OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SINO SCRAP, INC.**	OTA Case No. 19105385

OPINION

Representing the Parties:

For Appellant: Jonathan T. Amitrano, Attorney
A. Lavar Taylor, Attorney

For Respondent: David Hunter, Attorney

For Office of Tax Appeals: Oliver Pfost, Attorney

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Sino Scrap, Inc. (appellant) appeals actions by respondent Franchise Tax Board (FTB) proposing additional tax of $548,404, a late-filing penalty of $137,101, and applicable interest, for the tax year ending June 30, 2008 (2007 tax year), and proposing additional tax of $931,246, and applicable interest, for the tax year ending June 30, 2009 (2008 tax year).

Appellant waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUES[1]

1. Whether appellant has established error in FTB's disallowance of its cost of goods sold (COGS) deductions for both tax years.
2. Whether appellant has established error in FTB's disallowance of its commission expense deductions for both tax years.

[1] While appellant initially lists the late-filing penalty imposed for the 2007 tax year as an issue in its opening brief, the opening brief does not provide any argument with respect to the late-filing penalty, and appellant does not address the late-filing penalty in its supplemental opening brief. Because appellant does not provide any argument or evidence with respect to the late-filing penalty, this Opinion will not address the penalty further.

3. Whether appellant has established error in FTB's disallowance of its bad debt expense deductions for both tax years.
4. Whether appellant has established error in FTB's disallowance of its rent expense deductions for both tax years.
5. Whether appellant has established error in FTB's disallowance of its management fee deductions for both tax years.

FACTUAL FINDINGS

General Background, FTB's Audit, and FTB's Protest Determination

1. Appellant was a privately owned California C corporation. Its primary business activity involved purchasing used catalytic converters, core auto parts, and other scrap metals for the recovery and sale of platinum group metals such as platinum, palladium, and rhodium. It also sold its own brand of aftermarket catalytic converters.
2. FTB audited appellant's California Corporation Franchise or Income Tax Returns (Form 100s) for the 2007 and 2008 tax years and issued a 2007 Notice of Proposed Assessment (NPA) and 2008 NPA that made numerous adjustments to appellant's claimed expense deductions. Appellant protested FTB's NPAs.
3. Following appellant's administrative protest, FTB issued a Notice of Action (NOA) affirming its 2007 NPA and an NOA revising its 2008 NPA.[2] The 2007 NOA increased appellant's taxable income by $6,211,265 and proposed additional tax of $548,404, and a late-filing penalty of $137,101, plus applicable interest. The 2008 NOA increased appellant's taxable income by $11,602,426 and proposed additional tax of $931,246, plus applicable interest.
4. Per FTB's protest determination letter dated April 11, 2019 (Determination Letter), the NOAs reflect the following reductions to appellant's expense deductions for the 2007 and 2008 tax years, respectively:
    - Partially disallowed claimed COGS deductions of $5,336,993 and $11,154,851;

[2] Copies of the NPAs are not in the appeal record; however, the 2007 NOA indicates that it is affirming the 2007 NPA and the 2008 NOA indicates that it is revising (i.e., reducing) the 2008 NPA.

- Disallowed claimed commission expense deductions of $478,693 and $98,829;
- Disallowed claimed bad debt expense deductions of $163,778 and $31,113;
- Partially disallowed claimed rent expense deductions of $72,000[3] and $115,559;
- Partially disallowed claimed management fee deductions of $159,801 and $120,000; and
- Disallowed claimed officer compensation of $82,074 for the 2008 tax year only.[4]

COGS Deductions

5. Appellant claimed COGS deductions totaling $72,651,434 and $44,712,925 on its 2007 and 2008 returns, respectively. Of these amounts, appellant indicated that $72,411,788 and $40,527,922 were related to purchases of catalytic converters and other auto parts and scrap metal.[5]

6. The Determination Letter indicated that appellant provided general ledger details (GLs) to FTB for its 2007 and 2008 purchases account identifying the date, payee, and amount of each claimed purchase.[6] The Determination Letter indicated that FTB selected eight sample transactions totaling $5,336,993 for the 2007 tax year, and 18 sample transactions totaling $11,550,851 for the 2008 tax year from the GLs for examination. The

[3] Per the Determination Letter, $72,000 of appellant's claimed rent expense for 2007 was disallowed by FTB at audit and is the amount included in the 2007 NPA and NOA. However, at protest, FTB determined that it should have disallowed the $204,000 in total rent claimed for Ivory Holding LLC. FTB noted that it could not increase its 2007 NPA at protest as the statute of limitations had expired, but noted that this amount would be used to offset any additional expenses appellant may substantiate in the future. Given FTB's determination at protest, this Opinion will treat $204,000 as the rent expense amount at issue in this appeal for the 2007 tax year.

[4] This claimed deduction was disallowed by FTB at audit. Appellant did not raise this issue at protest or on appeal, and it will not be discussed further in this Opinion.

[5] The remaining COGS deductions for 2007 and 2008 related to labor costs, and/or other costs such as commissions. Appellant's COGS deductions also accounted for appellant's beginning and ending inventory balances for each year.

