BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
C. PARKES,) OTA NO. 18103936
)
APPELLANT.)
)
__________________________________)

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Wednesday, December 14, 2022

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings, taken at 12900 Park Plaza Dr., Cerritos, California, 91401, commencing at 9:55 a.m. and concluding at 11:18 a.m. on Wednesday, December 14, 2022, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ RICHARD TAY
Panel Members:	ALJ CHERYL AKIN ALJ OVSEP AKOPCHIKYAN
For the Appellant:	JOSEPH VINATIERI PATRICIA VERDUGO J. MATRANGA
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD DAVID HUNTER

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-25 were received at page 6.)

(Department's Exhibits A-I were received at page 6.)

PRESENTATION

CLOSING STATEMENT

Cerritos, California; Wednesday, December 14, 2022

9:55 a.m.

JUDGE TAY: We are opening the record in the Appeal of Parkes before the Office of Tax Appeals, Case Number 18103936. This hearing is being convened in Cerritos, California, on December 14th, 2022.

Today's case is being heard and decided equally by a panel of three judges. My name is Richard Tay, and I'll be acting as the lead judge for the purpose of conducting this hearing. Also on the panel with me today are Judges Cheryl Akin and Ovsep Akopchikyan.

Will the parties introduce themselves for the record, beginning with the Appellant.

MS. VERDUGO: Patricia Verdugo for Craig Parkes.

MR. VINATIERI: Joseph Vinatieri, Bewley, Lassleben & Miller, on behalf of the Appellant.

JUDGE TAY: Thank you. Mr. Vinatieri, would you please move the mic a little bit closer to you.

MR. VINATIERI: I think we had this issue last time as I recall. Sorry.

JUDGE TAY: That's okay. I think that will be okay.

MR. VINATIERI: There we go.

JUDGE TAY: All right. And Respondent.

MR. HUNTER: David Hunter, H-u-n-t-e-r, on behalf of Respondent Franchise Tax Board.

JUDGE TAY: Thank you, Mr. Hunter.

The issues we'll discuss today is whether Appellant has shown Respondent erred in its proposed assessment of additional tax for the 2008 tax year.

Prior to the hearing we circulated the exhibits submitted by both parties in a file we call the "hearing binder". It contains Appellant's Exhibits 1 through 25 and FTB's Exhibits A through I. There were no objections to admitting the exhibits into the record.

Is that right, Appellant?

MR. VINATIERI: That's correct.

JUDGE TAY: And Respondent?

MR. HUNTER: That's correct.

JUDGE TAY: Thank you.

The exhibits will now be admitted into evidence.

(Appellant's Exhibits 1-25 were received in evidence by the Administrative Law Judge.)

(Department's Exhibits A-I were received in evidence by the Administrative Law Judge.)

We will start with presentations, and I believe Appellant has one witness that they would like to produce. I would like to swear Mr. Matranga in, if that's okay at this point.

So Mr. Matranga, if you don't mind, you can bring your chair up to the table so that you're close to a microphone.

MR. MATRANGA: Okay.

JUDGE TAY: And if you would just stand and please just raise your right hand. Thank you.

J. MATRANGA,

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

JUDGE TAY: Thank you.

Okay. Appellant, you have 60 minutes. Please begin whenever you're ready.

MR. VINATIERI: Thank you.

PRESENTATION

MR. VINATIERI: So good morning and thank you for the opportunity to present our case this morning, and we recognize it's taken some time for this case to get to oral hearing. It's been a bit of a time. As a prefatory item the case was initially handled by different counsel for Appellant. We took over the matter, and shortly thereafter Covid hit. So as part of our research and our preparation, we were able to procure further documentation that had not apparently been previously presented at audit or at protest.

Information about the sale of the company, repayment of the loans in 2016 had not been previously provided until we were engaged, and we requested an update and review of the file. This appears to have caused consternation at the FTB. However, it's always been best as far as we're concerned to try to procure all the facts to make sure we have a complete record. So let's just briefly highlight the issues and the relevant facts.

So to take off on your issue, Judge Tay, to give little more depth, the issue here is whether it was Craig Parkes, the Appellant, or Anderson Audio Visual, Inc., Mr. Parkes wholly owned S corp, that made the capital contributions to the two limited partnerships, Anderson Security San Diego LP, otherwise known as Anderson Security, and to One Touch Audio and Video Integration LP -- we call it One Touch -- and as a result whether Mr. Parkes has basis in Anderson Security and One Touch to report certain flow-through losses.

Our position, of course, is that here Mr. Matranga is going to explain how the S corporation acted as what we call an incorporated pocket book -- and that comes out of a case -- an incorporated pocket book for Mr. Parkes and related entities, meaning that the S corp made payments on behalf of Mr. Parkes and other related entities and then made corresponding journal entries. You're going to hear all about that.

We're also going to provide evidence that these payments were treated as loans from the S corp to Mr. Parkes with subsequent contributions to the limited partnerships, increasing Mr. Parkes' basis in those limited partnerships. And we will show evidence that these loans to Mr. Parkes were repaid in 2016 when he sold his business interest in the S corp and the related entities. So as far as the law is concerned, and it's been pretty well briefed, going through the briefs on this. But the law says we -- the courts have basically upheld basis increases where there was back-to-back loans in contributions among related parties and where a controlled entity acts as the taxpayer's incorporated pocketbook.

So we note those cases in our briefs, but we're going to note them just briefly here. First of all, the tax court summarizes this line of case, in quote, Even though in each case the money never actually passes through the taxpayer's hands, we treat the transaction as a back-to-back loan involving the taxpayer because a controlled entity had acted as the taxpayer's, quote, incorporated pocketbook routinely paying off taxpayer's expenses on his behalf.

