

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)
SHAPROW FUNDING, LLC) OTA Case No. 21037381
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)
)

OPINION

Representing the Parties:

For Appellant: John E. Russi, CPA

For Respondent: Pamela W. Bertani, Tax Counsel III

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Shaprow Funding, LLC (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$13,948 and applicable interest for the 2014 taxable year.¹

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellant has established error in FTB’s adjustment to increase gross receipts to include security deposits.
2. Whether appellant has established error in FTB’s depreciation and deduction adjustments and the resulting increase in the gain on sale of business assets for the 2014 taxable year.

¹ Appellant appealed Notices of Proposed Overassessment (NPOAs) issued by FTB to appellant for taxable years 2013 and 2015, however the Office of Tax Appeals (OTA) does not have jurisdiction over NPOAs. (Cal. Code Regs., tit. 18, § 30104(e).) In addition, FTB did not issue a Notice of Action for 2013 or 2015, and appellant did not file a claim for refund, and FTB did not issue a denial of claim for refund, for those years. (Cal. Code Regs., tit. 18, § 30103(a)(1), (a)(3).) Thus, only the 2014 taxable year is on appeal.

FACTUAL FINDINGS

1. Appellant, an S corporation, is in the business of equipment leasing and sales. In 2014, appellant received from its customers security deposits which were refunded (less wear and tear) to the customer if the equipment was returned to appellant upon lease termination. If the customer opted to exercise the option to purchase the equipment at the end of the lease term, the purchase price was reduced by the amount of the security deposit. Appellant reports income and expenses using the cash basis of accounting.
2. Appellant reported \$1,618,814 in gross receipts, \$707,051 in depreciation expense, and \$186,658 in losses from the sale of business assets on its 2014 Form 100S Income Tax Return.
3. At audit, appellant provided depreciation schedules to clarify why it had changed the basis and depreciation of certain assets from the end of the 2013 tax year to the beginning of the 2014 tax year. Appellant stated that it discovered in 2014 that the cost basis of certain assets had been overstated, and provided a reconciliation schedule to explain the accounting. The reconciliation schedule included \$154,336 as a negative expense (referred to as “other deduction” on appellant’s schedule) to account for prior errors and included \$197,461 of additional depreciation that appellant failed to claim in prior tax years.
4. FTB accepted appellant’s adjustments to reduce the cost basis of the assets for the 2014 taxable year but determined that the prior taxable year depreciation figures were not carried over correctly, resulting in overstated depreciation expenses. FTB disallowed the claimed \$154,336 “other deduction” and the additional \$197,461 in claimed depreciation expense on the ground that it related to assets that were disposed of in earlier taxable years.² FTB permitted a depreciation expense adjustment in the amount of \$74,948 for the active leases. These adjustments resulted in an increase in the gain on the sale of business assets of \$414,541.
5. FTB also determined that appellant underreported gross receipts by \$594,686 by omitting the sum of retained security deposits. Appellant asserted that this sum should be

² The list of assets provided by appellant showed that the equipment used to offset the cost basis adjustment and resulting in the claimed depreciation expense of \$197,461 was no longer leased in 2014.

- deducted from gross receipts because appellant erroneously included the security deposits as income in prior taxable years.
6. On December 10, 2018, FTB issued appellant a Notice of Proposed Assessment (NPA) for the 2014 taxable year proposing additional tax in the amount of \$13,948. The NPA increased gross receipts by \$594,686, adjusted the gain on sale of assets in the amount of \$414,541, allowed depreciation expense in the amount of \$74,948, and disallowed the “other deduction” in the amount of \$154,336.
 7. Appellant timely protested the NPA, and FTB affirmed the NPA in a Notice of Action.
 8. This appeal followed.

DISCUSSION

Burden of Proof

FTB’s determination as to issues of fact is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) In the absence of credible, competent, and relevant evidence showing that FTB’s determination is incorrect, it must be upheld. (*Appeal of Chen and Chi*, 2020-OTA-021P.) A taxpayer’s failure to introduce evidence that is within his or her control gives rise to the presumption that the evidence, if provided, would be unfavorable to the taxpayer’s position. (*Appeal of Bindley*, 2019-OTA-179P.)

Issue 1: Whether appellant has established error in FTB’s adjustment to increase gross receipts to include security deposits.

Gross income is all income from whatever source derived, including compensation for services and gains derived from dealings in business and property. (Internal Revenue Code (IRC), § 61(a).)³ A taxpayer who uses the cash basis accounting method must pay tax on income in the taxable year in which it is “actually or constructively received.” (Treas. Reg. § 1.446-1(c)(1)(i).)⁴ Income is constructively received in a tax year when it is credited to the taxpayer’s account, set apart, or otherwise made available to be drawn upon at any time, and

³ California conforms to IRC section 61 pursuant to R&TC section 17071.

⁴ California conforms to IRC section 446 pursuant to R&TC section 17551.

income is not constructively received if the taxpayer's control is subject to substantial limitations or restrictions. (Treas. Reg. § 1.451-2(a).)⁵ In general, security deposits are not taxable unless the taxpayer has "complete dominion" over them when received. (*Oak Industries, Inc. v. Commissioner* (1991) 96 T.C. 559, 576.) Additionally, the taxpayer's unrestricted use of the security deposits during an interim period is not crucial in determining whether the taxpayer had control over the deposits. (*Id.* at p. 577.)