[6] Copies of the GLs are not in the record, but the Determination Letter indicated that the GLs reported that there were approximately 13,500 total catalytic converter purchase transactions for the 2007 and 2008 tax years at issue on appeal.

Determination Letter noted that appellant's explanation of its purchasing process identified relevant documents related to this process, including: converter purchase receipts, request for advance forms, warehouse receiving records, vendor receipts, and buyer invoices. The Determination Letter indicated that appellant provided FTB with QuickBooks statements, affidavit statements from some of its buyers, and some warehouse receiving records,[7] but that the remaining documents (e.g., converter purchase receipts, request for advance forms, vendor receipts, buyer invoices, etc.) were not provided to FTB at audit or protest. The Determination Letter further noted that for most of the COGS transactions selected for examination, appellant "has not provided supporting bank statements that substantiate the disbursement of funds." As a result, FTB "determined [appellant] failed to substantiate all 26 transactions" selected for examination and disallowed the deductions for these transactions totaling $5,336,993 and $11,154,851 for 2007 and 2008, respectively.

Commission Expense Deductions

7. Appellant claimed COGS "other costs" of $838,326 and $908,584 on its 2007 and 2008 returns, respectively. During the audit, appellant indicated to FTB that, for the respective tax year, $478,693 and $98,829 of these amounts related to commissions appellant paid to buyers it employed or contracted with to acquire catalytic converters or scrap metal.
8. The Determination Letter indicated that appellant provided GLs and schedules to FTB identifying the payees and amounts of commissions paid for the 2007 and 2008 tax years.[8] The Determination Letter further noted that appellant provided no other details regarding the payees (e.g., the address, taxpayer identification number, or payee type: individual, corporation, etc.) and no documents (e.g., copies of checks, banks statements, federal Form 1099s, etc.) to FTB to substantiate the claimed commission payments.
9. Appellant concedes that the claimed commission expense for 2007 is overstated by $396,000, leaving $82,693 ($478,693 - $396,000) at issue for the 2007 tax year.

[7] While FTB noted that appellant provided affidavit statements and some warehouse receiving records during the audit and/or protest, these documents were not provided during appeal and are not in the appeal record. With respect to the affidavit statements, the Determination Letter indicated that the affidavits provided only general statements and did not include specific information such as the dates or amounts of advances made to the individual buyers for the 2007 and/or 2008 tax year.

[8] The GLs and schedules are not in the appeal record.

Bad Debt Expense Deductions

10. Appellant claimed bad debt expense deductions of $163,778 and $31,113 on its 2007 and 2008 returns, respectively.

11. The Determination Letter indicated that appellant provided schedules to FTB reconciling the bad debt expense deductions claimed for 2007 and 2008, including the period, debtors, amounts written-off, and totals.[9] The Determination Letter further indicated that appellant did not provide FTB with supporting documents to substantiate the debts, the collection efforts undertaken by appellant to collect the debt before writing it off, or the reason for each write-off. The Determination Letter also stated that no supporting documents (e.g., copies of checks, bank statements, etc.) were provided to substantiate the advances were actually made or disbursed to the listed debtors.

Rent Expense Deductions

12. Appellant claimed rent expense deductions of $319,090 and $250,406 on its 2007 and 2008 returns, respectively.

13. During the audit, appellant provided a "Commercial Lease" agreement (Lease Agreement) between it and Ivory Holdings LLC (Ivory) indicating that for use of a 10,000 square foot warehouse located in Harbor City, California, appellant was to pay monthly rent of $17,000 for a period of five years beginning on July 1, 2006. The Lease Agreement was signed by SV,[10] on behalf of both appellant and Ivory.

14. The Determination Letter indicated that appellant provided GLs for the rent expense deductions, identifying the dates, payees, amounts, and total rent expense deductions claimed for the 2007 and 2008 tax years.[11] For the 2008 tax year, the GL reported total rent expense of $236,847, which is $13,559 ($250,406 - $236,847) less than the amount claimed on appellant's 2008 return. The Determination Letter also noted that the GLs reflected rent payments totaling $204,000 and $102,000 made to Ivory during the 2007 and 2008 tax years, respectively, that FTB selected these payments for examination, and that no supporting documents (such as check copies or bank statements) were provided to

[9] These schedules are not in the appeal record.

[10] Because this individual is not a party to this appeal, only his initials will be used in this Opinion.

[11] The GLs are not in the appeal record.

substantiate the claimed payments to Ivory. Ivory was identified in the Determination Letter as a related party to appellant,[12] and at protest, FTB recommended disallowing the claimed Ivory rent expense deductions totaling $204,000 for 2007 and $102,000 for 2008, because appellant had failed to substantiate the claimed payments.[13] For 2008, FTB disallowed total claimed rent expense of $115,559 (the Ivory rent of $102,000 plus the $13,559 difference between the rent expense per the GL and per appellant's tax return).