The court there, held that each taxpayer had made an economic outlay -- an economic outlay despite the fact that the money came from a related lender, i.e., the controlled entity. In approving the back-to-back loan structure, we have the court specifically noted that the transfers were made with a valid purpose of providing the S corporation with working capital -- with working capital. Thus, the court concluded that assuming such a valid purpose exist, taxpayers are generally free to arrange the transaction in a tax minimizing fashion. And this is Kerzner v Commissioner that we've previously delineated.

Well, similarly here the transfers were made with the valid purpose of providing the partnerships -- those other partnerships we talked about -- with working capital. Even if it were found that the structure was adopted in order to achieve tax basis for Mr. Parkes, that would not invalidate the transaction because taxpayers are free, of course, to arrange the transaction in a tax minimizing fashion. As such, the payment expenses by AAV, the S corp, on behalf of the partnerships, was properly recorded as contributions by Mr. Parkes increasing Mr. Parkes' basis in those partnerships.

Here, Mr. Parkes had a valid secured line of credit from the S corp, which specifically stated that the S corp could distribute funds to Mr. Parkes, either directly to him or by making payment on his behalf. That is exactly what happened here. The books, the tax returns, the financial statements were kept by Certified Public Accountant Joseph Matranga of San Diego, who you just swore in.

We have Mr. Matranga here today to go through and discuss the AAV family, and I say family -- you're going to hear all about that -- discuss Mr. Parkes and the sale of that family in November of 2016. So with that we call CPA Joseph Matranga, and co-counsel Patricia Verdugo will handle Mr. Matranga's examination.

Thank you.

MR. MATRANGA: Good morning.

DIRECT EXAMINATION

BY MR. VINATIERI:

Q Good morning. Mr. Matranga, can you please state your full name and address for the record?

A Joseph Matranga, 6255 Luske Boulevard, Suite 150, San Diego, California 92121.

Q Thank you. And can you please describe your background, including your education, professional credentials, and your expertise?

A I'm a CPA, member of the AICPA California Society of CPAs. I founded my practice back in 1986. I've got about 40 years of experience as a CPA.

THE STENOGRAPHER: May I please ask you to pull the mic closer to you and speak louder? Thank you.

MR. MATRANGA: Okay.

THE STENOGRAPHER: Thank you.

BY MS. VERDUGO:

Q Did you say 40 years?

A Yes.

Q Thank you. And could you describe the services you provide your clients?

A We provide accounting and tax services to -- I have a lot of clients, you know, small to medium-size businesses, individuals as well.

Q And what other type of services do you provide for them?

A Preparing tax returns, financial statements, accounting services.

Q And do you provide accounting services for Mr. Parkes?

A Yes.

Q And could you describe the services you provide for Mr. Parkes?

A For Mr. Parkes and his entities, we prepare the tax returns, financial statements, help adjust his accounting records to actual.

Q And can you describe Mr. Parkes' business as it relates to this case, naming again the entities that are involved here? Like, what is Mr. Parkes' business in general?

A So he owns Anderson Audio Visual, audio visual companies, and he has multiple partnerships and LLCs, all different audio visual entities. He owns 100 percent of Audio Anderson Visual, and he's owned 95 percent of all the other LLCs and limited partnerships.

Q Thank you. And can you describe the function of the S corp in Mr. Parkes' business?

A So in this case Anderson Audio Visual, the S corp, was the common pay master incorporated pocketbook. Those LLCs didn't have a bank account. So all money went through the Anderson Audio Visual, and then the bookkeeper would post entries to, you know, the various entities.

Q So the S corp paid expenses for the various entities and then recorded these transactions accordingly?

A Correct.

Q And so you mentioned the recording. Can you describe how these transactions were recorded by the companies and by whom?

A So they had an in-house bookkeeper, and the bookkeeper would post the entries from Anderson Audio Visual as a loan to Mr. Parkes. And then Mr. Parkes contributed to the LLCs, and that was a capital contribution to the LLCs.

Q And what was your role in recording these transactions?

A So, you know, as it's pretty complex having the one entity and, you know, with the common pay master and everything going to the various entities. We would sit down typically at year end and get together with Mr. Parkes and, you know, try and make sure the financial statements, we can get them as accurate as possible. So we would, just as part of the accounting process, make year-end journal entries to make the books accurate.

Q And in these journal entries, what -- can you describe what journal entries are and, you know, when they are typically done?

A Well, journal entries is part of the typical accounting process. No books are, you know, ever complete without, you know, year-end entries. So it's common in the industry. And which is something year-end to adjust balance actual and, like I say, make the books accurate and complete.

Q And why couldn't the bookkeeper do that? Why did you have to come in at year end?

A Well, it's pretty complex. You know, bookkeepers record transactions. They don't necessarily record them correctly. I have hundreds of clients, and I've never received a complete and accurate set of books from a bookkeeper. But at least they get the transactions in and then we, like I say, clean it up and try to adjust everything to actual.

Q And why wait until the end of the year? Why not be hired to be there full time?

A Well, it's a lot of work, and it would be very expensive to have us there all the time. With a bookkeeper it's just, you know, a better cost. It's more effective for them to do it then us come in once a year. Sometimes clients might have us come in, you know, after six months but typically at year end.

Q Thank you.

JUDGE TAY: Sorry. Can I interrupt for just a second.

MS. VERDUGO: Sure.

JUDGE TAY: Everything is going fine, but if you could help us out, Mr. Matranga, by bringing your mic just a little bit closer.

MR. MATRANGA: Okay.

JUDGE TAY: I think that would help Ms. Alonzo.

MR. MATRANGA: Okay.

JUDGE TAY: Thank you. I appreciate it, and I apologize again.

MR. MATRANGA: No problem.

MS. VERDUGO: Thank you.

BY MR. VINATIERI:

Q Mr. Matranga, for the year at issue is 2008. Can you explain how the payments to the lower partnerships were recorded?

A The payments to the partnerships were recorded as a contribution from Mr. Parkes to his entities. And the money coming out of Anderson Audio Visual, paid on behalf of Mr. Parkes, was recorded as a loan on Anderson's books.