In the instant appeal, appellant asserts it reported as gross income the security deposits it received in the year of lease acquisition. Under the lease agreements, if the customer did not opt to purchase the equipment upon lease termination, the security deposit would be returned to the customer, less payment for damages or excessive wear and tear. If the customer exercised the option to purchase the equipment upon lease termination, the security deposit would not be refunded but instead applied toward the purchase price of the equipment. Appellant asserts that because it already included the security deposits in prior taxable years, the amount previously reported should be excluded from income. However, as a matter of law, appellant must recognize the security deposits in the taxable year in which it had complete dominion over the security deposit. (*Oak Industries, Inc. v. Commissioner, supra*, 96 T.C. at p. 576.) The correct year for inclusion was not the year of lease acquisition, but the year of lease termination, if the customer opted to purchase the equipment. Hence, the security deposits from leases that commenced prior to 2014 were not reportable as gross income until the leases terminated in 2014 if the customer purchased the equipment, in which case the security deposits were counted toward the purchase price (i.e., included in gross income). Accordingly, appellant has not established error in FTB's adjustment to gross receipts by including the amount of the security.

Appellant's sole legal argument on appeal is that including appellant's security deposits in gross receipts would result in double reporting and taxation of the same security deposits that were previously reported in the lease acquisition years, some of which are now closed to audit and appeals. However, the Office of Tax Appeals' (OTA's) findings are bound by law, which provides that security deposits are reportable as gross income in the year in which appellant has complete dominion over them; in this case, the security deposits pertaining to leases that ended and where the customer purchase the equipment in 2014 must be reported in 2014, irrespective of the purportedly duplicate reporting in prior tax years. OTA has no authority to reverse this

⁵ California conforms to IRC section 451 pursuant to R&TC section 17551.

requirement solely on the basis that appellant included the income erroneously in a prior year. Each taxable year stands on its own terms and must be separately considered. (*Appeal of Kwon*, 2021-OTA-296P.)⁶

Issue 2: Whether appellant has established error in FTB’s depreciation and deduction adjustments and resulting increase in gain on sale of business assets for the 2014 taxable year.

The gain from the sale or other disposition of property is generally the excess of the amount realized over the taxpayer’s adjusted basis, and the loss is the excess of the adjusted basis over the amount realized. (IRC, § 1001(a); *Appeal of Johnson*, 2022-OTA-166P.) The adjusted basis is generally the cost of the property, plus any capital expenditures made with respect to the property, and less any depreciation taken with respect to the property. (IRC, §§ 1011, 1012, 1016.)⁷ FTB’s determination of basis is presumptively correct, and the taxpayer bears the burden of showing that such determination is erroneous. (*Appeal of Fraser* (86-SBE-157) 1986 WL 22836.)

Here, FTB made adjustments to appellant’s gain on asset sales based on various errors it discovered in appellant’s depreciation expense deductions and cost basis for assets sold in 2014. As a result of these errors, appellant had claimed depreciation in excess of the cost basis of certain assets. FTB adjusted depreciation expenses claimed and allowed only \$74,948 of depreciation expense and disallowed the “other deduction” of \$154,336. As a result of these adjustments, FTB adjusted appellant’s gain on asset sales in the 2014 taxable year by \$414,541.

On appeal, appellant does not address (or seem to contest) these adjustments. Although appellant claims to dispute the entire amount of the proposed liability, appellant only provides arguments relating to the security deposits. Notably, during FTB protest proceedings, appellant contended that the gain on the sale of assets should be allocated to multiple taxable years instead of exclusively 2014. However, other than a self-prepared schedule containing lease numbers and

⁶ The Board of Equalization, OTA’s predecessor, has ruled that equitable recoupment may be available where a single transaction or taxable event has been taxed twice to the same taxpayer on inconsistent legal theories. (See, e.g., *Appeal of Winkenbach* (77-SBE-081) 1975 WL 3565; *Appeal of Lipinsky* (92-SBE-002-A) 1992 WL 693751.) OTA notes that, based on the documentation provided, FTB determined that security deposits were incorrectly included in appellant’s gross income for 2013 and 2015 and reduced appellant’s gross receipts by \$256,276 for 2013 and \$251,440 for 2015. Appellant has not asserted that it is entitled to equitable recoupment and, even if it were available, appellant provides no source documentation or information to establish adjustments for further incorrect inclusions of security deposits in gross income for other years.

⁷ California generally conforms to IRC sections 1001, 1011, 1012, and 1016 pursuant to R&TC section 18031.

corresponding gain/loss sale adjustments, appellant provided no supporting source documents. Because appellant failed to provide evidence controverting FTB’s adjustment of basis of the assets sold in 2014, appellant has not met its burden to show that FTB erred in its determination. Accordingly, appellant has not established error in FTB’s adjustments to depreciation, deductions, and gain on the sale of assets for the 2014 taxable year.

HOLDINGS

1. Appellant has not established error in FTB’s adjustment to increase gross receipts to include security deposits.
2. Appellant has not established error in FTB’s depreciation and deduction adjustments and resulting increase in gain on sale of business assets for the 2014 taxable year.

DISPOSITION

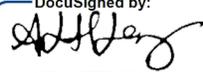
FTB’s action is sustained.

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Veronica I. Long
 Administrative Law Judge

We concur:

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Andrea L.H. Long
 Administrative Law Judge

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Asaf Kletter
 Administrative Law Judge

Date Issued: 4/14/2023