Management Fee Deductions

15. Appellant claimed management fee deductions of $400,192 and $228,554 as part of its "other deductions" on its 2007 and 2008 returns, respectively.[14]

16. The Determination Letter indicated that appellant provided GLs for the management fee deductions, identifying the dates, payees, amounts, and total management fee expenses for the 2007 and 2008 tax years.[15] The Determination Letter also noted that the GLs reflected payments totaling $159,801 for 2007 and $120,000 for 2008 to Mount Olson, a Nevada Corporation, and FTB selected these payments for examination. The Determination Letter indicated that appellant provided check copies totaling $56,000 for 2007 and $72,000 for 2008, but that no documents (e.g., check copies or bank statements) were provided to substantiate the remaining claimed payments to Mount Olson.[16] Mount

[12] SV is identified in the Determination Letter as appellant's officer, President, and majority indirect owner, and as Ivory's officer, Manager, and owner (direct or indirect).

[13] At audit, FTB disallowed smaller amounts—$72,000 for 2007 ($6,000 x 12 months), and $49,537 for 2008 (($6,000 x 6 months) + $13,537)—based on its determination that fair market value rent for the Harbor City Warehouse was $11,000 per month rather than the $17,000 per month as reflected in the Lease Agreement. However, at protest, FTB determined that no deductions should be allowed with respect to the claimed Ivory rent because appellant had failed to substantiate that these amounts had been paid. For the 2007 tax year, the NOA did not increase the proposed additional tax assessed per the 2007 NPA as a result of the additional disallowed rent expense because, as noted above, the statute of limitations had expired. For the 2008 tax year, FTB increased rent expense disallowance to partially offset other expense deductions which FTB allowed at protest. FTB issued a 2008 NOA reducing the proposed additional tax assessed per the 2008 NPA.

[14] Per the schedules attached to appellant's returns, these expenses were labelled as "Legal & Professional" expenses.

[15] The GLs are not in the appeal record.

[16] The check copies are not in the appeal record.

Olson was identified in the Determination Letter as a related party to appellant,[17] and FTB disallowed the Mount Olson management fee deductions totaling $159,801 for 2007 and $120,000 for 2008 in their entirety, because appellant failed to substantiate part of the claimed payments, and because appellant failed to show that the substantiated payments to Mount Olson were ordinary and necessary business expenses.

Appellant's Appeal

17. Appellant timely appealed the NOAs issued by FTB for the 2007 and 2008 tax years.

DISCUSSION

Applicable Law – Gross Income, COGS, and Expense Deductions Generally

FTB's determinations are presumed correct, and appellant has the burden of proving error. (*Appeal of Jindal*, 2019-OTA-372P.) Gross income means all income from whatever source derived, including gross income derived from business. (Internal Revenue Code (IRC), § 61(a)(2).)[18] A manufacturing or merchandising business, such as appellant, calculates gross income by subtracting COGS from gross receipts, and adding any income from investments and from incidental or outside operations or sources. (Treas. Reg. § 1.61-3(a).) COGS includes the cost of items acquired for resale, and the costs of producing items for resale, with proper adjustment for opening and closing inventories. (Treas. Reg. § 1.162-1(a);[19] *Hultquist v. Commissioner*, T.C. Memo. 2011-17.) COGS is an adjustment to gross income. (Treas. Reg. § 1.162-1(a); *Hultquist v. Commissioner*, *supra*.) The taxpayer bears the burden of substantiating the amount claimed as COGS. (*Sawyer v. Commissioner*, T.C. Memo. 2015-55.)

IRC section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Deductions other than COGS, such as ordinary and necessary business expenses, are subtracted from gross income in arriving at taxable income. (*Sawyer v. Commissioner*, *supra*.) Whether an expense is an ordinary and necessary business expense within the meaning of IRC section 162 is generally a

[17] The Determination Letter indicated SV, appellant's majority indirect owner, was Mount Olson's officer, acting President, Secretary, and Treasurer, and owner (direct or indirect).

[18] California generally conforms to IRC section 61 pursuant to R&TC section 24271(a).

[19] California generally conforms to IRC section 162, relating to ordinary and necessary business expenses, pursuant to R&TC section 24343(a).

question of fact. (*Elick v. Commissioner*, T.C. Memo. 2013-139.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that it is entitled to the deduction claimed. (*Appeal of Vardell*, 2020-OTA-190P, citing *New Colonial Ice Co., Inc. v. Helvering* (1934) 292 U.S. 435, 440.) To meet that burden, the taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Jindal*, *supra*.) The applicable burden of proof requires proof by the preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b);[20] *Appeal of Rios*, 2021-OTA-341P.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Vardell*, *supra*.) A taxpayer's failure to produce evidence within its control gives rise to a presumption the evidence is unfavorable to its case. (*Ibid*.)