Q Okay. So I'm going to refer to Appellant's Exhibit 9. Can you -- you have that in front of you? Yeah. Exhibit 9, and this is the secured line of credit promissory note. Is that in front of you?

A Yes.

Q Okay. Dated January 1, 2008?

A Yes.

Q Okay. Can you describe what this document is?

A So this is a secured line of credit promissory note where Mr. Parkes is the borrower Anderson Audio Visual is the lender.

Q And under -- you said it's a line -- secured line of credit. So can you explain what a line of credit is, and how it works?

A So a line of credit is an instrument where you're able to draw down money as you wish, you know, in different sums. And it can be, you know, random and dispersed in any amounts at any time. It's a secured line of credit secured by Mr. Parkes' stock in Anderson Audio Visual and his other entities.

Q And could you look at the introductory paragraph -- or I think -- yes. In that introductory paragraph, does it describe how Mr. Parkes can use those funds, or how those funds are distributed to him?

A Yes. It says they may distribute so much thereof as may be dispersed to or for the benefit of Mr. Parkes.

Q So for the benefit of Mr. Parkes. What does that mean?

A That means that's a common pay master. They could pay items that are for his limited partnerships and for him unrelated to Anderson Audio Visual.

Q So the holder being the S corp can make payments for the limited partnerships, but it's on behalf of Mr. Parkes?

A Correct.

Q So like he borrowed that money?

A Yes. Correct.

Q Okay. The note you said was a secured line of credit. What does that mean that it's secured?

A It's secured by the stock. Mr. Parkes' stock in Anderson Audio Visual and his ownership interest in all the other partnerships and LLCs.

Q So if he doesn't pay on these loans, the S corp could take the stock?

A Could take his stock, yes.

Q Okay. And was there any expectation that these investments, these entities would be sold?

A Yeah. You know, the plan always was to build the business, keep adding new locations, grow it, and then sell --

Q Now --

A -- was the ultimate goal.

Q -- were all of these investments successful?

A No.

Q So --

A Most of them. There was a few that had to be closed down. It didn't work. But at the end of the day, yes, he built up quite a substantial business and sold --

Q Okay.

A -- in '16.

Q So to your knowledge, you mentioned payments were made on behalf of and for the benefit of Mr. Parkes by the

S corp; correct?

A Yes.

Q So these payments that were made on behalf of Mr. Parkes, is there evidence of those payments?

A All the accounting records and books show the payments. And there's a note on the books in the financials referencing that.

Q Referencing the payments from the S corp for the limited partnerships?

A Yes.

Q So the general ledger shows these payments --

A Correct.

Q -- in it. And that was provided to the auditors?

A Yes.

Q And this note was provided to the auditors?

A Yes, it was.

Q Okay. I'm now doing to turn to Appellant's Exhibit 24, which is identified as notes receivable from Craig Parkes. Let I'll let you get there, 24.

A Okay.

Q Can you explain what this is?

A This is a summary year by year of the outstanding balance at year and.

Q And did you prepare this --

A Yes, I did.

Q -- summary? And how did you prepare this summary?

A I reviewed the general ledgers each year to derive at these numbers.

Q Okay. And can you explain, for example, what the beginning balance -- so this is the notes receivable. This is what Craig Parkes owes to the S corp. Can you describe what the beginning balance in that is?

A Yes. At the beginning, Craig put money in, and so the corporation owed him $986,000. And then subsequent to that, he was drawing down on a line of credit, and those are the -- to fund the other businesses. And so those were the running totals at year end.

Q So the beginning of 2008, the S corp owed him $166,000. At the end of 2008, the S corp owed him $863,000 approximately; is that correct?

A Correct.

Q And then you have every year after that. And then in 2016 what was the balance?

A The balance was zero. The loan was paid off. That's when he sold the company.

Q In 2016?

A In 2016.

Q Okay. So you mentioned 2016 as paid off. What happened in 2016 exactly?

A In 2016 the business was sold.
Q All of the entities --
A All the entities sold to a third party unrelated to him.
Q And this was this stock?
A Yes.
Q So the stock that had been pledged for these loans was sold as part of this --
A Correct. It was --
Q -- of this sale?
A Yes. It was stock purchase.
Q And could he have sold that stock if it still had -- was being held as security for something else?
A No. The -- it was required to be debt free.
Q So he had to payoff these loans in order to be able sell that stock --
A Correct.
Q -- would be a correct statement?
A Yes.
Q Okay. So Appellant's Exhibit 23 is the 2016 secured purchase agreement. So I'll let you go to that, Exhibit 23.
A Okay. I have --
Q So can you describe what this Exhibit 23 is?
A This is the purchase agreement to sell Anderson

Audio Visual.

Q So this is the document that -- by which Mr. Parkes sold all the stock in his entities?

A Yes.

Q Okay. Including the S corp?

A Yes.

Q And all of the other related entities, they're still in existence at that time --

A Correct.

Q -- correct? And prior to Mr. Parkes being able to sell the stock, was he required to pay off these loans --

A Yes. Yes, he was.

Q -- to your knowledge? And is that typical?

THE STENOGRAPHER: May I please have you both wait for the other person speaking to finish? You are both stepping on each other, and I cannot write both of you at the same time.

MR. MATRANGA: Okay. Sorry.

MS. VERDUGO: What was that?

THE STENOGRAPHER: I need you both not to step on each other.

MS. VERDUGO: Oh, okay.

THE STENOGRAPHER: Let him finish his answer before you ask your next question.

MS. VERDUGO: Thank you.

THE STENOGRAPHER: Thank you so much.

BY MS. VERDUGO:

Q So we we're talking about Exhibit 23, which is the secure purchase agreement. Give me one second.

So in this document, the sales agreement, does it say that he has to pay off any of these loans?

A Yes, it does.

Q And where would we see that?

