancy and informed his accountants that the loans should have been **paid** back to Faria by charging Faria for breeding services. He then asked his accountants to prepare amended tax returns for the two companies to properly claim the breeding fees. (Resp. Br., Ex. B.)

According to the accountants, because Golden State had always reported large losses on its tax returns, the change in income did not result in any taxable income for Golden State and because Faria had always had substantial taxable income, the charge for breeding services would not reduce **Faria's** tax to the minimum tax for any **year**. The accountant "decided that the process of amending the tax returns could be simplified by taking all of the charge in the year ended September 30, 1980, in which **Faria Dairy, Inc.** advanced the money to Golden **State.**" (Resp. Br., Ex. B.)

In response to appellant's claim for refund, respondent requested copies of canceled checks and detailed records for the bull semen transactions. Appellant submitted a portion of its general ledger which lists the amounts of **\$57,150.00, \$17,596.89, and \$3,000.00** transferred to Golden State Breeders, Inc., without specifying the purpose of the transfers. The ledger also lists additional amounts of **\$1,111.48, \$1,036.32, and \$685.50** transferred to Golden State Breeders, Inc., for "equipment" sold to appellant. Appellant explained it was unable to submit canceled checks because records of transactions between appellant and its subsidiary were **made** by journal entries. Upon examination of the journal **entries**, respondent determined that the entries for the two corporations do not indicate that amounts totaling \$80,580, transferred to Golden State, were for breeding **services**.

Respondent argues that appellant is not entitled to a business expense deduction **because** it has offered no evidence to substantiate its **adjustments** to gross income. **We** agree. Throughout the income year, appellant's transactions with Golden State were entered as loans. Appellant admits that Golden State **"was** continually short on

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cash." In fact, appellant's accountant surmised the amounts transferred to Golden State **"were** intended to be loans" because of the "substantial losses for several **years**" of appellant's subsidiary. Later, in October 1983, appellant claims **that** it discovered its failure to take a business expense deduction for bull semen fees; however, the ledger pages submitted by **appellant** do not indicate that **amounts** transferred to Golden State were for the purchase of bull semen. In fact, three entries in appellant's general ledger indicate **\$2,833.30** of the total amount of **\$80,580.00** was transferred to the subsidiary for **"equipment."** We agree with respondent that it stretches the imagination to expand the term "equipment," **as listed** in the ledger, to encompass bull semen. Moreover, the ledger entries for Faria and Golden State specifically indicate the amount of \$685.50 was for the purchase of a camera for Frank Faria. Additionally, appellant fails to set forth the number of breedable dairy cows, the total amount of bull semen needed to impregnate the **cows**, and the total amount of bull semen purchased for the year at issue.

Our inquiry does not end here. Respondent seems to **rely on** the fact that appellant has failed to substantiate the use of the bull semen during the appeal year. However, **it** appears **from** the documents submitted that, although **all** the payments for the bull semen occurred **in** the year ended September 30, 1980, there is a possibility that appellant was prepaying the amount and that it could have allocated the payments to other income years. (See **Resp. Br., Ex. B.**) **However**, while this may explain why appellant was unable to provide further documentation concerning the use of the bull semen for the income year in question, we have been presented with no evidence to support a prepayment theory other than the fact that no bull semen purchases were made for income years ended September 30, 1982 and 1983. Because of the lack of any evidence to the contrary, we must therefore agree with respondent's conclusion that all the bull **semen** was purchased for the income year ended September 30, 1980, since additional amounts were deducted in the next income year (1981).

Tax deductions are a matter of legislative grace, and the burden is on the taxpayer to show he is entitled to the deductions claimed. (New Colonial Ice Company v. **Helvering**, 292 U.S. 435 [78 L.Ed. 1348] (1934).) An ~~expenditure~~ **expenditure** is not deductible under section 24343 where there is no corresponding benefit received by the taxpayer as the result of the expenditure. (See

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Interstate Transit Lines v. Commissioner, 319 U.S. 590, 594 [37 L.Ed. 1607] (1943): Appeal of Jenkel-Davidson Optical Co., Cal. St. Bd. of Equal., Aug. 19, 1981. A related corporation, be it parent or subsidiary, may not deduct as ordinary or necessary business expenses amounts paid to cover the operating costs of its parent or subsidiary unless the payment is directly attributable to a corresponding benefit or service rendered. (Appeal of Jenkel-Davidson Optical Co., supra.) Appellant must present some evidence of expenses actually incurred in order to meet its burden of proof. It has failed to do so. As such, respondent's actions in this matter must be sustained.

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ORDER

Pursuant to the views expressed in the opinion of the board **on file** in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the **action** of the Franchise Tax Board in denying the claim of Faria Dairy, Inc., for refund of franchise tax in the amount of \$7,615 for the income year ended September 30, **1980**, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day
Of April , 1986. by the State Board of Equalization,
with Board **Members** Mr. Nevins, Mr. **Collis**, Mr. Bennett and
Mr. Harvey present.

Richard Nevins, Chairman
 Conway H. Collis, Member
 William M. Bennett, Member
 - Walter Harvey*, Member
 _____, Member

*For Kenneth Cory, per Government Code section 7.9