Appellant's General Assertions Regarding Its Disallowed Expense Deductions

Prior to discussing each specific disallowed deduction, appellant provides the following general assertions applicable to all of its disallowed expense deductions. Appellant asserts that its primary customer, Toyota Tsusho American, Inc. (TTA), through its subsidiary ELV Components Recycling, Inc. (ELV), acquired substantially all of appellant's assets pursuant to a May 2011 Asset Purchase Agreement (Purchase Agreement), which occurred several years after the tax years at issue in this appeal.[21] Appellant states that the Purchase Agreement was entered into after three years of negotiations, and that during this process, TTA/ELV thoroughly reviewed appellant's books and records as part of its due diligence. Appellant contends that TTA/ELV's acquisition of appellant "demonstrates that it found no issues with respect to [appellant's] financials" and that this "suggests that [appellant's] books and records had been properly maintained in accordance with industry standards." Appellant further contends that if FTB is correct regarding the disallowed expense deductions, TTA/ELV, "a very sophisticated company, would have discovered those items" during its due diligence prior to the acquisition. Appellant further asserts that as part of the sale, TTA/ELV acquired some of appellant's original

[20] Effective June 30, 2023, California Code of Regulations, title 18, (Regulation) section 30219, relating to the application of the burden of proof, was renumbered. Prior to June 30, 2023, the standard of proof currently found in Regulation section 30219(b) was contained in Regulation section 30219(c).

[21] This Purchase Agreement or other evidence related to appellant's asset sale to TTA/ELV is not in the appeal record.

source documents, including many "pertinent to the dispute at hand" that "would help substantiate the disputed items" in this appeal. Appellant contends it requested that FTB subpoena the documents from TTA/ELV, but that FTB did not comply with its request. For these reasons, appellant argues it no longer has possession or control of these original source documents, and therefore cannot produce them.

Finally, appellant provides arguments regarding the general economic conditions during the 2007 and 2008 tax years at issue in this appeal and asserts that FTB's findings are inconsistent with these economic conditions as well as TTA/ELV's subsequent acquisition of appellant's assets in May 2011. Appellant asserts that the net profit percentages resulting from FTB's disallowance of appellant's expense deductions is unrealistic in general and even more unrealistic given the Great Recession which started in 2007.[22] Appellant discusses the drop in platinum group metal sales prices during the Great Recession and contends that as a result of this price drop, the scrap metal business industry standard was to sit on inventory and wait for the best time to sell. Appellant also contends that the $3 million purchase price (after reduction for appellant's $3.9 million outstanding line of credit to TTA/ELV) paid by TTA/ELV in its acquisition of appellant's assets is representative of the fair market value of appellant. Appellant asserts that this price is inconsistent with FTB's determinations for the 2007 and 2008 tax years, and that appellant would have required, and TTA/ELV would have paid, a much higher price if appellant had the net income/profit asserted by FTB for these tax years preceding the sale.

With respect to appellant's arguments regarding TTA/ELV's due diligence in connection with the May 2011 asset purchase, OTA notes that the Purchase Agreement and other evidence related to the asset purchase transaction is not in the appeal record. As such, OTA declines to speculate as to the level of due diligence that may have been performed by TTA/ELV in connection with its purchase of appellant's assets in May 2011 and whether TTA/ELV identified any errors or issues with appellant's books and records or financial reporting. While OTA recognizes that TTA/ELV likely performed some level of due diligence in connection with its purchase, appellant has not substantiated that TTA/ELV specifically examined or evaluated appellant's 2007 and 2008 tax years, whether the books and records examined by TTA/ELV matched appellant's tax reporting for these years, or whether TTA/ELV specifically examined

[22] The Great Recession began in December 2007 and ended in June 2009. (See https://www.federalreservehistory.org/essays/great-recession-of-200709.)

the expense deductions or transactions at issue in this appeal. Even if TTA/ELV did in fact examine these tax years and some (or all of) the specific expense deductions or transactions at issue in this appeal, appellant has not substantiated the level, scope, or detail of such examination. Additionally, while appellant contends that TTA/ELV did not find any issues, appellant has not provided any evidence to substantiate this contention. It is possible that TTA/ELV identified issues that were reflected in the sales price and/or the Purchase Agreement, which is not in the record. Additionally, OTA notes that TTA subsequently sued appellant and certain appellant's employees and owners in July 2013, alleging a fraudulent scheme. Thus, contrary to appellant's assertions, this suggests that TTA/ELV may have identified issues with appellant's books and records subsequent to the May 2011 asset purchase transaction.

Additionally, while appellant takes issue with FTB's decision not to subpoena TTA/ELV for documents, OTA is unaware of, and appellant has not provided, any legal authority which requires FTB to comply with appellant's request to subpoena TTA or ELV. The language of R&TC section 19504 empowers FTB to issue subpoenas at its discretion; it does not require FTB to issue subpoenas when requested to do so by a taxpayer.[23] FTB was, therefore, not required to comply with appellant's request to subpoena TTA/ELV for source documents purportedly substantiating appellant's expense deductions. Appellant has the burden to substantiate by credible and competent evidence the expense deductions it claimed on its tax returns. (*Appeal of Jindal*, *supra*; *Appeal of Vardell*, *supra*.) The fact that it may be difficult, if not impossible, for the taxpayer to substantiate its claimed deductions does not relieve the taxpayer of this burden. (*Appeal of Johnson*, 2022-OTA-166P.) FTB declined appellant's request that FTB subpoena TTA/ELV, and this decision does not relieve appellant of its burden to submit evidence sufficient to establish the deductions it claimed on its returns.