A There's at least three separate places. I think 1.1 of the agreement states free and clear of any liens. I believe 2.1 -- 2.1-L also says he needs to provide proof of lien releases that all debts have been paid off.

Q Okay.

A And then also I think 3.2 says, again, he must -- he must be free and clear of all liens for them to purchase the business, the stock.

Q Okay. Give me one second. I'm going to refer you to Appellant's Exhibit 22. And these are journal entries, and there's a cover letter there from you describing what this is. But before the sale, were you asked to prepare these journal entries?

A Yes.

Q And can you describe what these journal entries were intended to do and what they did do?

A Yes. The purchaser wanted to see basically what the books were going to look like with all the intercompany and loans paid off. So these journal entries were prepared to basically pay off all intercompany debts and get the books free and clear of any loans, liens, et cetera.
Q So these journal entries -- I mean, I see a bunch of different entities, receivables from different entities back and forth, and from Mr. Parkes to different entities. So were these receivables sort of canceling each other out? Is that what's going on with these journal entries?
A Yes.
Q And at the end of the day after a receivable from one entity to Mr. Parkes or Mr. Parkes to another entity, after all of that was put in, were Mr. Parkes' loans from S corp paid off?
A Yes. In fact, at the end of all this, Anderson Audio Visual actually owed Mr. Parkes $580,000.
Q Okay. So it was not only paid off, but he was owed money --
A Correct.
Q -- $580,000? Thank you. So this -- when did this happen? When did these journal entries -- when were those done?
A They were done July 31st of 2016.

Q And when did the sale take place?
A The sale closed, I believe, November 30th of 2016.
Q So prior to the sale, everything had already been paid off. And were updated financials provided to the buyer at that time?
A Yes, I believe so.
Q Okay. So after the journal entries were done, around that time, July 2016, financials were provided to the buyer. And I do believe it's referenced in the sales agreement, the July 2016 financials.
A Correct.
Q Yeah. So at issue here, as mentioned by Mr. Joe Vinatieri, is whether it was the S corp or Mr. Parkes who made these contributions to the two limited partnerships in 2008 and, ultimately, whether Mr. Parkes had sufficient basis in the limited partnerships to report certain flow-through losses. Based on your experience and what you've just testified to today, were the contributions to the partnerships properly recorded as Mr. Parkes' contributions?
A Yes. Absolutely. And we've done that constantly all the way through 2016. It's been consistent and treated the same, yes.
MS. VERDUGO: Thank you, Mr. Matranga.

I have no further questions at this time.

JUDGE TAY: Thank you, Ms. Verdugo.

I'm going to give an opportunity for Respondent to cross-examine the witness at this point.

So, Mr. Hunter, I'm going to turn it over to you.

CROSS-EXAMINATION

BY MR. HUNTER:

Q Good morning, Mr. Matranga.

A Thank you.

Q Okay. I just have a few questions here just to clarify your testimony. You started off and said that Mr. Parkes was the 100 percent owner of the audio-visual companies and 100 percent shareholder of -- let's call it AAV. Is that correct?

A Yes.

Q Was that correct during the issue -- at issue 2008?

A Mr. Parkes owned 100 percent of Anderson Audio Visual.

Q In 2008?

A Yes.

Q And years leading up to that?

A Yes. The same.

Q And you also said the other companies -- maybe in the family of companies. So that would include San Diego and One Touch, was either 100 percent partner in those companies?

A No. I think I said he owned 95 percent of all those entities.

Q Okay. How about 2006?

A The same.

Q 2007?

A I believe the same.

Q Okay. And then I had a question about the adjusting journal entries, which you touched upon at the end of your testimony. I wanted just to confirm when they were prepared. I believe you said they were prepared July 2016, because they're not dated in the exhibits, which is now 22?

A So I'm not clear which journal entries.

Q The attached adjusting journal entries were proposed by our firm in order to close out the outstanding intercompany and shareholder loan amounts that were paid off through the sale of the AAV. And this is written by you in 2020 and attached. These are proposed audit journal entries. And I'm asking when were they prepared, and I believe you answered that question?

A They're dated July 31st, 2016, because we had provided this purchaser a July financial. So it would have been, you know, maybe in August --

Q Okay.

A -- of '16, but --

Q And then I heard that these proposed journal entries had to be, I don't know, inputted or recorded in the financial packet that was provided to the purchaser of the AAV stock; is that correct?

A I didn't follow you.

Q Well, these journal entries were made for a reason?

A Yes. The purchaser wanted all the intercompany loans closed out.

Q Okay. So --

A He wanted the financials free and clear at any means.

Q So I have these documents which shows that these were the proposed journal entries. And then I have -- I just heard you say that they were, in fact, no longer proposed but made in a document?

A Correct.

Q Do we have that document?

A These are the entries that were made.

Q But the documents these were incorporated into?

A The July 31st, financial statements? We can provide that.

Q Okay. And then also you -- I'm not sure if it was you or your -- well, taxpayer's counsel made the statement that these financials had to be provided as a condition of the closing of the sale of AAV stock, and it was referenced in this document; is that correct?

A Correct.

Q So I didn't know -- I'm not sure if you would know, but where is that referenced in the securities purchase agreement?

JUDGE TAY: Mr. Hunter, I apologize. But do you mind just moving your mic a little bit closer.

MR. HUNTER: Sorry about that.

JUDGE TAY: I appreciate that.

MR. HUNTER: I'll try harder. Please judge me by my second effort.

MR. MATRANGA: On page 37 of the purchase agreement at the top of the page, it references the unaudited consolidated balance sheet as of July 31st, 2016. It makes common sense, you know, that they want to see that everything is paid off before they close.

BY MR. HUNTER:

Q And I would too, including this purported loan from AAV to Mr. Parkes. So I thank you for that response. And then I'd like to jump to the notes receivable balance. It's a summary that I believe you prepared. I have it as a table in Appellant's reply brief. I don't have it as the exhibit, but I believe it's the same -- we're talking the same numbers. And what I'm trying to track -- excuse me. Let me back up.

So let's go back to 2006, if we could. We have Anderson Audio Visual, AAV, and we heard it described here as a family of audio-visual companies. Today's focus is only on San Diego and One Touch -- or Anderson Security and One Touch. How many other companies, if you can recall, operated under the umbrella or had a relationship with AAV, '06?

A I don't recall.

Q '07?

A I don't recall.

Q '08?

A I'm really not sure. I just remember there was numerous. I don't know if there was four or five or six. It could have been eight. I mean, I was only focusing on these three.

Q Okay. Gotcha. So when we have -- I mean, we're speaking about money that was spent to fund the operations of Anderson Security and then One Touch, these two entities at play here how. How do we know that that is what comprises this balance, starting in 2008 let's say, $863,000, when there are Anderson companies out there performing audio and visual services?

A Those were the two that were in question because I believe, if memory serves me right, those two businesses closed down in '08 or '09. And so that's when the, I think, Franchise Tax Board tried to re-characterize those contributions.

Q I understand. So we have --

A Those business were closed, so those were the two I focused on. Like I say, I know there was numerous.

Q Okay. So what I'm getting to is this 800 -- the round -- oh, sorry -- this figure of $863,000. Does that tie into the amounts that were paid by AAV to fund the operations for just these two companies or other companies?

A That was only those two companies in question.

Q Okay. So what's happening after 2010 all the way up to 2016? If these companies ceased operations in 2008, why is this balance increasing?

A Because like I say, he had numerous other entities. He had Irvine. He had Texas. He had a bunch of different locations. That was his business model. He'd open up in different locations and --

Q Okay.

A These all match the books and records of each individual entity, and they are all treated the same.

Q I gotcha.

A Okay.

Q I -- let me have a follow up to that one. And the way I -- okay. I won't go into that. So it's your understanding that the company -- I'm sorry. The stock at AAV was purchased in 2016 in a cash free and debt free basis; that's correct?

A Yes.

Q So that would include operating expenses in terms of, let's call it current accounts payable to vendors and folks that AAV would have to pay to operate its business; is that correct?

A I'm not sure. I just know all the intercompany and related party that had to go away. I don't know about accounts receivable and accounts payable, typically, not.

Q Okay. I ask that question as a lead up to on top of operating expenses, the liens, because this was new to me this morning, where in the agreement it specifies that because the purchaser is buying stock, the purchaser would like to purchase the stock in AAV free of liens. And what do we have in this record which evidences a lien on AAV stock that is comprised of or stems from a purported loan from AAV to Mr. Parkes?

A I don't know that I understand what you're asking.

Q So I'll ask the question another way that's my caveman way of describing it. So if I'm the taxpayer and I'm selling my stock in AAV to a bona fide purchaser, and so how would anyone who has a lien on said stock be able to show, hey, you can't sell that stock. I have a lien on that stock. You can't purchase that stock before you pay me off.

A I'm not -- I'm not following the --

Q Okay.

A The loans were paid off and the agreement requires that all the loans be paid off. So he did that. He paid off all the loans and then he was able to complete the sale.

Q So where is the trail -- the direct trail of money from Parkes to, I guess, AAV, which reflects that a purported loan was paid off? And, in fact, when reconciled it, Mr. Parkes was owed $580,000 when the dust settled and the sale was complete?

A Yes. It was all the journal entries that we referenced. That's how I showed you we zeroed that out in July of 2016.

Q Okay. Which were incorporated into financials, which were provided to the purchaser; right?

A Correct.

Q Which we don't have?

A Correct.
Q Okay.
MR. HUNTER: That completes my questions for you this morning. I thank you for your time.
Judge.
JUDGE TAY: Thank you, Respondent.
MS. VERDUGO: Can I -- I'm sorry. Can we redirect? Or go ahead.
JUDGE TAY: Sure. Go ahead, Ms. Verdugo. I'll give you an opportunity.
MS. VERDUGO: Thank you.
JUDGE TAY: And then I'm going to ask my judges to see if they have any clarifying questions, but please go ahead.
MS. VERDUGO: Okay. Thank you. Or I can wait until you do. Either way.
JUDGE TAY: Okay. I will do that then. I'm going to turn to my judges.
Judge Akin, do you have any clarifying questions for the witness?
JUDGE AKIN: Yes. Judge Akin speaking. I do have one question. If I can ask that we turn to Exhibit 23, I believe, which is the adjusting journal entries that were made in 2000 -- oh, I'm sorry. Exhibit 22 -- the adjusting journal entries that were made

in 2016 before the sale. I just wanted to clarify. I think you described these as the loans being paid off. It looks like looking at these -- I'll just use the AGE -- AJE1.

It looks like it's a debit to, let's see, note receivable Craig $580,399, and a credit to capital distribution Craig for the same amount. So if I'm reading that correctly, what occurred was essentially the note receivable from Mr. Parkes was converted into a distribution to him. Would that be accurate?

MR. MATRANGA: Yes.

JUDGE AKIN: Okay. That was my only question. I just wanted clarification on that. Thank you.

JUDGE TAY: Thank you, Judge Akin.

Judge Akopchikyan?

JUDGE AKOPCHIKYAN: No questions at this time. Thank you.

JUDGE TAY: Thank you.

Ms. Verdugo, I'm going to go ahead and turn it over to you.

MS. VERDUGO: Thank you. Thank you.

REDIRECT EXAMINATION

BY MS. VERDUGO:

Q Mr. Matranga, for 2008 I'm going to go back to the schedule on Exhibit 24, which you prepared. You said the beginning balance was $966,000 owed to Mr. Craig Parkes. And then at the end of 2008, the balance was $863,000 and change owed by Mr. Parkes to the S corp. And right next to it there's $1,830,000. Can you read that description next to the $1,830,000?