Finally, while OTA understands appellant's assertions regarding the general economic conditions during the 2007 and 2008 tax years at issue in this appeal, these general assertions are insufficient to meet appellant's burden of proof. As noted above, appellant must submit evidence sufficient to establish, by a preponderance of the evidence, the items it reports on a return, including its COGS and other expense deductions. (*Appeal of Rios*, *supra*; Cal. Code

[23] R&TC section 19504(a) provides that FTB *may* require by demand that an entity of any kind provide information or make available for examination or copying any book, paper, or other data relevant to FTB's duties under the R&TC, including ascertaining the correctness of any return. R&TC section 19504(c) provides that FTB *may* issue subpoenas or subpoenas duces tecum which may be served on any person for any purpose.

Regs., tit. 18, § 30219(b).) Appellant's unsupported and general assertions are not evidence and are not sufficient to establish that appellant is entitled to the deductions claimed in its returns and disallowed by FTB. (*Appeal of Vardell*, *supra*.)

Issue 1: Whether appellant has established error in FTB's disallowance of its COGS deductions for both tax years.

Appellant notes that it provided GLs to FTB for its purchase transactions. From these GLs, FTB selected 26 COGS catalytic converter purchase transactions for examination, eight transactions from the 2007 tax year, and 18 transactions from the 2008 tax year. Appellant explains that for purchases, it generally records advances it pays to its buyers in an asset account on its balance sheet, and upon delivery, the amount is reduced and charged to the purchases account. Appellant contends that its "purchases of these converters [were] always done with cash," and that as a result, "there is no record of who any one converter was purchased from," and that the cash nature of its business "prevents cleaner substantiation than what [] FTB would have likely preferred." Finally, appellant contends that "FTB [does] not dispute whether the payments were actually made to the buyers for the acquisition of the converters."

First, while appellant contends that FTB does not dispute that the payments were made to the buyers for the purchase of catalytic converters, this assertion is contradicted by the limited evidence in the record. In the Determination Letter, FTB expressly noted appellant's assertion at protest was that "there is no issue as to the amount of funds advanced to the employee or contract buyers – the auditor confirmed these amounts – the only issue . . . is whether the taxpayer used these funds to purchase [c]onvertors." In response, the Determination Letter stated that "[appellant's] assertion is inaccurate. For the majority of advances, [appellant] has not provided supporting bank statements that substantiate the disbursement of funds. As such, most of the advances are unsubstantiated."

While appellant may have provided some documentation to FTB during the audit and/or protest (e.g., GLs, QuickBooks records, warehouse receiving records for some purchases, and some buyer affidavit statements), appellant has failed to provide any of this documentation or

evidence to OTA in this appeal.[24] As a result, OTA is unable to verify if appellant did in fact substantiate the disbursement of funds for some or all of the purchase transactions selected for examination by FTB.[25] Because appellant provides no documentary evidence in this appeal to substantiate the disallowed COGS purchase transactions, appellant has failed to meet its burden of showing by the preponderance of the evidence that it is entitled to deductions for the claimed purchases. (*Sawyer v. Commissioner*, *supra*; *Appeal of Rios*, *supra*.) To the extent appellant asserts that it cannot provide adequate substantiation due to the cash nature of its business, OTA notes that a taxpayer who consciously chooses to transact in cash and does not keep adequate records of those cash transactions does so at its own peril. (*Olive v. Commissioner* (2012) 139 T.C. 19, 33-34.) Even if appellant paid its buyers cash for the catalytic converter purchases, appellant failed to maintain and provide receipts for its advances or payments of cash to its buyers. Appellant's unsupported assertions are insufficient to meet its burden of proof. (*Appeal of Vardell*, *supra*.) Because appellant failed to provide any evidence to substantiate the disallowed COGS purchase transactions, appellant failed to establish error in FTB's adjustments to its COGS deductions for 2007 and 2008.[26]

Issue 2: Whether appellant has established error in FTB's disallowance of its commission expense deductions for both tax years.

Appellant claimed COGS (other costs) of $838,326 and $904,548 for the 2007 and 2008 tax years, respectively. Of these amounts, $478,693 and $98,829 were reportedly related to commission payments for 2007 and 2008, respectively. Appellant concedes that the commission

[24] Appellant also contends that it provided FTB with the following documents to substantiate the purchases selected for examination by FTB: request for advance forms, vendor receipts, warehouse receiving records, converter purchase receipts, and buyer invoices. However, the Determination Letter stated that appellant identified these documents as being relevant to its purchasing process but only provided warehouse receiving records for some of the purchases and failed to provide any of the remaining documentation. OTA notes that none of these records have been provided by the parties on appeal and appellant has not provided any documentation, records, or evidence to OTA to substantiate its COGS purchase transactions.