A As of 12/31 as a result of funds invested into Anderson Security and One Touch.

Q So when you did this schedule, the balance changed from $966 to $863 as a result of 1.8 for the two limited partnerships at issue here; is that correct?

A Correct.

Q And that balance tied to what was provided to the auditors?

A Yes.

Q Thank you. And then on the note -- I believe that's Exhibit 9. On Exhibit 9, that's the note. On the second page, is there a pledge agreement reference there?

A Yes.

Q And that's the pledge agreement whereby the stock of Mr. Parkes is pledged as security for the note?

A Correct.

Q Okay. And this note was also disclosed to the auditors?

A Yes.

MS. VERDUGO: Thank you. That's it for now. Thank you.

JUDGE TAY: Thank you. Does that conclude your opening presentation? You do have about 20 more minutes.

MS. VERDUGO: No. I think we're done. Thank you.

JUDGE TAY: Okay. Thank you.

Respondent I'm going to turn it over to you for your presentation. You have 20 minutes. Please begin whenever you're ready.

MR. HUNTER: Okay. Thank you, Judge.

PRESENTATION

MR. HUNTER: Yeah. This case has a lot of moving parts, but at the end of the day, it involves a disallowed flow-through loss reported on the individual taxpayer's return from a limited partnership. Appellant claims that he has a loss from the limited partnership -- limited partnerships in this case, because he personally made capital contributions on behalf of the partnerships.

However, these capital contributions were made by a separate entity, albeit an S corp wholly owned by the taxpayer -- we have to respect corporate formalities -- a separate entity and these capital contributions do not qualify as contributions made by Appellant as an individual. And just to try to unpack this from a high level, Appellant formed two limited partnerships that operated audio visual companies, Anderson Security of San Diego, which we have been referring to as Anderson Security and One Touch Audio and Video Integration, and we've been referring to that limited partnership as One Touch this morning.

In 2008, Appellant was the 95 percent limited partnership of Anderson Security and One Touch. He was also the majority shareholder of AAV, which was an S corporation. In years leading up to 2008, he was not the only shareholder, he was the majority shareholder. I have other folks owning an interest in the company -- I'm sorry -- limited partnerships prior to this. Over time AAV, not Appellant, but AAV the S corp made direct payments of $398,000 of Anderson Security's operating expenses. And AAV made direct payments of $1.3 million of One Touch's expenses.

Because AAV was the general partner of both limited partnerships, Respondent correctly treated these payments as capital contributions to each of the partnerships by AAV. In fact, the partnership for both limited partnerships at the time allowed that the general partner could fund the operations and limit the ability of the limited partner to do so.

These capital contributions had the effect of increasing AAV's outside basis in the two limited partnerships, which became a capital loss in AAV's ownership in these two limited partnerships when both companies ceased operations in 2008. We're still at the S corporation level. Internal Revenue Code Section 704(d) provides that a partner's distributive share of partnership loss, including capital loss, shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which the loss occurred.

We're talking about the tax treatment of the partnership relative to its interest in the limited partnership. California law conforms to this provision. Again, AAV the S corporation directly paid the operating expenses for Anderson Security and One Touch. We have those transactions recorded on the books and records. We've heard that this morning.

As Appellant did not make the capital contributions, his adjusted basis in both the limited partnerships is zero. He owned a 95 percent limited partnership interest in both partnerships, and he didn't come out the money, AAV did. As Appellant was the 100 percent shareholder of AAV, and S corporation, in 2008 AAV's capital losses in its investments in One Touch and

Anderson Security flowed through to Appellant, and Respondent made the adjustment to Appellant's 2008 income tax return.

That's how it should have flowed, and that's where the analysis should end. However, what we're discussing is Appellant's reporting position, which creates more basis in his partnership interest in the limited partnerships and thus, a much larger flow-through loss on his individual income tax return. Respondent's position is that he had no basis in these limited partnerships. But Appellant claims that he should be treated as indirectly borrowing the amounts that AAV contributed to both limited partnerships to cover operating expenses even though he did not directly pay these amounts.

And then B, that he's deemed to have contributed these amounts to One Touch and Anderson Security, respectively, who in turn should be treated as paying their own creditors. But he's saying, "I'm out of pocket for those expenses, not AAV. AAV fronted me the money. This is a loan." That's why we're here this morning. Either there's a bona fide loan or there's not. In order to support the reporting position, Appellant provided two documents up to now.

One was a million-dollar secured line of credit promissory note. That's dated January 31st, 2008. We have discussed that. And the second were the AJEs or adjusting journal entries that were made at the end of the tax year. As it relates to the line of credit, the document is perspective in nature. It does not call out the sums to be loaned out, and it calls out a 25 percent repayment, which was not made unless we get to the sale of the security, which we have discussed today. At audit we protested up until we have these documents to even discuss. There has been no repayment even though this document calls for a 25 percent repayment.

The adjusting journal entries also do not support the existence of a loan from AAV to Appellant. AAV made distributions of $45,000 to Appellant during tax year 2008. Again, this is from the S corp to Appellant. And at year end, an adjusting journal entry was made to reclassify the entire $45,000 as a loan to the shareholder. And the reason provided for reclassification was, quote, "To re-class distributions to shareholder loans due to lack of basis."

Again, the basis is what gives rise to the loss on the individual income tax return. Up until 2015, Appellant admitted he had not repaid even this $45,000 purported loan from the time of dispersement in 2008. So it appears that the line of credit promissory note and the adjusting journal entry at the end of the year, which we reclassified the disbursement to Appellant as purported loans were executed as a precaution so that Appellant could avoid paying taxes on the disbursement which were in excess of the shareholder's basis.

Our briefing lays out the elements to be considered whether determining a bona fide debt existed between AAV, the S corporation, as lender and Appellant as the borrower. And we had no repayments. We did have security, which was the stock in AAV. No interest being paid back, open ended, no maturity date, the efforts to collect, the moving parts we typically see when a taxpayer who has the burden can establish a bona fide debt of their nonexistence in this case.