[25] Even if appellant did substantiate some of the claimed payments for purchases, appellant failed to substantiate the receipt of inventory for that payment, and failed to provide other evidence substantiating the purpose of the payment where no inventory is received. As such, appellant has failed to substantiate that the payment (if made) was properly included in its COGS or was otherwise deductible as an ordinary and necessary business expense.

[26] Appellant incorporates its general arguments (discussed above) into its COGS argument; however, as set forth above, these general arguments are insufficient to establish appellant's entitlement to the disallowed expense deductions, including the disallowed deductions for COGS purchases.

expense deduction for 2007 was overstated by $396,000, leaving $82,693 ($478,693 - $396,000) at issue for the 2007 tax year.

Appellant contends that the commission expenses relate to fees appellant paid to its independent network of buyers to acquire scrap metal. Appellant further contends it provided FTB its GLs and schedules identifying the payees and commissions paid, and information returns for several buyers.[27] For these reasons, appellant argues it has substantiated the commission expenses based on the information already provided to FTB. Appellant further asserts that FTB's position in disallowing these commission expenses is "not rooted in the fact that they were not incurred" and instead was "rooted solely in the failure to issue Form 1099's [*sic*] to the buyers as set forth in [R&TC] section 24447."[28] (Underline omitted.) Appellant asserts that because these commission expenses are part of appellant's COGS, appellant's failure to comply with R&TC section 24447 is not a proper ground for disallowing these expenses. Appellant notes that R&TC section 24447 permits, but does not require, FTB to disallow a deduction where the taxpayer fails to file Form 1099s, and further contends that COGS must be taken into account in computing gross income even if the COGS involve a payment that is illegal under federal or state law. As support, appellant cites the Sixteenth Amendment to the U.S. Constitution, and cases such as *Pittsburgh Milk Co. v. Commissioner* (1954) 26 T.C. 707, *Sullenger v. Commissioner* (1948) 11 T.C. 1076, and *Max Sobel Wholesale Liquors v. Commissioner* (1977) 69 T.C. 477, affd. (9th Cir. 1980) 630 F.2d 670.

While appellant contends that FTB's position in disallowing the commissions expenses is not rooted in the fact that they were not incurred and instead is rooted solely on appellant's failure to issue Form 1099s to its buyers as set forth in R&TC section 24447, this is contradicted by the limited evidence in the record. FTB contends that appellant both failed to "report payment for personal services received on Form 1099[,]" and "could not provide any supporting source documents to substantiate the commissions being paid." The Determination Letter noted,

[27] The Determination Letter noted that while appellant provided Form 1099-MISCs for some buyers, the forms were incomplete because they were missing the buyers' taxpayer identification number, they were not signed or dated by appellant, and there was no evidence that the Form 1099s were filed with the IRS. Additionally, the Determination Letter also noted that FTB was unable to reconcile the amounts on the Form 1099s to the amounts appellant reported for the same buyers on its schedule.

[28] R&TC section 24447 provides that FTB may disallow a deduction for amounts paid as remuneration for personal services if the payor fails to report the payments as required under Unemployment Insurance Code section 13050 or R&TC section 18631.

"To substantiate the commission expense, [appellant] provided a schedule listing the recipients' [*sic*], and the amount paid during [2007] and [2008]. Other than this, [appellant] only presents general statements, and provides no specific information, detail, or underlying evidence to support the alleged commission expense as a valid business expense." While the Determination Letter also noted that appellant failed to issue Form 1099s to the individual buyers and cites to R&TC section 24447 as an additional reason to disallow the claimed deductions, FTB's disallowance was not solely due to appellant's failure to issue Form 1099s. Rather, FTB disallowed the claimed COGS commission expense deductions both because appellant failed to substantiate the claimed expenses as ordinary and necessary business expenses paid or incurred during the taxable years, and because appellant failed to issue Form 1099s to the individual buyers.

While appellant provided GLs, schedules, and certain incomplete Form 1099s to FTB during the audit and/or protest, these documents have not been provided to OTA in this appeal. Appellant has provided no documents or evidence to OTA to support the claimed COGS commission expense deductions. Thus, OTA is unable to determine if appellant properly substantiated the claimed deductions (in full or in part) during the FTB audit or protest, and appellant has not met its burden of proof to establish by credible and competent evidence its entitlement to the claimed deductions. (*Appeal of Jindal*, *supra*; *Appeal of Vardell*, *supra*.) Because OTA concludes that appellant has not substantiated the claimed commission expense deductions, OTA need not address appellant's assertions regarding R&TC section 24447 and whether R&TC section 24447 can be applied to disallow COGS deductions as opposed to other non-COGS expense deductions.[29]

Issue 3: Whether appellant has established error in FTB's disallowance of its bad debt expense deductions for both tax years.

IRC section 166 permits a bad debt expense deduction for debts which become worthless within the taxable year.[30] For business bad debts, a deduction against ordinary income is

[29] Additionally, to the extent that appellant argues that R&TC section 24447 is unconstitutional when applied to COGS (as opposed to other expense deductions), OTA notes that under Article III, section 3.5 of the California Constitution, OTA lacks jurisdiction to determine whether a California statute is invalid or unenforceable under the California Constitution, unless a federal or California appellate court has already made such a determination. (See Cal. Code Regs. tit. 18, § 30104(a).)

[30] California conforms to IRC section 166 per R&TC section 24347(b).

permitted in the year in which the obligation becomes partially or totally worthless. (IRC, § 166(a).) In order to be deductible, 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 sum of money." (Treas. Reg. § 1.166-1(c); see also *Adelson v. U.S.* (Fed. Cir. 1984) 737 F.2d 1569, 1571.) A corporation 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.)

Appellant claimed bad debt expense deductions of $163,778 and $31,113 on its 2007 and 2008 returns, respectively. Appellant notes that it provided FTB with GLs and schedules for the bad debt expense deductions and that the deductions claimed on the tax return "materially agree" to the GLs/schedules it provided to FTB. Appellant also notes that it provided FTB with affidavit statements from some of the buyers to corroborate the process for advancing money. As a result, appellant contends, "It appears that there is no dispute as to whether these amounts were incurred" and the only issue is whether they were properly deducted as bad debt expenses. Appellant describes how its bad debts arise as follows:

> [Appellant] would advance money to its buyers for the purpose of purchasing scrap auto products, including the catalytic converters. When the goods were delivered to [appellant], they reduce the advance account and charge the purchases account. There was no traditional inventory system, but [appellant] did take monthly inventory to adjust its overall purchases. The bad debt expenses were determined by reconciling the advances to buyers and accounting for the difference between the taxpayer and their buyers' accounts. If the problem leading to any differences could not be located, [appellant] would deduct the amount as a bad debt. It is important to highlight that in this industry, advances are commonly deemed uncollectible because buyers will simply "take the advance and run," leaving a company like [appellant] unable to locate the buyer or recover its funds. It is simply the nature of the business.

While appellant again contends that it substantiated that the claimed expenses were "incurred," and the only issue is whether the expenses are properly deducted as bad debt expenses, this contention is again contradicted by the limited evidence in the record. FTB notes that while appellant provided it with QuickBook statements identifying the payee, payment method, date, and amounts, these statements "were not provided for all of the reported debts" and "no supporting documentation has been provided to substantiate [that] the advances were actually disbursed" to the claimed debtors. FTB notes that appellant failed to provide it with

proof of payment such as copies of checks, bank statements, invoices, or receipts. FTB also contends that appellant failed to provide it with supporting documents to substantiate the collection efforts undertaken by appellant to collect the debt before writing it off or the reason for each write-off. Finally, FTB asserts that the buyer affidavits provided by appellant only include general statements and did not include specific information such as the dates or amounts of advances appellant made to individual buyers for the 2007 and/or 2008 tax year.

Appellant has not provided the GLs, schedules, QuickBooks statements, or buyer affidavits to OTA, or any other evidence proving the advances occurred and were bona fide debts within the meaning of IRC section 166 and Treasury Regulation section 1.166-1(c). Absent evidence that the advances were in fact made to the claimed buyers, were bona fide debts, and that these bona fide debts became worthless during the 2007 and/or 2008 tax years, appellant has failed to establish that it qualifies for the claimed business bad debt expense deductions. Appellant also asserts that even if these amounts were not properly deducted as bad debt expenses, they would still be deductible as COGS for the amount advanced to the buyers. However, appellant did not provide any evidence to OTA to establish that the claimed amounts were in fact paid or advanced to buyers. As such, appellant has failed to meet its burden of proof to establish that it is entitled to deductions (under either IRC section 162 or 166) for the amounts claimed as bad debt expense deductions.

Issue 4: Whether appellant has established error in FTB's disallowance of its rent expense deductions for both tax years.

Rent expenses are business expenses within the meaning of IRC section 162(a). (Treas. Reg. § 1.162-1(a).) Appellant claimed total rent expenses of $319,090 for 2007 and $250,406 for 2008, of which $204,000 and $115,559, respectively, were disallowed by FTB.

Appellant contends that FTB disallowed the claimed Ivory rent of $204,000 for 2007 and $102,000[31] for 2008 because "FTB determined that the related party transaction with Ivory for rent was not at arm's length and that rental rates for commercial property in the same zip code . . . [was] $1.10 per square foot," rather than the $1.70 per square foot rate Ivory charged appellant. Appellant contends that FTB's determination was based on the fair rental value on

[31] For the 2008 tax year, FTB also disallowed rent of $13,559, which was the difference between the amount claimed on appellant's 2008 return and the total rent expense deductions reported per appellant's GL for 2008. Appellant notes this "small discrepancy" and does not provide any argument with respect to this amount. As such, it will not be discussed further in this Opinion.

October 13, 2010, towards the end of the Great Recession and not during the tax years at issue. Appellant argues that even if the average rental rate was less than what the building was rented for, it does not follow that the entire amount should be disallowed.