As these concessions -- sorry. As these conditions were not met, Appellant is not entitled to the additional flow-through losses from the limited partnerships as reported. Now, this securities purchase agreement -- the stock purchase agreement, which was recently introduced, calls for the company to be purchased on a cash-free, debt-free basis. Meaning, the purchaser does not want to pay cash for cash, and the purchaser does not want to take on the debt owed to others by the holder of the stock or the company as a growing concern.

There's an allotment for operating expenses and cash reserves. You need money to keep the company going, and you may have to owe vendors to keep the company in business. But for the most part it will be cash free and debt free. That happens every day all the time. It was our position -- it is our position this document does nothing to support the existence of a loan from AAV to Mr. Parkes as the sole shareholder in order for this sale to take place.

There's nothing in this securities purchase agreement that calls out a loan from AAV to Mr. Parkes. You don't have a provision where payment is being made from the purchaser to AAV to cover Mr. Parkes' reported obligation to AAV. Mr. Parkes just gets some money, and the stock is transferred over to purchaser. So I submit what's missing here is a direct connection that supports the existence of a bona fide debt from AAV to Mr. Parkes, which would provide him with the requisite basis to claim an additional loss during tax year 2008.

That would be shown intracompany. That's an agreement between AAV and Mr. Parkes. And what would really move things here is if we have a document which shows that this purported debt was paid off. We don't have the financial statement that incorporates these proposed adjusting journal entries and ties everything together.

We thank you for your time, for wrapping your head around all the moving parts in this case, but we stand on our original assessment. And additionally, on top of the varying ownership percentages and the entities, which does not line up with the testimony that we've heard this morning, for instance, AAV in 2006 had two partners with Appellant owning 55 percent and Mr. Akst, that's A-k-s-t, owning 40 percent. And in tax year 2007, we have Appellant owning 50 percent of AAV with Mr. Akst, A-k-s-t, owning 35 percent and a Mr. Templin owning 10 percent. And so that calls into question, at least in my mind, as to what happened with these contributions that were made prior to 2008.

Finally, I would like to bring to your attention, Judges, when it comes to this common pocketbook or intracompany pocketbook, there are some cases which will allow the result that Appellant is looking for. However, they are few and far in between, and they are distinguishable. Yates, the taxpayer in that case executed a note, received money directly from the closely held corporation. Again, directly. It was $1.2 million.

The shareholder used the money to pay his personal expenses and then had to turn around and pay the company back. He did so. So we have evidence of repayment in that case contemporaneous with that transaction. Yates, the taxpayer, in fact, repaid $855,000 of the $1.2 million that he borrowed from the company.

So in that situation it was called a personal checkbook or incorporated pocketbook. We don't have that here. We don't have Appellant receiving money directly from AAV paying personal expenses or even other company expenses and promising to pay the money back.

In Rucriegal, R-u-c-r-i-e-g-a-l, another case that's cited along these lines, there were wire transfers from one company to the taxpayer. And then the taxpayer then advanced the same funds directly to another company the taxpayer had an interest in. The company that received these loans proceeds, in fact, made repayments over time on that loan and interest payments. The taxpayer also pledged personally owned real property and other assets as collateral for the loan. And when it comes to interest payments on the loan, repayments on the loan, and money directly flowing from the corporation to the individual taxpayer, and then to a related company, we don't have that here.

Another case, Culnen, C-u-l-n-e-n, and in that case, we're dealing with two S corporations. So we're not dealing with a situation where a taxpayer has an S corporation on the one hand and an interest in a limited partnership on the other hand. We have two S corporations. We also have -- in that case there were 46 chicks -- sorry -- 46 checks that were written on the books of the S corporation that evidenced the loan in real time. The record was built that supported a bona fide loan over time by contemporaneous documentation, not by proposed or recorded adjusting journal entries. We don't have that here.

So just briefly and we can go into post-hearing briefing if you would like to, but although there's a -- there's just a line of cases out there that would provide a taxpayer with an increase in basis if the taxpayer makes contributions to the company and there's money going back and forth and all this can be substantiated, what is before you is simply not that case.

So that wraps up my presentation for you this morning, and I'm available to answer any questions you have. I thank you for your time, Judges.

JUDGE TAY: Thank you, Mr. Hunter.

I'm going to turn it over to Appellant for their rebuttal. You have -- I believe it's 10 minutes, but let me just double check my notes here. You have 15 minutes. Please proceed whenever you're ready.

MR. VINATIERI: So, Counsel made a statement relative to interest not being paid. We would like to have Mr. Matranga come back up and talk about interest and the fact that it was paid. And then we'll go into our other aspects of our rebuttal.

MR. MATRANGA: Interest was paid each --

MS. VERDUGO: Let me ask it.

MR. MATRANGA: -- oh, each and every year.

<u>RE REDIRECT EXAMINATION</u>

BY MS. VERDUGO:

Q So I refer you to FTB's Exhibit A, which is a letter from you, Mr. Matranga. And at the end of that letter, could you -- so, yeah. It's Exhibit A, FTB's own Exhibit A, and this is your response to the FTB. Could you read that last paragraph?

A Additionally, we have provided general ledger details of the interest income from 2008 through 2013. As a review of the balance sheet, it's clear the taxpayer didn't have any interest bearing accounts. Therefore, all interest income is payments from Craig to Anderson Audio Visual. I can tell you it was substantial interest each and every year all the way through 2016. He paid tax on that interest income each and every year. Clearly --

Q So you -- you're saying interest was paid. You reviewed it recently, and you had provided this information to FTB back during the audit?

A Yes. Numerous times.

MS. VERDUGO: Okay. Thank you.

JUDGE TAY: That concludes your questions for Mr. Matranga?

MR. VERDUGO: Yes. Thank you.