However, appellant's argument here ignores FTB's protest determination that appellant failed to substantiate the claimed rental payments of $204,000 and $102,000 to Ivory during the 2007 and 2008 tax years, respectively. FTB contends that "[a]ppellant failed to provide documentation for the alleged rental payments of $204,000 for [2007] and $102,000 for [2008]." Thus, the Ivory rental payments were not disallowed solely due to the difference between the market rental rate and the rate charged in the rental agreement between Ivory and appellant; rather, these transactions were also disallowed due to appellant's failure to substantiate that the claimed amounts were actually paid to Ivory.

Appellant has not provided any evidence to OTA substantiating the rent expenses it purportedly paid to Ivory. Appellant did not provide OTA with the GLs or schedules it provided to FTB during audit and/or protest, or any other documentation, such as bank statements or cancelled checks, substantiating that appellant actually remitted rent payments to Ivory during the tax years at issue. For these reasons, appellant has failed to establish error in FTB's disallowance of its rent expense deductions for the 2007 and 2008 tax years.[32]

Issue 5: Whether appellant has established error in FTB's disallowance of its management fee deductions for both tax years.

Management expenses are business expenses within the meaning of IRC section 162(a). (Treas. Reg. § 1.162-1(a).) A corporation may deduct management fees as a business expense so long as the services are "actually rendered" and the amount paid is "reasonable." (*Elick v. Commissioner*, *supra*.)

Appellant claimed management fee expense deductions of $400,192 for 2007 and $228,554 for 2008, of which FTB disallowed $159,801 and $120,000 claimed, respectively, in connection with Mount Olson, a related party. Appellant notes that "[i]nvoices were the primary source of substantiation for these expenses" and that appellant provided "14 invoices issued by Mount Olson from November 1, 2007, through December 1, 2008." Appellant acknowledges

[32] Because appellant has not substantiated the actual rent paid to Ivory, and the expense deductions are properly disallowed on this basis, OTA does not address appellant's contentions regarding the fair rental value of the property during the 2007 and 2008 tax year.

that "the documents provided did not support the full amounts claimed[,]" but contends that appellant put the information together to the best of its ability based on the circumstances noted above in its general contentions. Appellant asserts that "FTB's contention relies more on IRC section 162 than the actual substantiation," that the management fees are ordinary and necessary business expenses, and that the documentation appellant provided to FTB "circumstantially shows that these amounts were indeed incurred."

Of the $159,801 and $120,000 total amounts claimed in connection with Mount Olson for 2007 and 2008, respectively, FTB acknowledges that appellant substantiated payments totaling $56,000 and $72,000. FTB contends that the full amount was being disallowed (despite appellant's substantiation of payments to Mount Olson totaling $56,000 and $72,000) because appellant failed to substantiate that the claimed amounts/payments were ordinary and necessary business expenses. FTB asserts that it requested, but that appellant failed to provide, an explanation detailing the management fee transaction (including the business purpose, services performed, rates, parties involved, terms, etc.) and the supporting agreement(s) or contract(s).

While appellant contends it has "circumstantially" shown that the full amount of the claimed management fee expenses was indeed incurred through the invoices and the check copies provided to FTB, appellant has not provided this documentation or evidence to OTA. As such, appellant has not provided evidence showing the remaining Mount Olson management fees of $103,801 ($159,801 - $56,000) and $48,000 ($120,000 - $72,000) were actually paid to Mount Olson. Appellant also failed to provide any evidence showing Mount Olson provided services to appellant during the 2007 and/or 2008 tax years, or that the amounts appellant paid to Mount Olson for such services (if performed) were reasonable. (*Elick v. Commissioner*, *supra*.) To the extent appellant is asserting that it is unable to provide the relevant documentation to substantiate these management fee deductions because TTA/ELV retained these documents in connection with TTA/ELV's acquisition of appellant, OTA notes that appellant still has the duty to substantiate the deductions it claims on its returns. (*Appeal of Jindal*, *supra*; *Appeal of Vardell*, *supra*.) The fact that it may be difficult, if not impossible, for appellant to substantiate its claimed deductions does not relieve appellant of its burden. (*Appeal of Johnson*, *supra*.) For these reasons, OTA finds that appellant has not established it qualifies for the management fee deductions it claimed on its 2007 and 2008 returns.

HOLDINGS

1. Appellant has not established error in FTB's disallowance of its COGS deductions for both tax years.
2. Appellant has not established error in FTB's disallowance of its commission expense deductions for both tax years.
3. Appellant has not established error in FTB's disallowance of its bad debt expense deductions for both tax years.
4. Appellant has not established error in FTB's disallowance of its rent expense deductions for both tax years.
5. Appellant has not established error in FTB's disallowance of its management fee deductions for both tax years.

DISPOSITION

FTB's actions are sustained in full.

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

We concur:

DocuSigned by:
Sheriene Anne Ridenour
67F043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
A11783ADD49442B...
Huy "Mike" Le
Administrative Law Judge

Date Issued: 9/20/2023