JUDGE TAY: I'm going to Franchise Tax Board just an opportunity to ask any cross-examination questions of Mr. Matranga just because we opened up Mr. Matranga's testimony once again.

MR. VINATIERI: Relative to that issue only?

JUDGE TAY: Yes.

MR. HUNTER: I don't have anything to add to that.

JUDGE TAY: Okay. Respondent, no questions. I see. Okay. All right. Thank you.

Appellant, please proceed whenever you're ready.

CLOSING STATEMENT

MR. VINATIERI: So a couple of things have been said by Counsel that I want to make sure we talk about. First of all, there is neither a -- whether there's a bona fide loan or not. I think we have provided information. I don't have the exhibit list, but it's Exhibit 9, I believe. And that -- it's you have a piece of paper -- actually, a couple of pieces of paper. And as we all know a lot of times when it's been alleged that there is no loan, there, in fact, is usually no piece of paper.

And there's -- many of us, we've all had cases where there was no piece of paper memorializing it saying you have it here. You also have a pledged agreement that goes with that note to show that it's a bona fide transaction. You also have Mr. Matranga who just told you that interest was paid. There's no question. There's bona fide loans here. No question.

Second point, there is a discussion -- there was a discussion relative to the fact that in this case, allegedly, it's a little bit different than Yates and the other lines. And I think Counsel is saying, "Well, look. In those cases there was a direct payment from the person to the entity." And we made it very clear in the documentation that Ms. Verdugo asked Mr. Matranga about making payments on behalf -- on behalf, and that's in the documentation. So that -- there's no -- there's no need relative to this case law that's alleged that you have to make this direct payment.

That's what was going on because it was a common pay master situation. And I think what's really important here is these LLCs. They didn't even have a bank account. So it was the corporation AAV that was doing this on their behalf. That is -- it's basically all fours of the Yates case and the Yates progeny. And I point out to you in our briefs that we provided when -- a response to OTA's request for information, and this was Ms. Verdugo signing this. This was 5/21/2020 during the heart of the pandemic.

We talk about the fact in the Ruckriegal, and those -- that line of cases, they were all related to the fact that they found that where there was a valid purpose of providing working capital to those entities that that was okay. And that's the point because that's exactly what was going on here, and that's why we had -- we essentially had Mr. Matranga talk to you about what he was doing with the books and records during that period of time.

And then -- but the last thing that I think is particularly important here is the fact that we -- we wanted Mr. Matranga to show you exactly how this was paid off. These notes were paid off. And that was the whole point of the journal entries to zero out. And the fact that you heard it was $580,000 at the end of the day due Mr. Parkes after going through all that. And you saw the years, and it's in the exhibits.

Nobody in their right mind would give up money and pay money off in the context of a sale of the securities as we have here in Exhibit 20 -- Exhibit 23, if they didn't owe that money, if there wasn't an amount due -- excuse me -- if there wasn't an amount due on the books and records because the purchaser said this has to be a clean transaction. We don't want to take on any other indebtedness that you might have done, Mr. Seller. We all know that. We've been around long enough when somebody comes in, they want it clean -- clean and free. That's exactly what happened here.

JUDGE TAY: Thank you, Mr. Vinatieri. I --

MR. VINATIERI: Excuse me.

JUDGE TAY: No. No problem. Does that conclude your rebuttal.

MR. VINATIERI: Yeah. I think that takes care of it. This is a common-sense thing, members of the Panel.

JUDGE TAY: Great. Thank you. I'm going to turn to the Panel to see if they have any questions for the parties. I'm going to first turn to Judge Akin.

Do you have any questions?

JUDGE AKIN: I do. I have one question for Appellant's here. I heard the testimony regarding the payment of interest. I was wondering if there was anything in the record -- in the evidentiary record that you could point us to evidencing the payments of interest by Mr. Parkes to the corporation?

MS. VERDUGO: So Mr. Matranga is informing us that he provided this during the audit. And usually the FTB puts into the exhibits all of the audit work papers. I don't believe that was done here. So we can certainly provide that to you, pull it out of what was in the audit work papers. I believe it's in the K-1 showing the interest that flows through. I did see that from Mr. Matranga. It's also in the general ledger. But I think it's easier to see in the K-1s because there's an actual line item that flows through. So we can certainly provide that to you as a follow up.

JUDGE AKIN: I'm not sure that's needed, but let me consult with the Panel here.

MS. VERDUGO: Sure.

JUDGE AKIN: But just to clarify, the evidence would be the interest income that is reflected on the tax return that was filed by -- I think it's AAV but --

MS. VERDUGO: The S corp. Right.

JUDGE AKIN: -- the S corp.

MS. VERDUGO: So -- so Mr. Matranga is correct. The S corp would receive interest income, right. And then that would flow through to Mr. Parkes so you would be able to see the flow through on the K-1s, you know, pretty easily. But it's also in the tax return and in the general ledger.

JUDGE AKIN: Okay. That answers my question.

MS. VERDUGO: Okay.

JUDGE AKIN: So thank you.

JUDGE TAY: Judge Akin, any more questions?

JUDGE AKIN: No additional questions from me. Thank you.

JUDGE TAY: Thank you.

Judge Akopchikyan?

JUDGE AKOPCHIKYAN: I have no questions. Thank you.

JUDGE TAY: Okay. I have no questions either for the parties. And so I believe that concludes our hearing. Thank you everything for your presentations.

Give me one second to consult with my Panel. Hold on.

Okay. We're going to close the record in this appeal now. The appeal will be submitted for decision, and we will endeavor to send you our written decision no later than 100 days from today.

The hearing is now adjourned.

I want to thank everyone again for coming in today, and I want to wish everyone happy holidays.

(Proceedings adjourned at 11:18 a.m.)

<u>HEARING REPORTER'S CERTIFICATE</u>

I, Ernalyn 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 9th day of January, 2023.

____
ERNALYN M. ALONZO
HEARING REPORTER